Lehman Brothers

Introduction

Lehman Brothers existed as a firm, in one form or another, for 158 years. On September 15, 2008 its bankruptcy filing was the largest in U.S. history. Regulations applied to financial services institutions made it impossible to enter bankruptcy and reorganize. Almost immediately, the firm’s assets began to be sold off to a variety of firms, with Barclay’s Bank being predominant among the buyers.

Lehman was founded to service the cotton trade in Alabama—first with supplies and then as a commodities broker buying and selling cotton. It opened a New York office in 1858 and became a major force in the financing of the building of the railroads. Over the years, it continued to focus on emerging industries such as retailing, entertainment, and computing.

In 1984, American Express acquired Lehman Brothers. A decade later, it spun off Lehman Brothers through an initial public offering of stock.

Exhibit 1 is a page from the 2006 Annual Report of Lehman showing the “twentyfold” increase in share price from $3.72 in 1994 to $73.67 in 2006. That year, the firm reported record revenues at $17.6 billion (up 20% in the last year) and record net income at $4 B (up 23% in the last year.) In the text at the bottom of the graph of Exhibit 1 the firm states its “operating principles,” including “smart risk management.”

What happened?

The Financial Crisis and Market for Loans

One of Lehman’s major businesses was Capital Markets. In the same way it brought innovation to the raising of capital for the railroads, Lehman was a leader in the commercial and consumer mortgage business. For example, the 2006 Annual Report noted “as a mortgage lender in Japan, in 2006 we completed the first Japan securitization of non-conforming mortgage loans.”

This single sentence gives a hint of the major shifts which were underway in the mortgage business. Mortgage lending had been a pretty simple business involving local lenders and home buyers. Banks took money from depositors and lent that money to home buyers, keeping that mortgage “on its own books”