

THE FALL OF CORPORATE GOVERNANCE IN LEHMAN BROTHERS

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CHAPTER 1: INTRODUCTION

1.1 INTRODUCTION

In recent years, the ownership structure of companies has changed a lot. Public financial institutions, mutual funds, etc. are the single largest shareholder in most of the large companies. So, they have effective control on the management of the companies. They force the management to use corporate governance. That is, they put pressure on the management to become more efficient, transparent, accountable, etc. They also ask the management to make consumer-friendly policies, to protect all social groups and to protect the environment. So, the changing ownership structure has resulted in corporate governance.¹

In 2003 and 2004, with the U.S. housing boom well under way, Lehman acquired five mortgage lenders, including subprime lender BNC Mortgage and Aurora Loan Services, which specialized in Alt-A loans (made to borrowers without full documentation). Lehman's acquisitions at first seemed prescient; record revenues from Lehman's real estate businesses enabled revenues in the capital markets unit to surge 56% from 2004 to 2006, a faster rate of growth than other businesses in investment banking or asset management. The firm securitized \$146 billion of mortgages in

¹ *"Importance and need of corporate governance"*, <http://kalyan-city.blogspot.in/2011/10/importance-of-corporategovernance-need.html> last visited on 3rd October, 2012

2006, a 10% increase from 2005. Lehman reported record profits every year from 2005 to 2007. In 2007, the firm reported net income of a record \$4.2 billion on revenue of \$19.3 billion.²

On September 15, 2008, Lehman Brothers filed for bankruptcy. With \$639 billion in assets and \$619 billion in debt, Lehman's bankruptcy filing was the largest in history, as its assets far surpassed those of previous bankrupt giants such as WorldCom and Enron. Lehman was the fourth-largest U.S. investment bank at the time of its collapse, with 25,000 employees worldwide. Lehman's demise also made it the largest victim, of the U.S. subprime mortgage-induced financial crisis that swept through global financial markets in 2008. Lehman's collapse was a seminal event that greatly intensified the 2008 crisis and contributed to the erosion of close to \$10 trillion in market capitalization from global equity markets in October 2008, the biggest monthly decline on record at the time.³

The term corporate governance denotes the entire process by which corporations are managed and controlled. J. Wolfensohn, president of the World Bank has opined that corporate governance is about promoting corporate fairness, transparency and accountability⁴

Corporate governance of banks is an essential element of a country's governance architecture. It can have systemic financial stability implications and shape the pattern of credit distribution and overall supply of financial services. Hence the necessity and importance of enforcing effective corporate governance in the banking sector.⁵

Banks constitute the biggest money related mediators around the globe and have tremendous forces of influence. Not at all like in the corporate world, powers like RBI and the administration assume an immediate part in bank administration through bank regulation and supervision. This part is

² “Lehman brother collapse”, <http://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp> last visited on 4th October, 2012

³ “Case study on Lehman brother”, <http://coralvillecourier.typepad.com/community/2012/08/case-study-the-collapse-of-lehman-brothers.html> last visited on 1st October, 2012

⁴ J. Wolfensohn, *Corporate Governance*, FINANCIAL TIMES (London), June 21, 1999

⁵ Newspaper Article on, “Need for Corporate Governance”, <http://www.financialexpress.com/news/need-for-corporate-governance-in-banking/119080/0> last visited on 2nd October, 2012

supported by the need to guarantee systemic dependability, budgetary steadiness and store protection obligation contemplations. Banks appreciate the advantage of high influence with the drawback assurance of store protection, which weakens their motivations for solid administration observing.

According to Rekha Sethi (Director General-All India Management Association AIMA), "The whole idea behind corporate governance is ensuring the accountability of certain individuals in an organization through mechanisms that try to reduce or eliminate unfair practices within the corporate system." Corporate governance is all about transparency. It essentially indicates the trust-worthiness of a company.⁶

CHAPTER 2: RISE OF LEHMAN BROTHER

2.1 HISTORY OF LEHMAN BROTHERS

Like it's most aggressive rival Goldman Sachs, Lehman's history traces back to a German immigrant. Henry Lehman of Rimpar, northern Bavaria, settled in Montgomery, Alabama in 1844 and opened a small general store. Only in 1850, Henry Lehman and his brothers, Emanuel and Mayer, founded Lehman Brothers, which at this time was a cotton trading company. Until the late 19th century Lehman Brothers remained focused on the cotton market. The Lehman brothers moved the firm to New York after the civil war and were involved in the foundation of the New York Cotton Exchange in 1870.⁷

Only in 1883 Lehman went on to enter the coffee market, becoming a member of the Coffee Exchange. Four years later, in 1887, Lehman became a member of the New York Stock Exchange.

⁶ Akrani Gaurav, "Importance of Corporate Governance", (<http://kalyan-city.blogspot.in/2011/10/importance-of-corporate-governance-need.html>) last visited on 4th October, 2012

⁷ "History of Lehman Brothers", <http://www.library.hbs.edu/hc/lehman/history.html> last visited on 2nd October, 2012

⁸ "Case study on the fall of Lehman brothers," <http://www.investopedia.com/articles/economics/09/lehman-brotherscollapse.asp> last visited on 1st October, 2012

Lehman expanded into the profitable equity underwriting business which was strongly linked to the rapid industrialisation of the United States. In 1899, it underwrote its first public offering, the preferred and common stock of the International Steam Pump Company and subsequently developed to one of the most active equity underwriters. While the firm prospered over the following decades as the US economy grew into an international powerhouse, Lehman had to contend with plenty of challenges over the years.⁸

However, despite its ability to survive past disasters, the collapse of the US housing market ultimately brought Lehman Brothers to its knees, as its headlong rush into the subprime mortgage market proved to be a disastrous step. However, even at the time of the bankruptcy most units of Lehman were profitable and Lehman's last CEO, Richard Fuld, had spent most of his tenure with diversifying the company, making sure it would have other businesses to depend on if one collapsed.⁸ Equity trading accounted for one-third of Lehman's revenue in 2006, and the firm was the largest trader of stocks on the London Stock Exchange and Euronext. It ranked as high as No. 5 among mergers and acquisitions advisers in 2007, when it had a role in one-fifth of all corporate takeovers. Its research teams in equities and fixed income had ranked at the top of surveys of money managers conducted by Greenwich Associates, an industry consulting firm. Non-US revenue accounted for half of the total in 2007 for the first time.⁹

2.2 THE DEVELOPMENT OF LEHMAN BROTHERS

1930s Lehman underwrites the IPO of DuMont, the first television manufacturer.
1950s Underwrites the IPOs of Digital Equipment and Hertz Rent-a-Car
1960 Opens a Paris office. With Salomon Brothers, Merrill Lynch and Blyth and Company, Lehman forms an association
1962 nicknamed the "fearsome foursome" that challenges the major firms for underwriting business.
Becomes one of the first investment banks to open an office in London to take advantage of the
1972 booming bond market in Europe.
1975 Lehman acquires Abraham & Co.
1984 American

⁸ "Lehman Brother Collapsed" http://ndettovick.blogspot.in/2012_07_19_archive.html last visited on 20th September, 2012

⁹ *Ibid*

Express acquires Lehman Brothers and merges it with Shearson.1986 Seat on the London Stock Exchange.¹⁰

1988 Seat on the Tokyo Stock Exchange American Express divests Shearson, and the independent firm once again becomes known as Lehman1993 Brothers. Lehman becomes independent through a public stock offering and Lehman Brothers Holding Inc1994 common stock begins trading on the New York & Pacific stock exchanges.1994 Richard Fuld Jr takes the top job at Lehman. Fuld fights off rumors that the near collapse of Long Term Capital Management had caused a cash crunch1998 at Lehman.1999

In 2003 and 2004, with the US housing boom well under way, Lehman acquired five mortgage lenders, including subprime lender BNC Mortgage and Aurora Loan Services, which specialized in Alt-A loans, which were made to borrowers without full documentation. At that time, the unemployment rate in 2003 was at 6 percent, which fell the following year to 5.5 percent. The firm securitized \$146 Billion of mortgages in 2006, a 10 percent increase from 2005. Lehman reported record profits every year from 2005 to 2007. The national average wage index continued to immense at the same time from \$36,952.41 worth of salaries in 2005, followed by a rise to \$38,651.41 in 2006. In 2007, the firm reported net income of a record \$4.2 billion on revenue of \$19.3 Billion, while average wages in the US rose further to \$40,405.48 and the CPI fell to 2.36 percent.¹¹

The Balance Sheet of the Lehman Brothers:¹²

In Millions of USD (except for per share items)	3 months ending 31/08/2008	3 months ending 31/05/2008	3 months ending 29/02/2008	3 months ending 30/11/2007	3 months ending 31/08/2007
Revenue	1,971.00	5,826.00	11,933.00	14,433.00	14,267.00

¹⁰ “A brief history of Lehman brothers”, <http://www.reuters.com/article/2008/09/13/us-lehman-factboxidUSHAR27520620080913> last visited on 5th October, 2012

¹¹ “The Struggling US Force”, (Available at: www.fsifx.com) last visited on 1st September, 2012

¹² “Lehman Brother’s Balance Sheet” <http://www.google.com/finance?q=PINK:LEHMQ&fstype=ii> last visited on 1st October, 2012

Other Revenue, Total	432.00	414.00	437.00	458.00	472.00
Total Revenue	2,403.00	6,240.00	12,370.00	14,891.00	14,739.00
Cost of Revenue, Total	5,306.00	6,908.00	8,863.00	10,500.00	10,431.00
Gross Profit	-3,335.00	-1,082.00	3,070.00	3,933.00	3,836.00

In February 2007, the stock reached a record \$86.18, giving Lehman a market capitalization of close to \$60 billion. However, by the first quarter of 2007, cracks in the U.S. housing market were already becoming apparent as defaults on subprime mortgages rose to a seven-year high. On March 14, 2007, a day after the stock had its biggest one-day drop in five years on concerns that rising defaults would affect Lehman's profitability, the firm reported record revenues and profit for its fiscal first quarter. In the post-earnings conference call, Lehman's chief financial officer (CFO) said that the risks posed by rising home delinquencies were well contained and would have little impact on the firm's earnings. He also said that he did not foresee problems in the subprime market spreading to the rest of the housing market or hurting the U.S. economy.¹³

Richard Fuld holds the two positions CEO and Chairman of the company. The board consists of high portion of independent directors eight out of ten (whom met the independence standards of the New York Stock on the board). In addition to five committees. The board met the structural standers and there is nothing unusual. Their average age was 68 versus 61 on the large company. Directors had a diversity professional experience, but a significant lack of experience on financial issues.¹⁴

¹³ *"Dick Fuld's Fantastic Revisionism"*, <http://www.ritholtz.com/blog/2010/09/dick-fulds-fantastic-revisionism> last visited on 5th September, 2012

¹⁴ *"Structure of Lehman Brothers"*, Available at www.afcar.net last visited on 30th September, 2012

¹⁶ *Supra* note 28 at 10

2.3.1 DEFINITION OF INDEPENDENT DIRECTORS AT LEHMAN BROTHERS:

- A director is not considered independent if the director or a family member has been employed as an executive;
- Officer at the company within the last three years;
- Has earned a salary in excess of \$100,000 from the company in the last three years;
- Has been employed as an internal or external auditor of the company in the last three years;
- Is an executive officer at another company where the listed company's present executives have served on the compensation committee in the last three years;
- Is an executive officer at a company whose business with the listed company has been the greater of 2 percent of gross revenues or \$1 million within the last three years.¹⁶

CHAPTER 3: THE BEGINNING OF THE END

3.1 FALL OF LEHMAN BROTHERS

As the credit crisis erupted in August 2007 with the failure of two Bear Stearns hedge funds, Lehman's stock fell sharply. During that month, the company eliminated 2,500 mortgage-related jobs and shut down its BNC unit. In addition, it also closed offices of Alt-A lender Aurora in three states. Even as the correction in the U.S. housing market gained momentum, Lehman continued to be a major player in the mortgage market. In 2007, Lehman underwrote more mortgage-backed securities than any other firm, accumulating an \$85-billion portfolio, or four times its shareholders' equity. In the fourth quarter of 2007, Lehman's stock rebounded, as global equity markets reached new highs and prices for fixed-income assets staged a temporary rebound. However, the firm did not take the opportunity to trim its massive mortgage portfolio, which in retrospect, would turn out to be its last chance.¹⁵

The demise of Lehman Brothers can only be understood within the context of the current financial crisis, the biggest financial crisis since the Great Depression. The roots of this crisis have to be

¹⁵ *Supra* note 19 at 7

found in bad regulation, lack of transparency, and market complacency brought about by several years of positive returns. The seeds of current crisis were sewn during the real estate boom. As shows, a prolonged period of low interest rates leads to a rise in house prices that was completely abnormal by historical standards. From March 1997 to June 2006 the Case and Sheller national index of real estate prices increased every month, except for two. During the same period the average increase in real estate prices was 12.4% per year.¹⁶ This increase was in part fueled by extraordinary low interest rates. Between January 2002 and January 2004 the average 3-month Tbill rate was 1.3%, while the average in the previous forty years was 6.1%.¹⁹

On September 15, 2008, Lehman Brothers Holdings Inc filed for bankruptcy. It filed for protection under Chapter 11 of the U.S. Bankruptcy Code with the United States Bankruptcy Court for the Southern District of New York. It filed with \$639 billion in assets and \$619 billion in debt, Lehman's bankruptcy filing was the largest in history, as its assets far surpassed those of previous bankrupt giants such as WorldCom and Enron. Lehman was the fourth-largest U.S. investment bank at the time of its collapse, with 25,000 employees worldwide.¹⁷

3.1.1 SUBPRIME MORTGAGE

A type of mortgage that is normally made out to borrowers with lower credit ratings. As a result of the borrower's lowered credit rating, a conventional mortgage is not offered because the lender views the borrower as having a larger-than-average risk of defaulting on the loan. Lending institutions often charge interest on subprime mortgages at a rate that is higher than a conventional mortgage in order to compensate themselves for carrying more risk.¹⁸

¹⁶ Zingales Luigi, "Cause and effect of Lehman brothers on Bankruptcy" report by Committee on Oversight and Government Reform by United States House of Representatives October 6, 2008 ¹⁹ *Ibid*

¹⁷ *Supra* note 19 at 7

¹⁸ "Subprime Mortgage", http://www.investopedia.com/terms/s/subprime_mortgage.asp#ixzz28TUAdQxE last visited on 2nd October, 2012

3.2 WHY FEDERAL RESERVE SYSTEM IN USA COULD NOT SAVE LEHMAN BROTHER

The Federal Reserve System Act (Commonly also known as FED) as the central bank of the United States. In order to maintain the integrity of the financial system, some regulations have been made by them throughout the century. During the mandate of President Reagan, in the 1980's, a financial deregulation took place. The derivate market was deregulated whereas the commercial banks still would be regulated and supervised by the Fed. The aims of financial regulators are:

- To enforce applicable laws
- To prevent cases of market manipulation
- To ensure competence of providers of financial services
- To protect clients and investigate complaints
- To maintain confident in the financial system and reduce violation under law¹⁹

Inspite of so many check and balances, issues had been raised that why did the government not see or predict this kind of falling in advance. This is the response the Fed presented on the 10th march 2010, quoting: "The Federal Reserve was not Lehman's supervisor. Lehman was exempt from supervision by the Federal Reserve because the company did not own a commercial bank and because it was allowed by federal law to own a federally insured savings association without becoming subject to Federal Reserve supervision".

CHAPTER 4: CONCLUSION

In 2007 the business sector for private home loan sponsored securities started to lose great worth. Still, Lehman assumed more hazard in the trusts of profiting from the countercyclical emergency. They even disregarded their own danger investigation. This drove some of their advantages and different ventures being increasingly hard to offer without misfortunes. Offering at a misfortune has more negative impacts then losing cash, it may have demonstrated to e.g. moneylenders and

¹⁹ "Federal Reserve of USA", www.federalreserve.gov.us last visited on 6th October, 2012

financial specialists that the remaining resources were exaggerated, which could have prompted a misfortune in certainty. The counter gatherings of Lehman Brother concentrated on the influence proportions while assessing the bank. Keeping in mind the end goal to make it resemble their influence proportion was lower than in all actuality, they utilized flawed bookkeeping strategies.

Its ruin was the previous evening faulted for CEO Dick Fuld; Critics said his high-hazard procedure of putting resources into sub-prime home loans pushed the firm to the brink of collapse. Fuld, named The Gorilla in view of his intense person way, and took a £12million reward a year ago. The incalculable awards energized Mr. Fuld to go out on a limb, specifically heaping into high-chance home loans.

Therefore to finish up it can be said that the uncontrolled danger administration and absence of learning of the free chief in the budgetary part lead the way for the falling of Lehman Brothers. The 140 year old bank who survived numerous money related emergency and inspite of supporting both the world wars, the bank was sufficiently able to manage through the whole enormous emergency.