THE FAILURE OF LEHMAN BROTHERS: WHAT WENT WRONG

by

Victoria Bishop

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Victoria Bishop

Greenville, NC

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Approved by:

Matthew Walker

Finance Department, College of Business

Introduction

What happened? That is what many people were left thinking after September 15, 2008 when Lehman Brothers filed for bankruptcy and shut their doors forever. This event single handily changed the look of the financial industry. Prior to 2008 the biggest 5 investment banks, from biggest to smallest, was Goldman Sachs, JPMorgan Chase, Merrill Lynch, Lehman Brothers, and Bear Sterns. Everything was going great for Wall Street, money was pouring in with no end in sight and the market was only going up. That was until some of those investments that Wall Street was involved in started to fall apart. This led to Bear Sterns collapsing, and that were bought out by JPMorgan Chase, and the eventual demise of Lehman Brothers.

Unfortunately, there are no clear-cut answers to what happened to Lehman Brothers to lead to their undoing. There were a lot of factors that played a role into their failure, from both inside the company and outside of the company. A big factor inside the company was the management team, they loved to take risk, spend lots of money, even if they did not have any, and who failed to listen to the experts in their firm who were begging them to change directions before the company went under. There was also everything going on around Wall Street, which included selling risky mortgagees in the form of Mortgage Backed Securities, the interconnectivity of Wall Street, when something major happens to one of the big firms all of the firms can feel the effects, and in the end there was the decision by both The U.S. Treasury and The Federal Reserve Bank to not provide a bailout in any form.

Even though the focus of this paper is on Lehman Brothers and what led to their bankruptcy, other organization involved in Wall Street will have to be examined in some degree because of the interconnectivity on Wall Street. There is no way to complete isolate Lehman Brothers from all other organizations and not get a completer picture of what happened to them. Some of the players that were involved in their collapse included The Federal Reserve Bank, more specifically the New York Branch, The U.S. Treasury, Bear Sterns, as well as the other companies that showed interest in buying them out but chose not to do so. The actions of CEO Dick Fuld, President Joe Gregory, and other top Lehman Executives also need to be examined to see what steps they could have taken to avoid the collapse of the company.

This paper aims at answering the question what happened to Lehman Brothers, through finding out what steps the leadership was taking or not taking, what role other companies played in the collapse, and trying to see if there was in fact something that could have been done to save the company. Understanding these events and steps that could have been taken to save them can help prevent another major collapse of that scale from happening again.

Setting the Stage

On September 16, 2008 there were many investors who were left not knowing what just happened. One of the biggest investment banks on Wall Street, Lehman Brothers, had filed for bankruptcy sending shock waves throughout the world. This would lead to one of the worst recessions since the Great Depression later known as the Great Recession or the Great Panic. The whole financial system would be turned upside down and on the verge of collapse. How in the world did the financial system end up in this position of complete failure?

Alan Greenspan. Wildly successful during his time as Chairman of The Federal Resave, "The United States had been in recession for only 16 months in Greenspan's 211-month tenure" (Wessel, 2009). Greenspan had become nothing short of a rock star, through numerous turbulent times, Greenspan was always somehow able to keep the economy on track and moving in the right direction (Wessel, 2009). However, for his successor Ben Bernanke times would not prove to be much more difficult and turbulent. The Great Panic of 2008 would rear its ugly head and the economy would be more off track that it had been in a long time. While many praise Greenspan for his prosperous time in the economy there are several moves that The Fed took while he was in office that would ultimately set-up 2008.

Interest rates. One of the biggest and most used tools that The Fed has in its pocket to influence the economy. Greenspan would use this tool after the attack on 9/11, interest rates would be dropped to a low to help the economy keep from collapsing in the wake of the tragedy. Interest rates would not rise until 2004, and even then the rise in interest rates would be slow and steady with little movement in the rate with each hike. Low interest rates means cheap credit, and cheap credit means there is going to be an abundance of credit since a lot of people can afford the credit. Investors would take risk like there was no tomorrow and spend money like there was no end to the supply. This all would come to a crashing stop in 2008 when credit started to become scarcer. Overnight credit would dry up, and because people were depending on that credit to do basic functions the economy would also come crashing down. (Wessel, 2009).

Irrational market. There were many times that the market during this time started to act irrationally, which led to trouble in the markets because no one knew how they were supposed to respond. Later in this paper I will discuss one of the employees that actually left Lehman Brothers because she was unable to do her job successfully since nothing in the market was acting the way that it should. There were also some irrational or unwise decisions that were made by the company that led it to trouble. There were signs of trouble in businesses and in the market but everyone chose to ignore the signs because they just wanted to see the market go up. All of these problems came together to create the perfect storm to bring down a bog company like Lehman Brothers, even when there were people trying to bring attention to the signs that Lehman could be in danger.

Voices of Reason in an Unreasonable Time

Prior to the crash in 2008 there were multiple people that could sense the tide turning for the worst, even when the rest of Wall Street could not. Some of these people were a part of Lehman Brothers, they included Christie Daley and Mike Gebland to name a couple of the employees. Despite their best efforts their pleas to change the direction of Lehman Brothers to prepare for the worst fell on death ears. The management at the top refused to listen to them because they were focused on making Lehman Brothers big no matter what the risk was.

One of the people to speak up early on was Christine Daley, Head of Distress debt research. According to McDonald she was the best in the business. Through tedious research Daley could determine whether a company was getting ready to go big or go bust and then decide when and how to buy bonds for a company. She was successful during her years at Lehman Brothers, she made lots of money for the company, but most importantly she earned the respect of her colleagues. Some of Daley's biggest victories for the company included GM and Delta, she was able to spot the trouble with those companies early on and was able to capitalize on the opportunities and make millions of dollars for Lehman Brothers. These of course are just a few of the successful deals that Daley made during her time. As mentioned before Daley had earned the respect of her co-workers, many, including McDonald, would come to her for advice when they were making trades and would listen to every bit of her advice because she had a track record that showed that she knew what she was talking about.

However, the tides turned against her in 2007. Christine Daley was busy doing what she did best, researching companies, determining which companies were headed to bankruptcy and suggest short positions for the company. Even though businesses had all the signs of bankruptcy businesses during this time simply were not going under. The market was not acting rationally, everything was headed up, up, up when signs showed it should be going down, down, down. This proved challenging for Daley because her short positions would go bust leading to losses in the business. After going through this for a time Christine Daley decided it was time for her to leaver her position at Lehman Brothers, there was nothing that she could do because of the market was simply defying gravity and there was no accurate way for Daley to predict what bond prices for companies were going to do. She could sense that a storm was coming and she decided to jump ship before everything started to blow up when the market decided to come back to reality. Christine Daley could see the trouble brewing in the real estate market, there were companies that showed signs of going under. Daley was one of the few people that could see a problem in the real estate market coming before others could see it.

Mike Gelbland was another voice of reason at Lehman Brothers during this unreasonable period. Mike Gelbland was the Head of Fixed Income at Lehman Brothers in 2007. One of the major concerns that he had was the amount of money that Lehman brothers was spending, as well as the way that they were spending it. Lehman Brothers for the most part was taking high risk high return investments, mainly focused in the real estate industry. Gelbland was concerned with the high risk because if anything went wrong with the investments that Lehman Brothers had there was going to be a huge loss, especially since Lehman was leveraged somewhere

around 32 to 1. Gelbalnd was so concerned with the exposure that the company had to loss that he took his concerns to CEO Dick Fuld. Fuld would not listen to the concerns that Gelbalnd presented because that meant taking safer bets which shirt run meant less money for the company. Fuld despite hearing these concerns decided to keep the company on the same track and continue to spend lots of money.

Mike Gelbalnd had strong convictions that Lehman Brothers needed to change the directions of spending to prevent it from going under if the economy took a turn for the worst. Despite Gelbland's best efforts Fuld would not listen to him at all, even though Gelbland went to Fuld repeatedly to try to change Fuld's mind. In fact, CEO Dick Fuld and President Joe Gregory was bully Mike Gelbalnd into complying with the direction that they wanted to take the company in. Even though Gelbland was on the leading experts in his field of investments Fuld and Gregory would not budge on their sending habits even though they were in no way experts in this field.

After having his concerns fall on deaf ears and being bullied, Gelbland decided that it was time for him to leave the company. He decided that it would be better for him to leave then to go back on his beliefs and follow what Gregory and Fuld wanted him to do. So in May of 2007 Mike Gelbland left Lehman Brothers with his head held high and his convictions intact. This was yet another example how a voice of reason ended up leaving the firm. It seemed that the way that the upper management was being run there was no hope for the firm. As with anything everything starts from the top, including the CEO of Lehman Brothers at the time Richard Fuld.

Leading the Company Straight to the Bottom

In Larry McDonald's book, *A Colossal Failure of Common Sense,* McDonald points out that the day that Dick Fuld started at Lehman Brothers was the day that the last founder retired and that could become known as the day that Lehman Brothers would die. Eventually Fuld would lead the company to their bankruptcy in 2008. There are many decisions that Fuld would make during his time as CEO that would lead Lehman Brothers to troubles and then once there Fuld would not listen to others to help them recover. Fuld was also stubborn which would prove to drive people away who could have helped save his company. Fuld would also proved to focus on having the largest company no matter what risk was involved. Instead of having a smaller stronger company Fuld would lead the company to become bigger but also more exposed to the dangers of economic downturns and would have no way of hedging the risk. There was no plan B or safety net for the company, Fuld would go for it and not consider the dangers or problems that could come along with his plan.

As mentioned before there were multiple employees who tried to help the company get out of trouble by offering advice on what the company should do to avoid potential downfalls. There were many deals that Lehman Brothers was making that were risky, which is what lead then to a ratio "in the late winter of 2007 [of] thirty-four to one and rising" (McDonald, 2009), and Fuld never looked to lower the leverage rate instead most of what he wanted to focus on would lead to an increased in the leveraged ratio. There was no end in sight for the amount of leverage that Lehman Brothers would take on, it would keep rising and rising until the day that they went bankrupt. A majority of the transactions that Lehman Brothers dealt with, in some fashion, real estate, some of the forms included Mortgage Backed Securities, buying real estate, and many other financial tools that Wall Street would come up with to make more money in the real estate market. When asked about diversifying investments top leadership said they did diversify between commercial and residential real estate. They did not see a need to do anymore 'diversification' since prices in the real estate market would only go up, prices going down was a completely absurd thought that there was no way that anything like that would happen. This led some employees and investors to have concerns that if the real estate market went bust there would be no room for error and Lehman Brothers would be in trouble since they were on the hook for a lot of money and they did not have a whole lot of cash on hand at this point. (McDonald, 2009)

Who you surround yourself with in life is one of the life lessons that many are taught. The people that Dick Fuld decided to surround himself with reflected the bad decisions that he would make time and time again leading to the demise of the company. One of ways that Dick Fuld showed that he was selective about who he let in in was his actions that kept people at arm's length away from him. According to Larry McDonald, Dick Fuld would hide away on the 31st floor, he had his private elevator that would take him straight to that floor without running into anyone. Fuld was also known for going out of his way to not interact with employees in the company. As mentioned before he did not even go and congratulate the employee that set the record for the single day trading profit. There was also little interaction between him and other upper managers. The only person that he was known to keep close to him was the President Joe

Gregory, there are some theories as to why this was the case. He was also know to have Lehman set up like his kingdom, where he would have people close to him that would rubber stamp whatever he told them to (McDonald, 2009). There was also the case of the CFO that Fuld hired in the last year of the company. The lady that he hired had no experience that would suggest that she would be a good fit for the position. There were in fact many who were confused by the choice, the thought was they would need someone highly qualified to help steer the company during these challenging time. However, whatever her name is was chosen and many thought that she was chosen because of her looks and that she could better communicate with people outside the company. She did not stay in the position long, when some of the employees stood up to fight Fuld she was one of the people who got forced out of their position. (McDonald, 2009)

To fully understand Dick Fuld and his actions there needs to be an understanding of how he came to be the CEO. Dick Fuld started out as a commercial paper trader and worked his way up the chain till he was a bond trader in a strong bull market (McDonald, 2009). Fuld was taken under the wing of Lewis Glucksman, who had been promoted to co-CEO and managed to push out the other CEO in a manner of only eight weeks, (McDonald, 2009). Glucksman would then bring up Dick Fuld to the board, which would set the stage for the new era of Lehman Brothers, one where "swashbuckling, rough-edged traders took over from the traditional sure-footed bankers: (McDonald, 2009). During their era, Glucksman and Fuld went through the lucrative years of 1982 and '83. The profits those years would go towards numerous projects and bonuses and none of it would be saved as a 'rainy day fund'. Turbulent waters would come up for the investment bank following these two years, which would ultimately lead to demise of the Glucksman/Fuld era and lead to the next. The next era would be started off with Shearson buying the firm, there had been many difficulties that Lehman Brothers had been through but they could not make it through the leadership of Glucksman and Fuld. (McDonald, 2009)

That, however, was not the end of Lehman Brother, they would make their comeback in 1994 when Lehman Brothers was spun off again on its own. During this time Glucksman and Fuld were able to keep the Lehman Brothers identity alive, and Fuld would grab ahold of the CEO position when the spin off was made (McDonald, 2009). Some employees in Lehman Brothers believed that is was the playing out of these events that led Dick Fuld to become very cautious, shrinking his inner circle to the bare minimum to protect himself, he did not want someone to force him out the way that his mentor, Glucksman, forced out his Co-CEO. However, because of his cold distance demeanor there were many employees that he alienated in the process, they believed that he did not care about them or the opinion that they had about the direction that Lehman Brothers was going in. Employees felt like their voices were not listened to, that no matter what they said, even in their expert opinion, Dick Fuld, and his rubber stampers, would do whatever they wanted to do anyway. Employees would end up leaving the company because of the way that Fuld ran Lehman Brothers before their failure in 2008.

Even during a time of trials Dick Fuld would not open himself up to others outside of his inner circle for help. Many employees were passionate about the company and wanted to help save Lehman before it was too late, they would try in different ways to get their voices heard.

On multiple occasions employees would suggest for Lehman Brothers to stop spending money and reduce the leverage of the company and therefore reducing the risk that the company was taking on. Dick Fuld wanted to make Lehman Brothers the biggest investment bank on Wall Street, which to him meant he needed to spend money and lots of it. Lehman bought up risky investments left and right trying to expand their balance sheet and in the process was increasing the leverage of the company. Due to the need for Dick Fuld to be the biggest investment bank there was a lot of prideful decisions made that were questionable to say the least. One of the biggest moves that he was that showed this was buying back stock in a time where Lehman Brothers was in search for cash. Prior to this Bear Sterns had recently undergone a takeover, which led to fears that Lehman Brothers would be the next to go under. Since the heat moved over to Lehman Brothers the stock had slowly declined in price and Fuld thought that was ridiculous and decided to buy back stock to try to raise the price of the stock. The decision by Fuld to buy back Lehman Brother shares at $75 was met with lots of disapproval from all around him, (McDonald, 2009). Fuld also attacked people who shorted the company and tried several times to make it impossible for investors to short Lehman Brothers. Fuld felt that the shorting of the company was what was driving the price down and he wanted it to stop. He did not see anything wrong with Lehman Brothers internally to him the problems that the they were facing were all from the outside. So instead of focusing on fixing the company from the inside Fuld wanted to blame the problems on those outside of the company and he wanted to make all of them stop.

During their time of trying to raise cash for the company there were several deals that were almost reached when Fuld was not in the picture and as soon as he entered the picture the deal would fall apart. In *Too Big to Fail*, there is discussion of the deal that almost came to be with an investment group that was from Korea. There was a preliminary deal that was reached for the group to put cash in the company for some equity in the country. This plan was set to go through until CEO Dick Fuld came into the picture. He shared that he did not think that the amount of equity that the investment group wanted was too much for cash that they wanted to invest. Fuld would then try to get more money from the investment group and in the end would chase them off. There was also preliminary talks with Bank of America that fell through when Fuld came in. Additionally, there was talk with the British company, Barclays, who would end up getting part of the broken company after Lehman Brothers declared bankruptcy. In all of these failed deals there was one common factor, Dick Fuld and his overvaluation of Lehman Brothers. Fuld would always value his company more than what others around him was valuing the company at, and his unwillingness to move on the valuation led to failed deals and alienation from those who could save him. Dick Fuld's pride would ultimately help him lead his company to bankruptcy, it would get in his way to make deals with people to get cash into the company and save it from going under.

Dick Fuld had the opportunity over and over again to save Lehman Brothers, but time and time again Fuld would make decisions that helped lead the company straight to the bottom. There was pride that got in the way. Fuld wanted to be the biggest investment bank on Wall Street, which would lead the company to making questionable decisions and putting their balance sheet in a place that was exposed to any fall in the real estate market. Fuld would also

overvalue Lehman Brothers, which made it harder for the company to get cash in a time where they really needed to raise cash. He also made moves to show the power of Lehman Brothers even when that was not the best choice. The biggest example of this is the buyback of stocks, in a time that Lehman Brothers was starved for cash they used cash instead of raising cash. The list could go on for the decisions that Dick Fuld made during his time as CEO, especially during the final days, that led Lehman Brothers straight to the bottom and ultimately to bankruptcy.

The Federal Reserve and The Treasury Response

Two of the institutions that have been put into place over the years to help keep the American economy going along as smoothly as possible. While each of these institutions have their own distinct roles, during The Great Panic of 2008 they spent a lot time making decisions together over the state of the economy during that period. There were specifically three people from these two institutions that made most of the decisions during the turbulent times of late 2008. There was Ben Bernanke, who was the Chairman of the Federal Reserve at the time, before that he was professor at Princeton where he studied The Great Depression. His study in The Great Depression would prove valuable in the times of The Great Panic, avoiding the mistakes that were made during The Great Depression by a number of government agencies. There was also Timothy Geithner, President of the New York Federal Reserve, he would have much to say as many in the world of Wall Street were familiar with him. There was also the Secretary of the Treasury Henry Paulson, former CEO of Goldman Sachs. Paulson of course had the experience on Wall Street working as CEO for one of the biggest investment banks. These three came together time and time again to solve problems that would come along the way during this financial panic and take unprecedented actions to keep the financial system from going over the cliff completely.

Ben Bernanke was named Chairman of The Fed in October of 2005, prior to that he was a professor at Stanford, tenure at Princeton (and eventually the Economic Department Chair), on the Federal Open Market Committee (FOMC) and an advisor to President George W. Bush (Wessel, 2009). Bernanke grew up in a small town in South Carolina and would work his way to Harvard, where he earned his bachelor's in economics, MIT where he received his master's and of course eventually to Washington D.C. Bernanke would prove to be the opposite of the his predecessor at that The Fed, while Alan Greenspan was huge personality and had a celebrity status of sorts, Bernanke was the opposite. He did not want that celebrity status.

Time and time again there were many actions that The Federal Reserve and The Treasury took that had never been taken before. In times of distress The Fed had always been able to take 'normal' actions to keep the economy on track such as raising or lowering interest rates, however, 2008 proved to necessitate more drastic action that had never been seen before. According to David Wessel's book *In Fed We Trust,* the fed was the first responder to the financial crisis and the steps, all within one week, they took included:

- "married venerable brokerage house Merrill Lynch and Bank of America
- All but nationalized AIG, pumping in $85 billion of Fed money to keep it alive
- Risked taxpayer money to halt a run on money market mutual funds no one ever considered guaranteed by the government"

and so many more steps. These actions barely scratch the surface of what they did to keep the financial markets from completely melting down. One of the most surprising moves to some during all of the panic in September of 2008 was the decision to let Lehman Brothers fail and go into bankruptcy. Some of these actions had never been taken by The Fed before and the wait and see game would have to play out to see the ultimate outcome of these actions.

Prior the failure of Lehman Brothers the Federal Reserve had helped backstop a deal to assist with the takeover of Bear Sterns, an investment bank that was on Wall Street that found themselves facing bankruptcy. After this deal went through in early 2008 the pressure moved to Lehman Brothers, there was a lot of talk about whether or not they would end up being the next investment bank would go down. Talk like this would even continue after Lehman Brothers went bankruptcy, the focus would move to the next investment bank, which would cause concern when leaders were trying to decide how to respond to troubled businesses on Wall Street. Wessel also points out that The Federal Reserve and other agencies came under fire for the steps that they took in response to Lehman Brothers, "as the crisis accelerated, the Fed came under fire from all sides – accused of being overly generous to Wall Street by helping JPMorgan Chase buy Bear Sterns, overly punitive in its terms for lending to AIG, and overly complacent for letting Lehman Brothers" (2009). There were so many different moving elements and players that it was impossible for The Fed or the Treasury to make everyone happy.

Lehman Brothers was in a position similar to the position that Bear Sterns had been in just months earlier. As mentioned above The Fed had help broker a deal between Bear Sterns and JPMorgan Chase, which would save the assets of the company. Some say that Bear Sterns had an advantage because they failed first, before Lehman Brothers. Of course because The Fed took part in this deal that set the precedent that they would continue to take actions like that. Lehman Brothers was a different story, despite companies such as Barclays coming to The Fed saying that they would buy Lehman Brothers if the deal was backstopped. The Fed had made up its mind that it was not going to help Lehman Brothers in any way no matter what idea was brought to The Fed. Lehman Brothers was going to left to figure out how to solve their problems on their own. There were deals that were held out because those involved assumed that The Fed would come in during the eleventh hour to save Lehman Brothers, which of course never happened.

Ben Bernanke and others would spend countless hours making countless decisions that would make countless people upset. There were tough decisions that had to be made with little to no information on how the outcome of that decision would play out in the real world. There were many decisions made curing the crisis and any number of them could have been the right one or the wrong one. In the end Bernanke did the best that he could with the information that he had at the time when the crisis was unfolding.

Conclusion

In the end there were a lot of questionable decisions that Lehman Brothers made. However, there were factors that were outside of their control that helped lead to their demise. Despite the best efforts of lower level employees there was nothing that could be done to save the institution. The CEO decided to take an aggressive path because it had worked in the past and there was no reason for them to change the path that they were going down before. It had worked time and time again before why would it not work this time. Also, as the CEO of nay company a too conservative path can also mean your demise because the company is not making as much money as it should, but when a risky path is taken there still needs to be some hedge against the risk. In this case something as simple as diversifying the company's portfolio to diversify some of the risk away.

Some of the problem was the tools that were being used to invest, no one truly understood these instruments and the risk that they carried. This included those who were using them to invest. There were many things that that company did that could have been done different to possibly save the company. One of the biggest was listen to those who were trying to raise the warning flags.

The market was also setup to bring the company down. With record low interest rates there was a credit bubble that was destined to buildup and burst and bring the economy down with it. The response that the Federal Reserve had was the best response that they could have at the time. The best thing that we can do with what has happened is look at what happened and take away the lessons that we should have learned. Such as trying to limit a credit bubble, not just give everyone a mortgage. However, it seems as people still haven't learned from that crisis as there are some signs of similar trouble happening now.

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