The Collapse of Lehman Brothers: A Case Study

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On Sept. 15, 2008, Lehman Brothers filed for bankruptcy.[1] That name may bring up images millions of people saw in the news for the first time: Hundreds of employees, mostly dressed in business suits, leaving the bank's global offices one-by-one with bankers boxes in their hands. It was a sombre reminder that nothing is forever—even in the richness of the financial and investment worlds.

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. [1]

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 Oct. 2008—the largest monthly decline on record at the time. [2]

In this article, we take a look at what happened that led to the collapse of the bank.

KEY TAKEAWAYS

- Lehman Brothers had humble beginnings as a dry-goods store, but eventually branched off into commodities trading and brokerage services.
- The firm survived many challenges but was eventually brought down by the collapse of the subprime mortgage market.
- Lehman first got into mortgage-backed securities and CDOs in the early 2000s before acquiring five mortgage lenders.
- The firm posted multiple, consecutive losses and its share price dropped.
- Lehman filed for bankruptcy on Sept. 15, 2008, with $639 billion in assets and $619 billion in debt.

Lehman Brothers History

Lehman Brothers had humble origins, tracing its roots back to a small general store founded by German immigrant Henry Lehman in Montgomery, Alabama, in 1844. In 1850, Henry expanded the scope of the business into commodities trading and brokerage services.

As the U.S. economy grew into an international powerhouse, the firm prospered over the following decades. But Lehman still had to contend with plenty of challenges over the years. The company survived them all—the railroad bankruptcies of the 1800s, the Great Depression of the 1930s, two world wars, a capital shortage when it was spun off by American Express (AXP) in 1994 in an initial public offering (IPO), and the Long Term Capital Management collapse and Russian debt default of 1998.

Despite its ability to survive past disasters, the collapse of the U.S. housing market ultimately brought Lehman to its knees, as its headlong rush into the subprime mortgage market proved to be a disastrous step.

The Prime Culprit

The company, along with many other financial firms, branched into mortgage-backed securities (MBS) and other collateral debt obligations (CDOs) in 2003 and 2004. With the U.S.

A loans. These were made to borrowers without full documentation.

At first, Lehman's acquisitions 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. [3] The firm securitized $146 billion of mortgages in 2006—a 10% increase from 2005. Lehman reported record profits every year from 2005 to 2007. [4] In 2007, the firm reported net income of a record $4.2 billion on revenues of $19.3 billion. [5]

The Colossal Miscalculation

In Feb. 2007, the stock reached a record $86.18, giving Lehman a market capitalization of close to $60 billion. [5] But by the first quarter of 2007, cracks in the U.S. housing market were already becoming apparent. Defaults on subprime mortgages began to rise 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. [6]

In the company's post-earnings conference call, Lehman's chief financial officer said the risks posed by rising home delinquencies were well contained and would have little impact on the firm's earnings. He also said he did not foresee problems in the subprime market spreading to the rest of the housing market or hurting the U.S. economy. [7]

The Beginning of the End

Lehman's stock fell sharply as the credit crisis erupted in August 2007 with the failure of two Bear Stearns hedge funds. During that month, the company eliminated 1,200 mortgage-related jobs and shut down its BNC unit. [5] 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. [5]

portfolio made it highly susceptible to the deteriorating market conditions. On March 17, 2008, due to concerns that Lehman would be the next Wall Street firm to fail following Bear Stearns' near-collapse, its shares plummeted nearly 48%. [8]

By April, after an issue of preferred stock—which was convertible into Lehman shares at a 32% premium to its concurrent price—yielded $4 billion, confidence in the firm returned somewhat. [8] However, the stock resumed its decline as hedge fund managers began to question the valuation of Lehman's mortgage portfolio.

On June 7, Lehman announced a second-quarter loss of $2.8 billion, its first loss since it was spun off by American Express, and reported that it raised another $6 billion from investors by June 12. [5] [9] According to David P. Belmont, "The firm also said it boosted its liquidity pool to an estimated $45 billion, decreased gross assets by $147 billion, reduced its exposure to residential and commercial mortgages by 20%, and cut down leverage from a factor of 32 to about 25." [8]

Too Little, Too Late

These measures were perceived as being too little, too late. Over the summer, Lehman's management made unsuccessful overtures to a number of potential partners. The stock plunged 77% in the first week of Sept. 2008, amid plummeting equity markets worldwide, as the Korea Development Bank would take a stake in Lehman were dashed on Sept. 9, as the state-owned South Korean bank put talks on hold.[11]

The devastating news lead to a 45% drop in Lehman's stock, along with the firm's debt suffering a 66% increase in credit-default swaps (CDS).[11] Hedge fund clients began abandoning the company, with short-term creditors following suit. Lehman's fragile financial position was best emphasized by the pitiful results of its Sept. 10 fiscal third-quarter report. [8]

Facing a $3.9 billion loss, which included a $5.6 billion write-down, the firm announced an extensive strategic corporate restructuring effort. Moody's Investor Service also announced that it was reviewing Lehman's credit ratings, and it found that the only way for Lehman to avoid a rating downgrade would be to sell a majority stake to a strategic partner. By Sept. 11, the stock had suffered another massive plunge (42%) due to these developments.[8]

With only $1 billion left in cash by the end of that week, Lehman was quickly running out of time.[3] Over the weekend of Sept. 13, Lehman, Barclays PLC, and Bank of America (BAC) made a last-ditch effort to facilitate a takeover of the former, but they were ultimately unsuccessful.[8] On Monday, Sept. 15, Lehman declared bankruptcy, resulting in the stock plunging 93% from its previous close on Sept. 12.[3]

> **Important:** Lehman stock plunged 93% between the close of trading on Sept. 12, 2008, and the day it declared bankruptcy.

Where are They Now?

You're probably wondering where some of Lehman's key figures are now. Former chairman and CEO Richard Fuld now runs Matrix Private Capital Group, a firm he founded in 2016 after the collapse of Lehman. The firm is an asset management firm that services high-net worth individuals. Fuld sold an apartment in New York City, as well as a collection of art he owned. He is still fairly critical of the U.S. government for not bailing out Lehman Brothers like it did with the other banks. At the time, officials said the bank was much weaker than its peers and that the government was unable to find a buyer for Lehman.

Erin Callan Montella was in her early 40s when she assumed the role of chief financial officer (CFO) of Lehman. She resigned from the bank in June 2008 shortly after it reported its second-quarter loss. She did a short stint at Credit Suisse working with hedge funds. She from business.

The Bottom Line

Lehman's collapse roiled global financial markets for weeks, given the size of the company and its status as a major player in the U.S. and internationally. Many questioned the U.S. government's decision to let Lehman fail, compared with its tacit support for Bear Stearns, which was acquired by JPMorgan Chase (JPM) in March 2008.[12] Lehman's bankruptcy led to more than $46 billion of its market value being wiped out. Its collapse also served as the catalyst for the purchase of Merrill Lynch by Bank of America in an emergency deal that was also announced on Sept. 15.[13] [14]

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