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Assessment of Lehman Brother's Failure

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Abstract: **The financial crisis of 2007 – 2008 imperiled the global financial institutions to nearly collapse state because of liquidity constraints for severe constriction of US housing market. The unexpected home price reduction nearly 40% created real estate market destabilization eventually financial market crush that plummeted unimaginable loss to many world financial institutions. For instance, Japanese banks, Royal Bank of Scotland and Germany state-owned bank lost a combination of approximately $5.9 billion in this crisis (Kwaku & Mawutor, 2014). Thus, this study intended to assess the significant factors that contributed the failure of the Lehman Brothers investments bank from both financial and non-financial (operations and regulatory environments) aspects and the possible preventative measures that could have being taken to rescue Lehman.**

The study revealed the main causes of the Lehman's failure to be imbalances between executive and company's interest, invisible accounting manipulation and malpractice, uncalculated risk taking and excessive borrowing culture, lack of professional external audit, deregulation of the financial market and unsuccessful bail-out and takeover attempts. Finally, the preventative measure that could have been used to rescue the collapse of Lehman were use of more proactive risk mitigation strategy, controlling leverage, liquidity, solvency and efficiency ratios. Placement of competent rating agencies that could have accountable for their rating system since the public trusted their rating system.

Keywords: **financial crisis, real estate market, financial regulations, liquidity, solvency and efficiency ratios.**

1. INTRODUCTION

Lehman Brothers was founded in 1844 by three brothers Henry, Mayer and Emanuel Lehman Alabama USA for small shop for grocery. Later, company commenced cotton trading and expended its scope of business into commodities trading and brokerage services. In 1975 Lehman Brothers merged with Kuhn, Loeb and company and established Lehman Brothers, Kuhn, Loeb which labelled them to become 4the largest bank in United States of America. In 1990s Lehman acquired Neuberger Bremen, Lincolm capital with the adoption of business diversification policies to generate greater revenues and contribute national economic growth by employing up 28,000 employees (Kwaku & Mawutor, 2014). However, its lifeline ended by financial crisis in 2007- 2008 for multifaceted factors.

In the global aspect, the financial crisis of 2007 – 2008 imperiled the global financial institutions to nearly collapse state because of liquidity constraints for severe constriction of US housing market. Ma'm Madiha Latif, (2018) adventitious home price reduction nearly 40% in the real estate market was the prime factor caused the financial crush that plummeted

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unimaginable loss to the largest financial institutions in US and world at large. This endangered to paralyze the entire world's financial system particularly commercial and investment banks, insurance, saving and potential lenders. As consequence of this, Japanese banks, Royal Bank of Scotland and Germany state-owned bank lost a combination of approximately $5.9 billion (Kwaku & Mawutor, 2014). One of the largest banks this financial tsunami engulfed was Lehman brother's investment bank which was US's 4th largest bank.

The global financial crisis (2007- 2008) caused many companies not to meet their short-term obligations due to the liquidation tragedy that resulted many enterprises to file bankruptcy, some government bailed out while others experienced severely financial constraints that affected their normal operations, the most affected sectors were banks, real-estate and insurance companies. US government unprecedently intervened the financial market in response means to handle the financial crises that engulfed the whole economic activities of the world to prevent to worsen the situation which could have ended up the total collapse of the financial system and other related sectors.

Under the US rescue program federal reserve allocated 700 billion bailout plan to support the most affected companies and employed new fiscal policies that seemed to help market normalization such as reducing interest rates and increased government expenditures as well as bailout programs (Schwarcz, 2018). Unfortunately, despite all those efforts and extraordinary supports given to the financial institutions certain companies ended up bankruptcy including Lehman Brothers (employed over 20,000 staff and had approximately $640 billion worth assets before it announced its bankruptcy) where American taxpayers lost around $9.8 trillion in wealth.

2. LEHMAN'S DESTRUCTIVE BUSINESS STRATEGY

Lehman Brother's investment bank deployed extremely aggressive business strategy for investing real estate sector with the aim of diversifying its capital structure. Unfortunately, the adopted strategy led negative growth and increased leverage on its capital level in the industry because the available cash was tied up in the real estate which later started to loss its value.

Wiggins, (2014) Lehman Brothers had $26 billion of net assets before its bankruptcy declaration just for liquidation crisis meaning that it had $639 billion worth assets and $613 billion in receivables which made it the largest bankruptcy event in the history of United states, this concluded the existence of 164-year-old company's operations.

This study is intended to assess the attributes for Lehman Brother's failure from both financial and non-financial (operations and regulatory environments) aspects to get wider understanding of the situation while using the available literatures reviews about the financial crisis and the disclosed information about the Lehman Brothers bankruptcy testimony before US House Oversight and Government Reform Committee (6 October 2008).

3. CAUSE OF THE FAILURE

It is generally agreed that there is no one single factor that was responsible the collapse of Lehman however the main contribute factor for the failure is likely to be unexpected price drop of real estate markets and the securitized subprime mortgages.

Imbalance between executive interest and company's interest for instance Richard Severin Fuld Jr. who was the final CEO of Lehman Brothers testified before US House Oversight and Government Reform Committee in bankruptcy inquiry session that he was the responsible for all the decisions that the company made during his tenure and argued these decisions and actions were wise, suitable and best available choice for the company in those circumstance. However, in reference to his actions in the payment of salaries, bonuses as shown in the figure 1, it is clear that he had rewarded himself approximately half a billion dollars, from 2000 – 2007 as salary, compensations, cash bonus and stock sales while the company was in financial needs, and economy was experiencing in state of crisis so instead of keeping the company's cash and reducing the unnecessary expenses to avoid any liquidity problems that might occur, the CEO took such amount of money from the company now applying bankrupt resulting billion of losses to the public. It shows that the company's interest was not aligned to the executive's interest such that they used the company to work for themselves.

TABLE 1: Lehman Brothers Bankruptcy Testimony before US House Oversight and Government Reform Committee (6 October 2008)

Year	Salary & other compensations	Cash bonus	Option Exercise	Stock Sales	Total
2000	$763,710	$8.8 mil	$43.0 mil.	------------	$52.5 mil
2001	$762,710	$4.0 mil	$93,6 mil	------------	$98.4 mil
2002	$763,008	$1.1 mil	$21.1 mil	------------	$22.9 mil
2003	$764,439	$6.7 mil	$37.5 mil	------------	$45.0 mil
2004	$766,028	$10.3 mil	$13.9 mil	------------	$24.9 mil
2005	$767,791	$13.8 mil	$75.0 mil	------------	$89.5 mil
2006	$939,585	$6.3 mil	$31.9 mil	$31.9 mil	$106.2 mil
2007	$903,169	$4.3 mil	$40.3 mil	-----------	$ 45.5 mil
					$484.9

Zingales, (2008) studied the case of Lehman and found that the executives approved $16 billion between 2004 and 2007 in bonuses and the CEO alone received over $40 million in cash under bonus scheme, above all during these years his total compensation surpassed over $260 million. This show the level of unethical behavior of the managers who were considering their interest alone and not the shareholder's interest as well as the public. Financial experts blame the appointment approach and independence of compensation committee were the CEO had major role in the appointment stage, this opportunity facilitated him to direct and manipulate the compensation committee decisions instead of the committee take their responsibility in guiding and control the executive to balance their interest and shareholder's interest such that the company works for both groups.

Many financial analysists believe that Lehman's executive members increased their bonuses expressively prior to the bankruptcy to $480 million knowing that there will be tough period a head such that they did not spent enough time to looking for solution to the challenges of the company, meaning that they just considered their personal interest rather than the company (Kwaku & Mawutor, 2014)**.** In addition to that Lehman's CEO bought $14 million Ocean front home in Florida USA, summer vacation home and art collection costing 1 million dollars, the chief operating officer Mr. Jeo Gregory used private helicopter for travelling while they were aware that the company did not paid billions of dollars for dividend and high level of leverage position of 30:1. These actions show gross misuse of company's resources. Furthermore, looking thoroughly the actions of the Lehman CEO, it look like they were not aligned to the company's interest however much he was the single largest shareholder in the company owned 10 million shares because days before the bankruptcy he fired involuntarily Andy Morton the Head of Global fixed income and Benoit Slava the chief operating office for Europe and Middle East who were part of the decision marking body which led poor performance in return the CEO provided approximately 20 million compensation as the company was in financial trouble.

Azadinamin, (2012) Lehman Management used Repo 105 by mispresenting intentionally their financial position to mislead the public and pretend their financial statement healthier than actual. Repo 105 is a legal system that banks engage to solve the short-term cash problems. It is a repurchase agreement where companies use to solve their short-term cash needs in exchange of high liquid security collaterals such that if repayment become defaulted the bank or investor uses the collateral to cover the loan for reimbursing the money back. Jeffers, (2011) emphasized that Lehman's executive intentionally misused repo 105 to cover up the true face of their balance sheet and leverage position from the public particularly relevant partners such as rating institutions, market regulators, suppliers and financial experts, this loophole provided them an opportunity to remove nearly $ 50 billion for bad assets in 2008. The main strategy for using repo 105 was portray the Lehman's financial affairs to look strong, sound and safe to the public.

Lehman exploited speculative market opportunities deliberately for their sole interest and reduced its vulnerability of credit risks in the market, they joined derivate market to transfer their risks which they expected to affect their asset and exposure. For instance Lehman presented in their books account an estimated notional derivates of nearly $35 trillion in their affiliates (Summe, 2011). This act is grossly violation of financial management practice and very unethical to persuade any institution to securitize or take uncollectable debts in any means.

Top management of Lehman had accustomed in ridiculous culture of borrowing to finance their operations which consequently increased the company's leverage position in very high level. It is common for companies to use leverage as source of investment income for achieving the pre-determined earnings however, there are risk associated increment of leverage such as failure to make repayments of principal amount and interest to avoid repossession. Kwaku & Mawutor, (2014) state that the Lehman's position become unacceptable level that adversely affected the image of the Lehman, trust level and finally leading its bankruptcy because for every $1 of cash and cash equivalent, Lehman would lend $44 that was too high a leverage ratio to maintain in any business.

The primary factor for Lehman failure is due to inability to meet short term obligations as they due and trust fall in doubt. Trust is very crucial and paramount among business community particularly investors, lenders and customers, Lehman brother's impotence to meet their short-term debts caused loss of trust, negative public perception of the bank increased due to recurring liquidity issues. Summe, (2011) argued that a week before the application of bankruptcy Lehman Brothers liquidity level was providing alarm sign as very low despite the announcement of liquidity pool of $41 billion. It was financial regulators and financial analysts to understand the situation and provide respective views to the investors and Wall Street however, Lehman's struggled to solve the liquidity issues by reducing their gross asset base $147 billion to strength their position $45 billion but nothing more it achieved. Hence it become the starting point of market confidence loss, subsequently led most of the banks to stop trading with them and withdraw their service and credit lines from Lehman.

Corsetti et al., (2009) found that Lehman management failed to maintain corporate governance rules and regulations specially investment of subprime mortgages and mortgage backed security with high risk of being written off, this indicates the mise of power for spreading the risk to market and consequently caused several hedge funds and investment vehicles which mainly relied on the mortgage backed securities to liquidate as needed and lead defaulted in the mortgage market.

Failure to disclose financial statements, Lehman executive members failed to disclose the proper accounting standards used and true statement of their financial statements but portrayed how management wanted to look like by manipulating the financial statement. This gross negligence made to the corporate system to work for them not for the shareholder's interest as well as the public just for personal gain or short-term interest of the organization while not considering the long term of the organizational goals. Many researchers and financial experts accused Lehman's managers decision were irresponsible because they did not consider the risks associated mortgage market, not respected the leverage position and they dependence on short-term funding.

Deregulation of the financial market also contributed Lehman's failure because the regulations were not enough to oversee the transactions of the Lehman in the appropriate time and Lehman used as an opportunity to take the advantages of unregulated bonds, influence the rating agencies through incentives given so they rate and portray Lehman's risky bonds as safe and healthier investment to the public.

Unsuccessful bail-out and takeover attempts contributed significant role in the collapse of Lehman investment bank. Lehman's executive prepared rescue plan and bailout strategy to the US Congress as Bear Beach Stearns was given an opportunity for bailout but they declined to provide any financial assistance by arguing that Lehman's bailout plan was not credible and did not have enough collateral to back their proposal and finally the bank lost half of its stock prices and public confidence leading bankruptcy.

Several financial analysists claim that dismissal of the Lehman's rescue strategy by US Treasury department was based on political motive because six months prior to the Lehman's failure Treasury department facilitated $29 billion of financial assistance to Bear Stearns which was smaller investment bank compared to the Lehman bank so this shows that the smaller banks needed to be assisted and bailed out while larger and banks did not worth to be rescued. Henry Paulson who was US secretary of the treasury in the financial crisis period (2006-2009) had rival history with the Lehman CEO Dick Fuld as prior to his secretary of treasury role, he was the CEO of multinational investment bank of Goldman Sachs.

The reasons for failure of Lehman Brothers can be summarized in the following: -

- Lehman's failure partially triggered the 2007 economic collapse and prolonged depressions.
- Huge investment in the real estate that resulted losses when housing demand decreased drastically.
- High leverage position of the bank which caused public to get negative perception for the bank's operations.

- Negligence from rating agencies and financial regulators also played touchable roles in the collapse of Lehman bank because they kept on a blank eye all the illegal and manipulation of Lehman's management while could have ability to provide the right information to the public before bankruptcy stage.

- Incompetent of the external audit, financial statements prepared by the management need to be verified and checked by an independent certified public accountant to ensure transparent, accurate and reliability of the information. Due to the close relationship between Lehman's executive and its external audit firm Ernst & Young Global Limited led the accountant's independence and objectivity to be compromised then the public responsibility ignored such that many items were mispresented in the financial statements to conceal the true picture of the company's financial affairs.

- Lehman's dependence on short-term borrowings, usually short-term financing strategy is associated higher risks such ash high fee and interest rates and short payback period so failure to meet these dues created substantial drawback to Lehman's operations because lenders lost faiths in the bank and did not expect failure to repay the agreed time therefore this resulted potential damage to bank's credit score. As consequence of these, investment banks cut off from funding and bank missed any opportunity to get cash to finance its operations.

4. PREVENTATIVE MEASURES

Lehman's failure could have been avoided if the management had taken more proactive risk mitigation strategy since there was alarming indicators as company was becoming familiar with the problems of leverage, liquidity, solvency and efficiency.

Predication of rating agencies and regulators seemed to be dependent on Lehman's executive attitude in exchange of their payment because they were paid more than enough fees for their rating services. If rating agencies had acted independently they could have ability to predict, caution and directed the Lehman but they kept quite intentionally the illegal, unscrupulous activities and manipulation of the company's financial statements by the Lehman's executive.

5. RECOMMENDATIONS AND SUGGESTIONS

If US treasury could have bailed out or any other part had given an opportunity to survive by any means Lehman Brother would be needed radical change in the management system such as: -

a) Creation of Independent compensation committee. It was obvious that the Dick Fuld CEO of Lehman Brother had significant role in the appointment and guidance of the compensation committee this influence weakened the control and balance of the executive interest and shareholders interest. For instance, when company was in financial trouble particularly cashflow shortage he management to spend unimaginable amount of money under the compensation and bonus scheme. So, for saving these tremendous amounts of money could have been used to manage the company's financial problems.

b) Establishment of strong audit procedures, Lehman Brothers had inefficiency in the audit processes which also contributed partially the failure of the company. Lehman's external audit neglected to attest the state of the company's financial statement consequently misled the investors and public till they lost the whole confidence and billions of dollars. So, creation of strong audit procedures would ensure to assess the true presentation and fair view financial statements, conformance, keep integrity of the financial information and provide necessary guidance on how the company's performance could be improved. Wiggins et al., (2015) blamed the carelessness of Lehman Brother's independent audit firm Ernst & Young Global Limited (EY) for not disclosing the accounting method used and permitting number of items to be mispresented in the financial statement like Rep 105 which empowered Lehman to eliminate $50 billion from its balance sheet to look more healthier than as it was.

c) Strict adherence of the financial regulations, Lehman's bankruptcy played significant role the non-compliance of the financial regulations of the financial market therefore maintaining high level of obedience to the regulations would create predictable and preventable environment. In addition to the Policy makers and the financial regulators need to set up their own effective control mechanism to ensure financial performance indicators are used properly and time such as leverage ratios, liquidity position, and profitability to avoid future re-occurrence.

d) Placement of strong credit rating rules, credit rating agencies should maintain highly of integrity as they are expected to conduct there rating systems in a transparency and accountability manner with the purpose of providing reliable judgement about the creditworthiness of the debt securities. However mutual interdependence and interest among rating agencies and investment intuitions created conflicting of interests because of that integrity is compromised in many occasions as Lehman's case occurred. There government should ensure that CRAs to be accountable and face severe punishment from any inaccurate ratings so that they become vigilant and proactive in the rating system (Bayar, 2014).

6. CONCLUSION

Lehman's demise was attributed to different factors including accounting malpractice, excessive investment risk taking(real-estate), deregulation and management's unethical behavior over compensations and bonuses. Other factors had vital parts in the failure among these are the general economic conditions, over-reliance of rating agencies, incompetent of the external audit firm for not evaluating the compliance, financial regulations, policies and procedures needed to be kept for preventing perpetuated fraud that resulted miserable economic situations that global financial instructions had experienced in 2008.

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