Case Study: The Failure of Lehman Brothers

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(1) Identify the four major factors contributing to the failure of Lehman Brothers. What Lehman Brothers could have done differently to avoid this fate?

Ans: There is no single cause for the failure of the Lehmen brother. After the fall of Lehmen Brothers, a number of reasons and factors came out behind the failure such as major changes in the business structure and strategies like shifting from a lower risk brokerage model to a higher risk, more capital intensive investment banking model, poor management choices, financial leverage, liquidity crisis, investing in Mortgage Backed Securities, fall of US Housing market and many more. Among all these factors, four major factors that contributed the most to the failure of Lehmen Brothers are-

1. Investing in Mortgages Backed securities (Subprime Mortgages): Not long before the collapse, U.S Housing market was blasting and individuals and banks were more into MBS. In view of that Lehmen obtained five Mortgage lenders including BNC Mortgage and Aurora Loan Services. Aurora Loan Services was well known for giving loans without appropriate full documentation that implies they were giving loans without legitimizing and checking the creditworthiness of the clients. So basically, Lehmen was getting involved with customers whose creditworthiness was not checked and they were entering into risky investments. So, the rising of loan defaults thus investing in subprime mortgages eventually contributed a huge portion to the failure of Lehmen Brothers.
2. The collapse of U.S Housing Market & poor Management: Before the fall of Lehmen the US Housing market was a blasting sector to invest for which Lehmen put intensive investment in MBS. As Lehmen merged with Mortgage Backed Securities, US Housing Market started to fall in view of the expansion in defaults of those mortgages. This triggered the collapse of Lehmen Brothers. Thus, it contributed a huge portion to the failure of the Lehmen Brothers.
3. High Leverage Ratio: Lehman 's high borrowing conduct to fund its assets resulted in a high leverage position. The financial leverage of a company is the ability of the company to fund a portion of its assets with fixed interest rates of securities in the hope of raising the overall returns to shareholders. The leverage ratio of Lehmen as of 2007 increased from 20 to 31. Which means for every $1 of cash and other available financial resources, Lehman would lend $31 which was too high a leverage ratio to keep. The high degree of leverage and its big portfolio of loan securities made it more and more prone to weakening marketplace conditions. Because of the global financial crisis that led to decline in prices with a rise in interest rates, Lehman’s financial position was badly affected resulting to their bankruptcy.
4. Liquidity Crisis: The crisis began when Lehman brothers were unable to fulfill their payment obligations, routinely borrowed funds from the market at a reasonable price, to finance real or planned commitments or to liquidate assets. Their incapacity to fulfill short-term commitments was key to Lehman 's collapse. Lehman was experiencing irregular liquidity issues in spite of its large asset base. As a result, Lehman was losing

business confidence and market reputation. Lenders and other reliant parties continuously lost confidence in the bank which brought about growing capital expenses and problems in getting short-time period investment to maintain Then, most of the banks stepped back to give any services and credit lines to Lehmen brothers. They are vulnerable to liquidity threats. They relied on short-term financing for long-term investments which turned out to be a serious mistake as the credit market dried up and left them with illiquid assets. To address this challenge, Lehman reduced their gross asset base $147 billion to boost their liquidity position $45 billion (Mawutor, 2012). Thus, their liquidity redemption plan saw a 20 percent reduction in their exposure to commercial mortgages and a leverage from a factor of 32 to about 25.

To avoid this fate, Lehmen brothers could have done-

- Lehmen should not have invested intensively in Mortgage Backed securities and merge with Aurora Loan Services which was popular for subprime Investment in MBS and collapse of US housing market played a huge role in the failure of Lehmen.
- There could have been a lot of market risk avoided if Lehman had not invested heavily in co-related assets. The subprime crisis hit could have been less adverse if the bank had more diverse portfolio with different sectors and industries.
- Lehmen should have not increased its leverage ratio this much high that it affected the other risk factors badly which leads to the failure so fast.
- They would not have shifted their attention from brokerage and financial services if they had done better stress test to find out the real capabilities to face

(2) How did the management of Lehman Brothers manage their risk? In what ways did they fail.

Ans: Before the bankruptcy, Lehman Brothers' risk management department had identified five specific risks inherent in their business (Chasan, 2008). They are-

- Market risk represents the potential unfavorable change in the value of a portfolio of financial instruments due to changes in market rates, prices and volatilities (Chasan, 2008).
- Credit risk represents the possibility that a counterparty or obligor will be unable or unwilling to honor its contractual obligations to Lehman Brothers (D'Arcy, 2008).
- Liquidity risk is the risk that Lehman brothers are unable to meet their payment obligations, borrow funds in the market at a good price on a regular basis, to fund actual or proposed commitments or to liquidate assets (Mawutor, 2012).
- Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events (Chasan, 2008).
- Reputational risk concerns the risk of losing confidence from the customers, public and the government due to unfortunate decisions about client selection and the conduct of their business (Chasan, 2008).

The way they failed to manage the above risks is that while evaluating Lehman Brothers risk management we can say that Lehman's administration on many occasions surpassed their own risk limits, at last surpassing their risk polices by edges of 70% as to real estate business and by 100% as to leverage loans. One clarification of this somewhat risky conduct is the pay

framework. So as to pull in and be the best in the business and industry, they remunerated their most income creating workers with huge financial rewards. In any case, the extra motivators were uneven. All things considered; the reward framework urged the administration to take big risks. The operational mistakes made while doing stress tests it excluded assets, surpassing built up risk limits and overleveraging the asset report, may have been powered by extra reward system.

The loss would have been stopped if the management had taken more constructive measures on risk control than its reactive measures at a time when the company was nearly down. The indicators were written throughout, but management was unable to find the right approach to curb the crisis

(3) Use your knowledge about systemic – risk and Bank Contagion to discuss about the failure of Lehman Brothers and the market reaction.

Ans: There are 2 most important factor of commercial banks which leads to create systemic risk and Bank Contagion which also reflected in the case of the failure of Lehmen Brothers.

First of all is the Bank Run. This means not having enough liquid short-term assets to cover for short term liabilities. When banks do not have cash or other short-term assets which can be quickly converted into cash to pay the short-term liabilities. This causes a panic to the depositors and when depositors line up in front of the bank to withdraw deposit and if the bank is unable to pay then bank run happens. It occurs when a large number of customers of a bank withdraw their deposit simultaneously over concerns of the fact that the bank is heading towards bankruptcy. As more people withdraw their funds the probability of default increases prompting more people to withdraw their deposits. When bank run happens, this leads to liquidity crisis and banks starts having less cash in hand. Second factor is Insolvency. When a bank does not have enough capital to cover the losses in their asset values which means banks will owe more than own. When both of the factors combined together it creates Systemic Risk which means creating a crisis in the financial market

The same thing happened with Lehmen brothers because they were facing liquidity crisis very crucially as they were highly dependent on long term fund for short-term need. Their cash was locked up in the long-term investments and also credit defaults were rising rapidly for which they were unable to pay the short-term obligations that means bank run happened in their case. In addition, their loans/ default loans become higher than their asset or than their capital which is used to cover for the loans. So, the liability became greater than assets. This caused to their insolvency. So, both of the factors fuelled to their systemic risk and created a crisis to the financial market which led to the collapse.

Bank contagion means rumours that a bank is failing and this cause crisis in the market like depositors will try to withdraw their money as they scared and shareholders will try to sell their stocks. During the time of the bankruptcy of Lehmen, it was the 4th largest U.S Investment bank with 25000 employees worldwide. So, when it collapsed it created a huge impact or huge crisis in the financial market that affected other banks too because people were scared and got panic for their funds. Market reaction for them was that, Lehman was losing business confidence and market reputation. Lenders and other reliant parties continuously lost confidence in the bank which led to increasing capital costs and difficulties in getting short-term funding to maintain

liquidity. Then, most of the banks stepped back to give any services and credit lines to Lehmen brothers. Thus, the failure of Lehman Brothers happened.

References

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