The Causes of Lehman Brothers Bankruptcy and Lessons for Chinese Financial Markets

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Abstract: Lehman Brothers remained the giant of the US financial market for a century. It was established by Henry Lehman in 1850. Lucrative cotton and other commodities were the main areas of operation in the beginning which later shifted to purely financial services in 1906. This article will point out the key reason for the bankruptcy of the firm and various viewpoints of research scholars regarding the event. It is divided into four parts each addressing the various issues. The first part will be consisting of the research work of other scholars regarding the incident. Part two will put the focus on the three-key aspect regarding the Lehman Brother bankruptcy that includes as an investment, government regulation, and risk. The final part will include the key lesson and learning points from this event for the Chinese financial market. Derivative regulation from the Chinese perspective will be discussed in detail. Poor management along with the existence of derivative risk contributed to the failure of firm success operations resulting in bankruptcy on September 15, 2008.

1. Introduction

Henry Lehman established the famous company named as Lehman Brother in 1850. It filed its bankruptcy protection on September 15, 2008. Cotton and other lucrative commodities were the main trading segment of the company. The first contract was made in 1899 regarding IPO business so that to completely shift the dynamics of the business from agricultural to financial services. By the end of 1906, the company was purely a financial company fully ready to dip into the financial transactions. It was the time of great depression in 1930 when companies outperformed in the financial services despite the crisis situation in the market. (BURKHANOV, 2011, p17). Lehman Brother remained the front seater in the investment banking sector in the US financial market for almost a century. But the crisis of subprime mortgage eventually hit the bank very bad resulting in bankruptcy. Financial markets, analyst and researchers were quite shocked by the decision of the management. (Johnson and Mamun, 2012, p380) Various reasons are attributed to the bankruptcy of Lehman Brothers. The company was trapped under the burden of heavy leverage due to external market shocks and subprime mortgage crisis. The case of Lehman Brothers remained a case study for the learners to learn valuable insight regarding the financial services sector and practices accordingly. It includes an objective view of the financial market’s knowledge, monitoring and assessing the early warning signs so that to come up with plans to mitigate the risk. This study will explore the various aspects of Lehman Brothers bankruptcy and the lesson which Chinese corporate and financial sector companies can learn.

2. Literature Review

The section of the literature review will cover some research work from authentic journal articles that have explored the various reasons for Lehman Brothers bankruptcy. It will give some valuable knowledge for the Chinese derivative investment market and regulatory bodies.
Some of the major reasons which are given valuable insight when it comes to studying the major reasons for bankruptcy of Lehman Brothers. These include asset structures, funds, mortgages and core business areas of the company. (Lopatta and Kaspereit, 2011, p479) There is one research work done in this regard by Anton Valukas in January, 2009. This work was done on the basis of 20 million emails and 10 million various documents that the company sent and received. The author pointed out the fact that false account declaration was made by the Lehman Brothers which resulted in competitive advantage taken by other companies such as Citigroup and JP Morgan as well as other giants of the financial market. This report has given a very detailed analysis of the company operations and described in detail the major aspect of the Lehman Brothers downfall. One aspect was missing in this report which is related to the impact of the downfall of the company on the other financial markets. (Lartey, 2012, p403).

The bankruptcy of the Lehman Brothers resulted in affecting negatively the tradition positions of some hedge funds along with external shocks into the financial markets because the company was itself the giant in the market. The company was the prime brokerage of Wall Street before this process of bankruptcy. It was engaged in various activities such as security lending services financing of other hedge funds clients and custodial services. (Ying, 2012, p114). This bankruptcy resulted in knockdown effects on the real estate business because it was no longer in position to perform the major functions in the financial market. Assets were frozen of the hedge fund’s clients creating more challenges for the company to survive in the market. (Madhani, 2009, p357). The liquidity of these hedge fund’s clients decreased significantly after the declaration of bankruptcy by the company. This financial crisis has also opened new dimensions of research as well to focus on the sustainable financial operations of the markets. (Murphy, 2009, p54)

Another research conducted by Madhani resulted that the subprime crisis was due to the several negative factors which were building up in the housing and credit market for years. The major reason behind this crisis was unable to pay mortgage payment by the homeowners, property loans incorrect disposal, poor judgment of lenders, lack of government regulation, excessive speculation on the real estate market and lack of financial product innovation in a timely manner so that to disclose the appropriate risk levels. (Das, 2012, p23 and Chakrabarty and Zhang, 2012, p323). Some other scholarly work attributed the operational structure and asset management of Lehman’s brothers the main cause of failure to perform. (Sosnick, Schodek, and Loo, 2000, p54)

Investment banks do not maintain the stable source of funding the same as the conventional commercial banks because their operations do not depend on the saving accounts. The interbank lending market along with bonds are the two major sources of capital. These two factors did not perform well for the Lehman Brother’s operations and led to the unwanted circumstances for the firm. (FERNANDO, MAY, and MEGGINSON, 2009, p252).

Every major investment bank, as well as a securities firm, were having investments in the bonds but as the operational structure of the Lehman Brothers was very large so its share in bonds derivatives was much higher as compared to other financial institutions on Wall Street. The market value of the financial derivatives went into decline due to the subprime mortgage defaults. (Greenfield, 2010, p33). The case of Lehman Brothers has given this thought to the scholars that appropriate measures should be taken by the Chinese regulatory bodies to supervise the derivative markets. The study was done by Zhang also investigated the firm with a viewpoint that how a company having a long history of 158 years resulted in such a disastrous end. (Ying, 2012, p114) These researches proposed this viewpoint that financial innovation is the key factor behind the sustainable operations of the financial markets. Financial supervision is another key factor that needs to be implemented in the operations of the market with strict auditory policies. The government should take the necessary steps to encourage financial institutions to integrate efforts so that an investment banking network can be established. (Nicholls, 2011, p120)
3. Lehman Brothers Bankruptcy Analysis

3.1. Lehman Brothers Bankruptcy Analysis

Lehman Brothers adopted the strategy of purchasing mortgage assets in the time of the real estate sector peak period that consists of many low rated securities. The strong suit of the firm was dealing with fixed income securities. They had also had the special skills to adjust the balance sheet without incorporating specific risk. (Gambacorta and Mistrulli, 2011, p760) Richard Fuld’s was the CEO during the time of the financial crisis of 2008 has the quite a good track record in the past. On the other hand, the firm successfully managed to sustain earning per share to $0.81 in the first quarter of 2018 despite having the crisis. (Das, 2012, p23). This was made possible by writing off assets which have given investors’ confidence to invest in the firm’s operational activities. Richard took a bold decision of issuing preferred stock of worth $1.9 billion so that to improve the portfolio of assets and liabilities of the company. But subprime crisis speed and rapid development turned the scales upside down.

The second quarter of the fiscal year 2008 showed the loss of $2.8 billion for the firm resulting in turning the eyes of the financial markets towards the sudden change in the company operations. The leverage ratio of the firm was 20 times higher and even the first-quarter results were very promising of about $3.17 billion before the break of second-quarter news. (Chen, Chidambaran, Imerman and Sopranzetti, 2011, p123) Investors turned their eyes due to the fears of the company's substantial write off of assets and the balance sheet of the firms was showing no more significant improvement. The stock value of the firm to the below of its net assets.

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<tr>
<th>Sr. No.</th>
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<tr>
<td>1</td>
<td>June 9, 2008</td>
<td>A loss of a massive amount worth $2.8 billion was announced by the firm. This was the first major blow to the investment bank since the American Express into the business.</td>
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<td>2</td>
<td>September 2, 2008</td>
<td>It was announced by the KDB that discussion is in progress with the firm regarding future investment into the bank.</td>
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<td>3</td>
<td>September 9, 2008</td>
<td>The discussion which was going on between KDB and Lehman Brothers was unsuccessful and discontinued eventually.</td>
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<td>4</td>
<td>September 10, 2008</td>
<td>Lehman Brother announce the major financial loss of $3.9 billion for the third quarter. It was also intended by the company to sell its majority of stake into the investment business. Moody's also announced that credit ratings of the firms are under review.</td>
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<td>5</td>
<td>September 15, 2008</td>
<td>Bankruptcy was filed by the firm.</td>
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Lehman Brother tried to use every possible action to avoid bankruptcy and save the company such as shorting. But results were not in favor of the company ultimately leading to bankruptcy. (Murphy, 2009, p55). The majority of the investment banks were having long but Goldman Sachs which was the largest Investment Bank in the US held subordinated debts short. The actions of the Goldman Sachs regarding securities shorting was not due to the subprime crisis. (Sosnick, Schodek, and Loo, 2000, p54). Lehman Brothers did try to save the company by trying to short Fannie Mae as well as Freddie Mac in June and July 2008 respectively. Bruce Harting was the analyst in the firm. He prepared a research report in this regard that both of the above-mentioned securities need to add 75 billion in the capital before making the short movie. This resulted in a sharp decline in the share prices of about 50% in only a week. Small buffer was although created this proved to be temporary relief. Richard Fuld's move of overpricing and not linking the sale of an asset in a timely manner resulted in the binding of the Federal Reserve Fund. This increases the financial crisis impact on the firm operations leading to the situation of bankruptcy. (Nicholls, 2011, p121).

A new form of the financial derivative has emerged in the light of Lehman's bankruptcy process that has the ability to transfer risk as well as can impact the economy in a negative manner. People’s
right approach to know about derivatives and using them in an effective manner can play a healthy role in stable development and economic growth.

3.2. Financial Derivatives Risk Intensity Increased

The risk of derivatives was the primary reason for the downfall of the giant financial market. The value of these financial instruments is attached to the changes in the prices of basic products. Therefore, the sensitive level of these instruments was much higher as compared to traditional products. Secondly, such financial derivatives that pose a high risk with a small amount of insurance can lead to an increase in financial transactions leading to higher interest rates. This situation generates a loss situation for the firm. (Gambacorta and Mistrulli, 2011, p759).

Imperfect internal control systems of the organization along with enterprise risk preference management systems play a key role in the effective operations. Derivates are much more linked to management risk preferences. A leading example in this regard includes that Lehman Brothers did not use the funds for self-investment purposes before 2006. But management perception changed after 2006 believing that mortgage back securities can bring economic benefit to the company. Such business which poses an increased risk and higher income expected the higher-yield returns. A misconception was made by the management of the firm that the subprime crisis will not hide too bad to the operations of the firm. Aggressive expansion decision was made which broke the risk management policy of the company and at the same time, the company’s chief risk officer was also fired in 2007. Both aspects of internal control and risk management were on the downfall. (FERNANDO, MAY, and MEGGINSON, 2009, p253).

Lack of assessment was the third key reason which contributed to the dark times for the company ahead. Selling trend was increased by the Lehman Brothers management after 2006. Junk bonds held by the company were increasing along with the significant decline in the forecasted growth in the real estate sector very soon. System risk was ignored and the rising market fascinated the manager and ignored the risk accordingly. (Madhani, 2009, p356) Risk diversification was the grey area in which the firm was not successful and business operations were highly concentrated by focusing more on the fixed income section. Lehman’s 80% assets were consisting of short-term contracts as well as investment in securities. Prices were on increase and suddenly collapsed due to crises and people were not willing to buy. (Lartey, 2012, p410).

There were managerial lapses as well as on Lehman’s’ executives end which did not handle the situation in an effective way. The executive body of the firm was undecided to respond to the cries and their estimation of survival was entirely wrong which resulted in major losses. This event is remembered as a landmark in the history of financial markets and lessons exist for the firms in a more realistic manner. (Chakrabarty and Zhang, 2012, p323)

4. Requirements for China to Improve the Regulation of Financial Derivatives

The derivative market of China is not as old and experience as the European countries and the US which is a drawback. On the other hand, stringent regulatory systems exist and being implemented by the regulators to deal with such financial transactions that possess high risk. (Ying, 2012, p114) Lack of supervision and self-regulatory mechanism makes the Chinese derivative market prone to more threats and challenges. The importance of regulators has increased in recent times due to the complex nature of financial derivative and complexity. China’s financial derivatives market supervision structure is not effective enough which can be improved by the following means.

The first step in this regard can be regulatory powers rational allocation. The current system of financial markets led to the lack of efficiency of derivative regulations. China should promote this transition to the development of its financial market. The role of government in this regard can be very decisive in this regard.

Then comes the Future Act and relevant laws development which should be accelerated. The current system of the financial derivative markets lacks the uniform legislation as well as stability issues which requires improvement on the policy maker’s part. All relevant department rules and
the regulatory document should be unified and legal loopholes, as well as a shortcoming, should be managed accordingly. Transparency related factors also require improvement in the derivative market. The asymmetry level of information can reduce the significant challenges which are currently being faced by the investors and regulators to operates in the market. Regulators need to focus on voluntary coordination by creating awareness in the various stakeholders of the derivatives market.

5. Conclusion

This research paper analysed the major reasons for the downfall of the financial market giant Lehman Brothers. Poor management and ignorance of the executive parts to not realize the existence of derivate resulted in the bankruptcy of the firm. Global financial markets severely impacted the sale of subordinated debt due to this bankruptcy. The failure of supervision was also found after the detailed analysis of the Lehman Brothers Bankruptcy. This was linked with the Federal Reserve's ineffective practices regarding supervision. This gives a value less in the Chinese financial market perspective that Central Bank should establish tight monetary controls and supervisory measures must be implemented in a more effective manner. Financial markets have seen sudden shocks due to the announcement of bankruptcy by the firm. Financial innovative products require immediate supervision so that to enhance the control risks. A higher degree of risks in the financial markets includes due to variety of reasons such as ineffective supervision, underestimation of risk and ineffective process of asset securitization. The credit rating method needs to be improved in this regard. The role of Moody’s and Standard and Poor’s can be decisive and very effective in establishing the fair credit rating mechanism. Regulatory bodies should play their role in this regard to ensure the compliance of laws as well as strengthening the financial market operations in a more effective manner.

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