The Reasons US Financial Secretary Pauson Gave Up Lehman Brothers From the point of the Non-American Investors

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Abstract

This purpose of this article is to find a more logic reason behind the Ex-US financial secretary Paulson's non-rescue of Lehman Brother. Comparing with Bear Stearns, there are more non-American Lehman Brothers bond holders. Since Lehman Brothers held much assets containing US real estate if Lehman Brothers fails, the loss from US real estate will be shared with the Lehman Brother bond holders through the failure of Lehman Brother. This article compares the business allocations between Lehman Brothers and Bear Stearns. We find there are more non-American corporate bond holders than those of Bear Stearns. In such case, we conclude Paulson intentionally share the loss of US real estate with the investors outside American through the failure of Lehman Brothers.

Keywords: Financial Secretary, Lehman Brothers, Bear Stearns, business allocations

1. Introduction

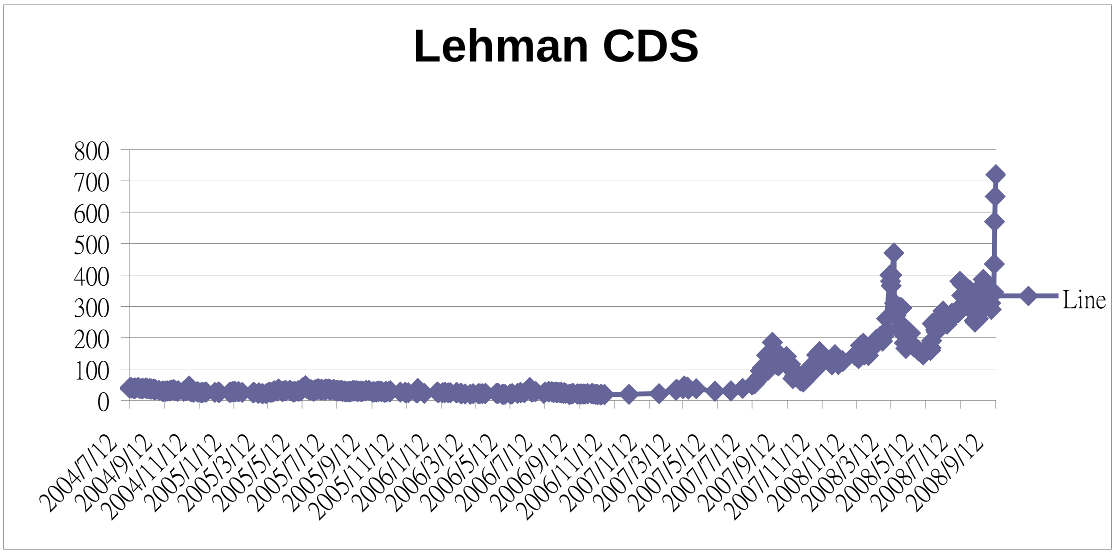
Lehman Brothers Holdings, Inc. filed for chapter 11 bankruptcy protection on September 15,2008. This filing marked the biggest bankruptcy in US history. From that day on, the Sub-prime crisis has transformed into the Financial Tsunami. A few chain reactions occurred after Lehman Brother's failure. These reactions included US government's 700 Billion funds to help the distressed financial organizations, the British government's strong support of banks (For example :it owned more than 40% of Lioyds bank) , the bankruptcy of General Motors corporation and so on. One important matter was that people started to lose confidence in banking industry. As we recalled, a similar situation happened six months ago. The Bear Stearns Companies, Inc. Like Lehman Brothers Holdings, Inc. was one of the largest global investment banks. Unlike Lehman Brothers Holding, Inc. Bear Stearns was acquired by JP

Morgan Chase in March 16,2008 at $10 for a share. This merger of JP Morgan Chase and Bear Stearns Companies, Inc. benefited the bond holders of Bear Stearns. Their bond were replaced by a better rating organization. Why did two similar banks had totally different fate? This article will discuss the possible reasons why Ex US Treasury Secretary Henry Paulson Jr stood aside while Lehman Brothers was in danger.

Unlike commercial banks, the investment banks do not take deposit from the individuals. Their funding source are issuing banking bonds to the investors. This made the existence of the investment banks has nothing to do with the general people but only with the bond investors. The related parties are: counterpart banks, bond holders, and shareholders. This article thinks bondholders are the most effected parties by the bankruptcy of the investment bank. The counter parties can easily swap their trading position with Lehman Brothers or Bear Stearns through Credit Default Swap [1](CDS). The shareholders can also easily converted their share into cash through the liquidate stock market.

The CDS of Lehman Brothers went to the top before it filed chapter11 (Fig1). The CDS was about 200 basic points on March12, 2008 which is lower than that of Bear Stearns (Fig 2). The credit market gave Lehman Brothers higher credit. But the results were quite different. Bear Stearns CDS went to the top before it was acquired by JP Morgan.

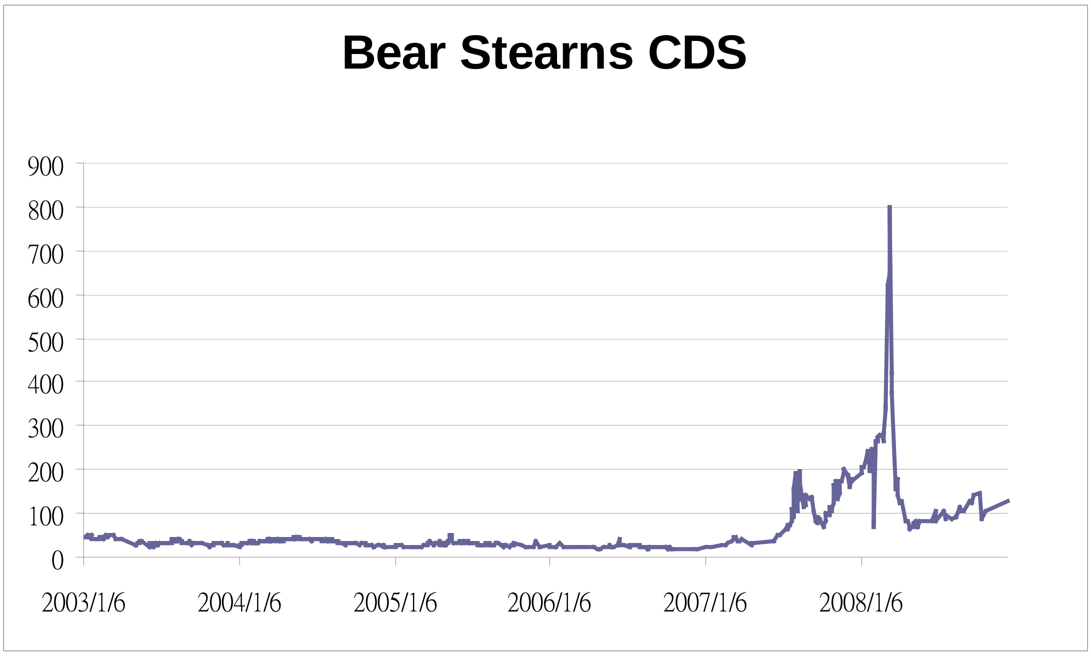
Figure 1 Lehman Brothers CDS



Source: Bloomberg

[1] Credit default swaps (CDS) are financial instruments intended to provide risk insurance to banks and bondholders in case a particular bond or security goes into default. Their purpose is to make it easier for banks to issue complex debt securities by reducing the risk to purchasers. They were invented by Wall Street in the late 1990's.

Figure 2 Bear Stearns CDS



Source: Bloomberg

2. Bear Stearns

The Bear Stearns Companies, Inc. was the fifth investment banks in US and securities trading and brokerage firms prior to its sudden collapse and sale to JP Morgan Chase in March 2008.

Bear Stearns was founded in 1923 and became public traded in 1985. Before its merger with JP Morgan, the company's business included corporate finance, mergers and acquisitions, institutional equities, fixed income sales, trading, research, private client services, derivatives, foreign exchange, future, asset management and custody services and so on.

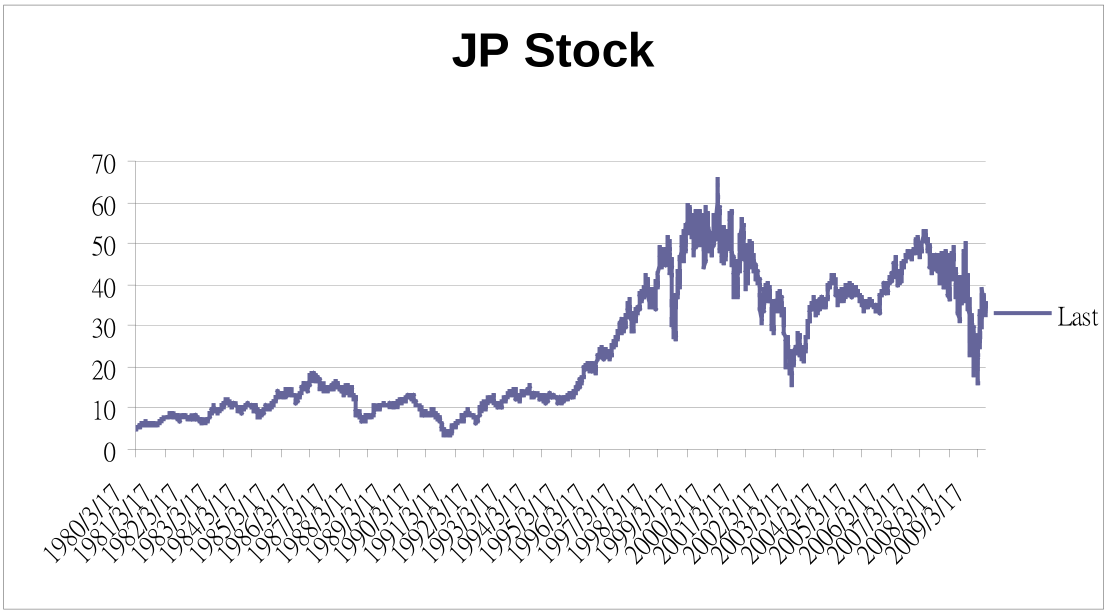
Bear Stearns was the first international investment bank which got into subprime trouble. The Sub-prime Crisis was brought by the collapse of its two funds: The Bear Stearns High-Grade Structured Credit Fund and The Bear Stearns High-Grade Structured Credit Enhanced Leverage Fund. These two funds were invested in the Collateralized Debt Obligation[2] (CDO) which were high credit rated but illiquid at the market. These funds made their profits by pledging the CDO to other banks for short term funds. For example, with higher yield (Libor+100-150bp) from the CDO and low fund cost at short term (Libor+20bp), these funds can easily accumulated the extra profit margin for their investors with leverage effect. Since February 2007, the

[2] An investment-grade security backed by a pool of bonds, loans and other assets. CDOs do not specialize in one type of debt but are often non-mortgage loans or bonds.

mortgage delinquency rate has soared and the value of the mortgage related products has dropped a lot over the concern of deteriorated credit. Bear Stearns originally only put about $35 million at the funds under its own management, the deteriorated value of the funds had only small impact on the Company. The CEO James Cayne and other executives were afraid the collapse of the funds will has effects on the reputation of Bear Stearns. On June 22, 2007, Bear Stearns pledged a $3.2 billion collateralized loan to bail out the Bear Stearns High-Grade Structured Credit Fund. When market went down again, the loaning counterparty banks inspect the value of their mortgage related collateral and they found these pledged CDO worth far less than the mark-to-market value ,especially rumored has it, the Bear Stearns might have to liquidate all its underling assets-CDO. The expectation made another big mark-down of the similar assets in other portfolios which almost existed in all banks' books. The article thinks this is the fire spot of Sub-prime crisis and it brought down lots of funds and banks from that day on. On November15, 2007 Bear Stearns revealed a 1.2 billion loss in mortgage-related securities and it was its first loss in 83 years. At the same day, Standard & Poor downgraded Bear Stearns long term credit rating from A+ to A; back to its 1993 level but still above investment level.

Alough the credit rating is still above investment grade, yet the faith of Bear Stearns' ability to repay its obligations has diminished among its trading parties, On march 16,2008, JP Morgan Chase merger Bear Stearns for a share at $2. Eight days latter, a new agreement for $10 for a share was reached. This sale price represented a staggering loss as its stock had once traded at $172 a share as late as January 2007, and $93 a share as late as February 2008. The merger was pushed by Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson. To achieve this merger, the Federal Reserve agreed to issue a non-recourse loan of $29 billion to JP Morgan Chase which is about the amount of Bear Stearns' level 3 assets ($28 billion) book value at the end of fiscal 2007. The `non-recourse loan means the loan from the Federal Reserve is collateralized by the Bear Stearns assets and the Federal reserve can not ask J.P. Morgan Chase's to repay the loan if these collaterals' cash flow are insufficient to repay the loan. thereby US government assuming the risk of Bear Stearns's less liquid assets (see Maiden Lane LLC). From the equity price of J.P. Morgan Chase (Fig3), the market did not recognize it was the beneficiary of the merger.

Figure 3.stock price of J.P. Morgan



Source: Bloomberg

3. Lehman Brothers

Lehman Brothers Holding Inc. is an investment-banking firm. It did business in investing banking, equity and fixed-income sale, trading, research, wealth management and private banking. Lehman Brothers was founded in 1850. Its primary business was commodity trading and brokerage business. At Lehman's 150 year history, it became the fourth largest investing bank in US. During the time, Lehman did pass several crises including Asian crisis and the September 11 terrorist attacking but it could not survive itself from the Sub-prime mortgage crisis.

In 2008, Lehman faced a big loss for having held a large portion of assets relating to the sub-prime and commercial real estate. At the second fiscal quarter of 2008, Lehman reported a loss about $2.8 billion and sold $6 billion assets trying to calm down its market to market loss. During that time, market rumored about Lehman's merger with Korea Development Bank or British bank Barclays. All these merger were not successful and the US government did not announce any plan to assist the merge with any possible candidate.

On September 13, 2008, the president of the Federal Reserve Bank of New York called a meeting at New York to decide the fate of Lehman Brothers. At this time, the US government did not give any sign of supporting any merger of Lehman Brothers. On September 15, 2008, Lehman Brothers Holding Inc. filed Chapter11 for bankruptcy protection. It is the largest bankruptcy in US history.

4. The difference between Bear Stearns and Lehman Brothers

After the merger of Bear Stearns, Ben Brake explained the bailout of Bear Stearns' was the bankruptcy would have affected the real economy and could have caused a "chaotic unwinding" of investments across the US markets. If this is the true reasons for the bail out of Bear Stearns , how come it did not apply to Lehman Brothers' failure. This article tried to use the financial number behind two banks to locate a reason to explain why US government stood aside while Lehman Brothers got into trouble. As shown in Table 1 and Table 2, the balance sheet of both banks at 2007.

Table 1 Lehman Brothers balance sheet

LEHMQ US LEHMAN BROTHERS HOLDINGS INC

	11/2007	11/2006		11/2007	11/2006
Cash & near cash	7286.00	5987.00	Total Deposits	90569.00	63107.00
St inv't & sec inv	627106.00	457843.00	ST borrowings	438815.00	338875.00
Net receivables	2650.00	2052.00	Other ST liab	16039.00	14697.00
Total Loans	40627.00	25919.00	LT borrowings	123150.00	67675.00
Loan loss reserve	.00		Other LT liab	.00	
Net loans	40627.00	25919.00	Total Liabilities	668573.00	484354.00
Real estate invest	.00		Preferred equity	1095.00	1095.00
Other LT Inv	.00		Minority interest	.00	
Total LT Inv	40627.00	25919.00	Share cap & APIC	9794.00	8788.00
			Retained earnings	11601.00	9308.00
Net fixed assets	3861.00	3269.00	Shareholder equity	22490.00	19191.00
Other assets	9533.00	8475.00			
Total Assets	691063.00	503545.00	Tot liab & equity	691063.00	503545.00
			Total Debt	561965.00	406550.00
Earning Assets	667733.00	483762.00	Int bearing liab	652534.00	469657.00
# treasury shares	81.00	76.46	Shares out	531.89	533.37
Amt treasury stock	5524.00	4822.00	Assets Under Mgmt	282000.00	225000.00

Source: Bloomberg

Table 2 Bear Stearns balance sheet

2942331QUS BEAR STEARNS COS LLC/THE

	11/2007	11/2006		11/2007	11/2006
Cash & near cash	21406.00	4595.18	Total Deposits	83204.00	72988.66
St inv't & sec inv	276854.00	272982.00	ST borrowings	203405.00	182049.30
Net receivables	785.00	744.54	Other ST liab	2952.00	4018.39
Total Loans	52737.00	35601.15	LT borrowings	58952.00	48085.91
Loan loss reserve	.00	.00	Other LT liab	35056.00	31160.91
Net loans	52737.00	35601.15	Total Liabilities	383569.00	338303.20
Real estate invest	.00	.00	Preferred equity	352.00	359.16
Other LT Inv	.00	.00	Minority interest	.00	.00
Total LT Inv	52737.00	35601.15	Share cap & APIC	5171.00	4763.78
			Retained earnings	6270.00	7006.45
Net fixed assets	605.00	479.64	Shareholder equity	11793.00	12129.38
Other assets	42975.00	36030.07			
Total Assets	395362.00	350432.60	Tot liab & equity	395362.00	350432.60
			Total Debt	262357.00	230135.20
Earning Assets	329591.00	308583.20	Int bearing liab	345561.00	303123.90
# treasury shares	71.81	67.40	Shares out	136.16	145.69
Amt treasury stock	5641.00	4444.55	Assets Under Mgmt	44600.00	52500.00

Source: Bloomberg

(1)From the asset site of balance sheet of the two investment banks, we can concluded as:

(a)The investment banks have more liquidity concerns than commercial banks. Bear Stearns' cash & near cash position was 4,595.18 Million USD at November, 2006 and jumped to 21,406 Million USD at November, 2007. Lehman Brothers only adjust its cash & near cash position from 5,987 Million USD to 7,286 Million USD. The Bear Stearns seemed to have prepared for its liquidity at the crisis and Lehman Brothers' management level did not seem to have doubt liquidity to be its main issue and it just kept the ordinary cash position to meet its liquidity. Maybe that is because the Lehman Brothers' management has faith at their assets quality and did not think it may be the victim of the market.

(b)From the loan size of 2006, 2007, we know the Bear Stearns are larger than that of Lehman Brothers. But the security Lehman held were 627,106 Million USD which were double than that of Bear Stearns. The higher potation of security inventory at its assets maybe the main reason that Paulson decided Lehman Brothers' poor fate. The depreciation of these securities could cause the insufficient of Lehman's capital. This sounds to be a good explanation for Lehman's failure for holding too much and complexity securitization products. But if we take a deeper consideration for Lehman's level 3 assets which did not have to mark to market and were the main toxic assets the stock market really concerned. At 2007, Lehman Brothers held level 3 asset for 41,979 Million USD and Bear Stearns held 28,168 Million USD.

(2) The Level 3 Asset[3] / total equity of Lehman brother is 186.66 and The Level 3 Asset / total equity of Bear Stearns is 238.86. We did not see Lehman has a serious ratio than that of Bear Stearns. In such case, the securitization should not be the main factor here. (See Table 3and Table 4)

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[3] Assets whose fair value cannot be determined by using observable measures, such as market prices or models. Level 3 assets are typically very illiquid, and fair values can only be calculated using estimates or risk-adjusted value ranges. In addition to Level 1 and Level 2 assets (both of which have more accurate fair values), Level 3 assets must be reported on by all publicly traded companies as of 2008.

Table 3 level 1,2,3 Bear Stearns assets' fair valve

Financial Analysis

2942331Q US Equity | FV Overview | Edit | Options | Related Tickers

Period 1 Years Sort Descending Currency USD View Table

Filing Most Recent

		O:11/2007*+			5Y GeoGr
	Fair Value (SFAS 157)				
2)	Level 1 Assets	29467.00			NM
3)	Level 2 Assets	227146.00			NM
4)	Level 3 Assets	28169.00			NM
5)					NM
6)	Level 1 Liabilities	23096.00			NM
7)	Level 2 Liabilities	163436.00			NM
8)	Level 3 Liabilities	4232.00			NM
9)					NM
10)	Level 3 Total Gains	(1725.00)			NM
11)	Lev1 Assets to Tot Eqty	249.87			NM
12)	Lev2 Assets to Tot Eqty	1926.11			NM
13)	Lev3 Assets to Tot Eqty	238.86			NM
14)					NM
15)	Lev1 Assets to Tot As...	7.45			NM
16)	Lev2 Assets to Tot As...	57.45			NM

+Indicates period with As Reported Data links

Source: Bloomberg

Table 4 Lehman brothers level 1,2,3 assets' fair valve

LEHMQ US Equity | FV Overview | Edit | Options | Related Tickers

Period 1 Years Sort Descending Currency USD View Table

Filing Most Recent

		O:11/2007+			5Y GeoGr
	Fair Value (SFAS 157)				
2)	Level 1 Assets	72574.00			NM
3)	Level 2 Assets	176659.00			NM
4)	Level 3 Assets	41979.00			NM
5)	Total FV Assets	291212.00			NM
6)	Level 1 Liabilities	109113.00			NM
7)	Level 2 Liabilities	37409.00			NM
8)	Level 3 Liabilities	3095.00			NM
9)	Total FV Liabilities	149617.00			NM
10)	Level 3 Total Gains	406.00			NM
11)	Lev1 Assets to Tot Eqty	322.69			NM
12)	Lev2 Assets to Tot Eqty	785.50			NM
13)	Lev3 Assets to Tot Eqty	186.66			NM
14)	Tot FV Assets to Tot Eqty	1294.85			NM
15)	Lev1 Assets to Tot As...	10.50			NM
16)	Lev2 Assets to Tot As...	25.56			NM

+Indicates period with As Reported Data links

Source: Bloomberg

From revenue site, Lehman's revenue increased from 17,583 Million to 19,257 Milliom USD. But its revenue from US decreased from 11,116 Million 63.2% (2006) to 9,634 Million 50% (2007). As for Bear Stearns, its main revenue source at 2005 and 206 is at USA above 85% of its total revenue. Alough it dropped a lot at 2007: it is still above 70% which is still bigger than Lehman's 50%.(See Table5 and Table6) From geography point, Lehman diversified its asset portfolio by geography better than Bear Stearns did. This is the main difference between Lehman and Bear Stearns. To conclude, Lehman's failure would be much sophisticated than Bear Stearns did since it has a deep globalization but its loss would not be totally absorbed by US. This article thinks this may be the reason behind Paulson's choice.

Table 5 Bear Stearns

2942331Q US Eq 93) Output To Excel BEAR STEARNS COS

Period 4 Years ○ Value ◉ Value & Percent Cur. USD

Grouped by Measure	11/2007	%	11/2006	%	11/2005	%	11/20
⊟ Net Revenues	5945.00	100.0	9227.16	100.0	7410.79	100.0	68
United States	4219.00	71.0	8006.41	86.8	6487.32	87.5	61
Other	1726.00	29.0	1220.75	13.2	923.47	12.5	6
⊟ Assets	395362.00	100.0	350432.59	100.0	287292.64	100.0	2521
United States	480824.00	79.2	437418.64	82.5	344757.17	83.0	3293
Other	126507.00	20.8	92836.34	17.5	70436.12	17.0	545
Eliminations	-211969.00	N.A.	-179822.39	N.A.	-127900.65	N.A.	-1317

Numbers are in Millions

Source: Bloomberg

Table 6 Lehman Brothers

LEHMQ US Equity 93) Output To Excel LEHMAN BROS HLDG

Period 4 Years ○ Value ◉ Value & Percent Cur. USD

Grouped by Measure	11/2007	%	11/2006	%	11/2005	%	11/20
⊟ Net Revenues	19257.00	100.0	17583.00	100.0	14630.00	100.0	115
United States	9634.00	50.0	11116.00	63.2	9270.00	63.4	82
Europe & Middle East	6296.00	32.7	4536.00	25.8	3601.00	24.6	21
Asia Pacific	3145.00	16.3	1809.00	10.3	1650.00	11.3	12
Other Americas	182.00	0.9	122.00	0.7	109.00	0.7	

Numbers are in Millions

Source: Bloomberg

We also compare the equity and bond holders of both banks, we can hardly find the difference behind it. In such case, this article thinks the equity or bond holder are not a decisive factor for Paulson's decision.

From the liability side, we can see the Lehman issue two times more bond than that of Bear Stearns. Is this the reason behind Paulson's decision? This article does not think this is an accurate reason for debating for the following reasons:

(1) Too big to fail: If "big" is the reason for government's "bail out" From the asset and liability, Lehman is almost double that of Bear Stearns. There should be no reasons for Lehman's "non-bailout".

(2) Some might think it is too big for Lehman's toxic assets. According to Bloomberg news "Barclays asked the same terms JP Morgan had, but the US did not agree." The article thinks the US government one a chance to save the falling Lehman Brothers with limited price. If it chose to did so. The sub-prime crisis could not turn out to be Financial Tsunami.

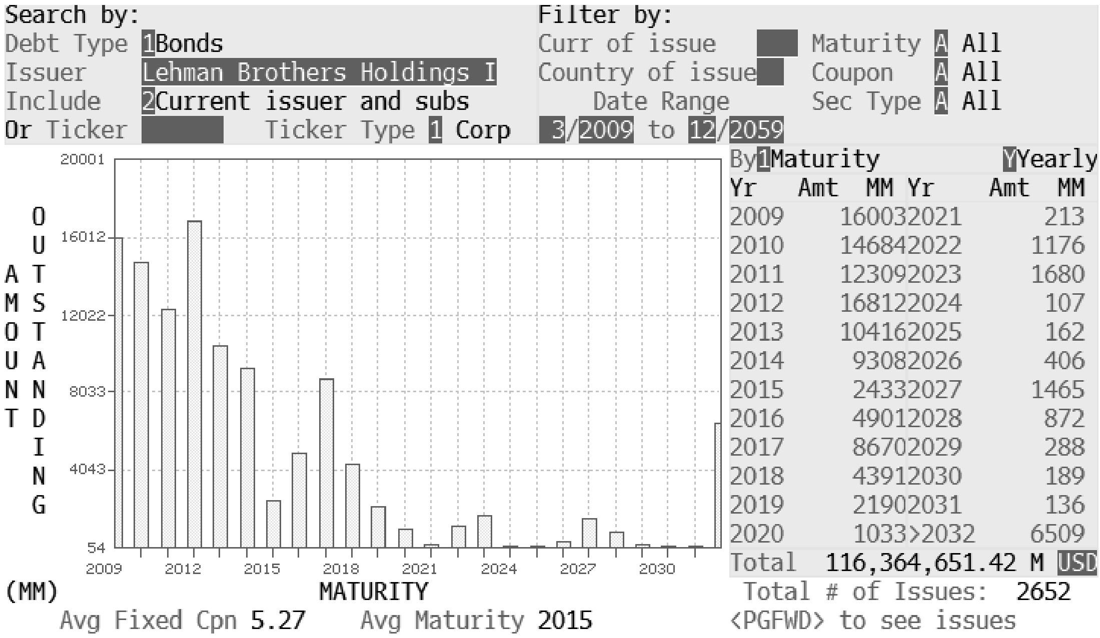
In Minsky[4]'s view, a financial crisis has possibility of debt-deflation process. But the debt-deflation process has not taken place in the United States since the Great Depression. Minsky thinks a big bank and a big government is the two development to keep the economic from debt-deflation process. A "non-bailout" of Lehman may cause it to file chapter 11 and made the debt settlers to settle Lehman's assets at all cost which would cause other banks to sell their assets at even cheaper price to initiate the debt-deflation. All of these would cause damage consequence. Paulson would not risk on Bear Stearns but how come it dares to bat on Lehman Brothers? Unless the consequence is not bad for US.

5. **Banking bond issuance**

This article thinks the reasons for Lehman Brothers "non bail-out" is because its advanced globalization. From the debt distribution of both banks, Lehman's non-US debt issuance is far bigger than that of Bear Stearns (See Fig 4 and Fig 5). These non-US issuance focus on three nations (See Fig6, Fig7 and Fig8); Netherlands (5,167 Million USD), England (4,4Million USD) and German (71 Million USD). There is no fully list of the nationality of these bond holders. But the Taiwan and Hong Kong's Lehman Brothers bond investors' held the bonds issued at Netherlands.

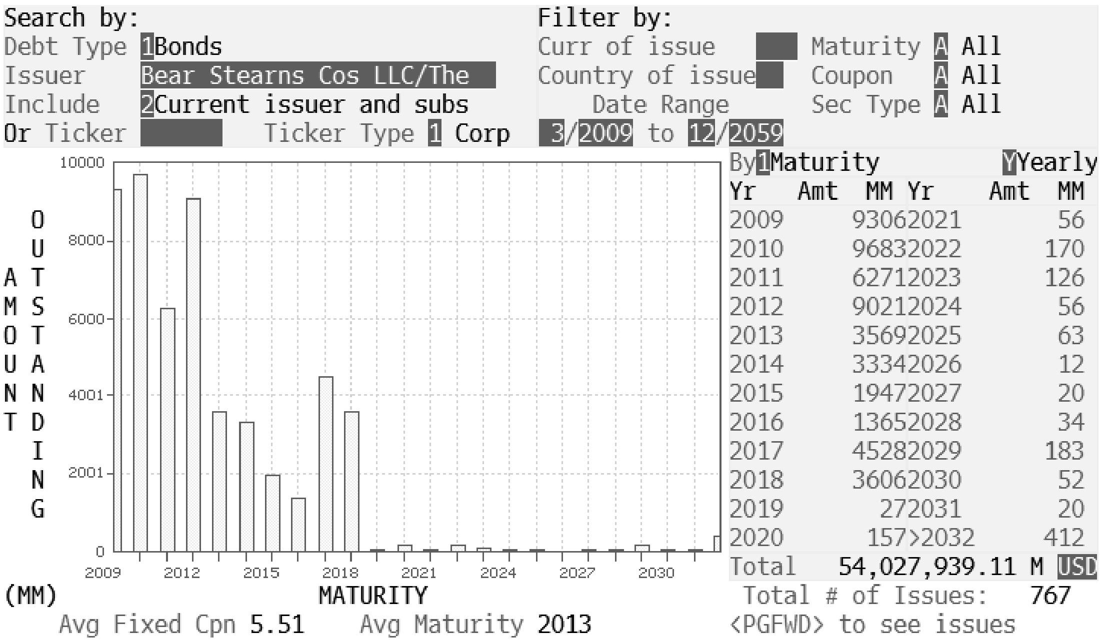
[4] Minsky Theory: Hyman Minsk, Ph.D. (1919-1996), was an economist and professor at Washington University in St. Louis, Minsky's research focused on the understanding and explanation of financial crisis. Minsky broke down the process from stability to instability into three types of debt phases: hedge, speculative, Ponzi.

Figure 4 Lehman Brothers total issuing bond globally



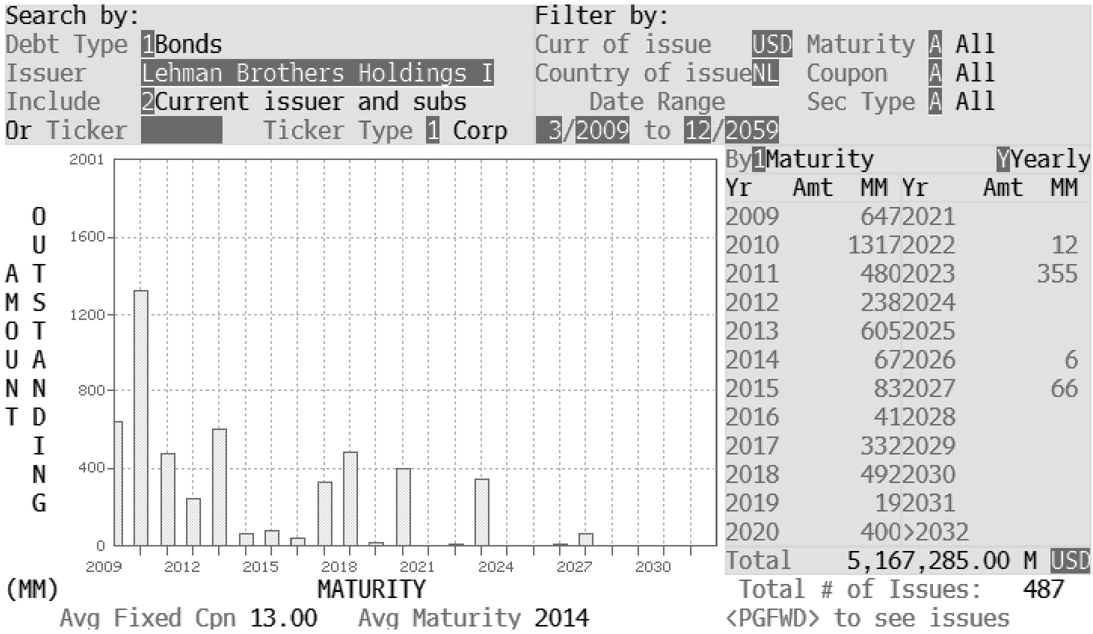
Source: Bloomberg

Figure 5 Bear Stearns total issuing bond globally



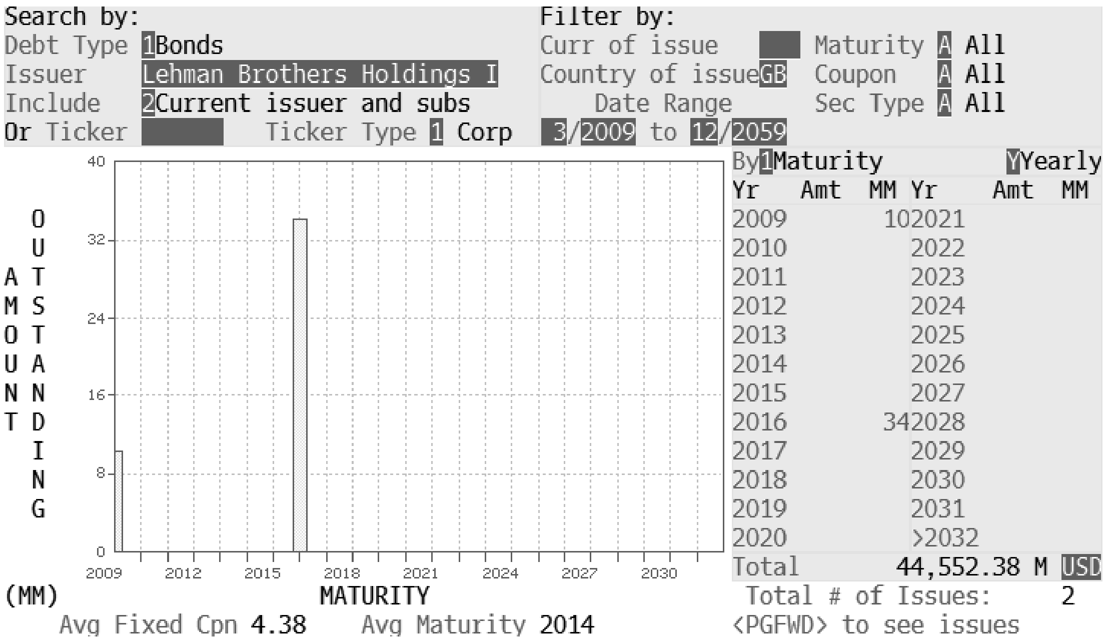
Source: Bloomberg

Figure 6. Lehman Brothers debt issuing at Netherlands



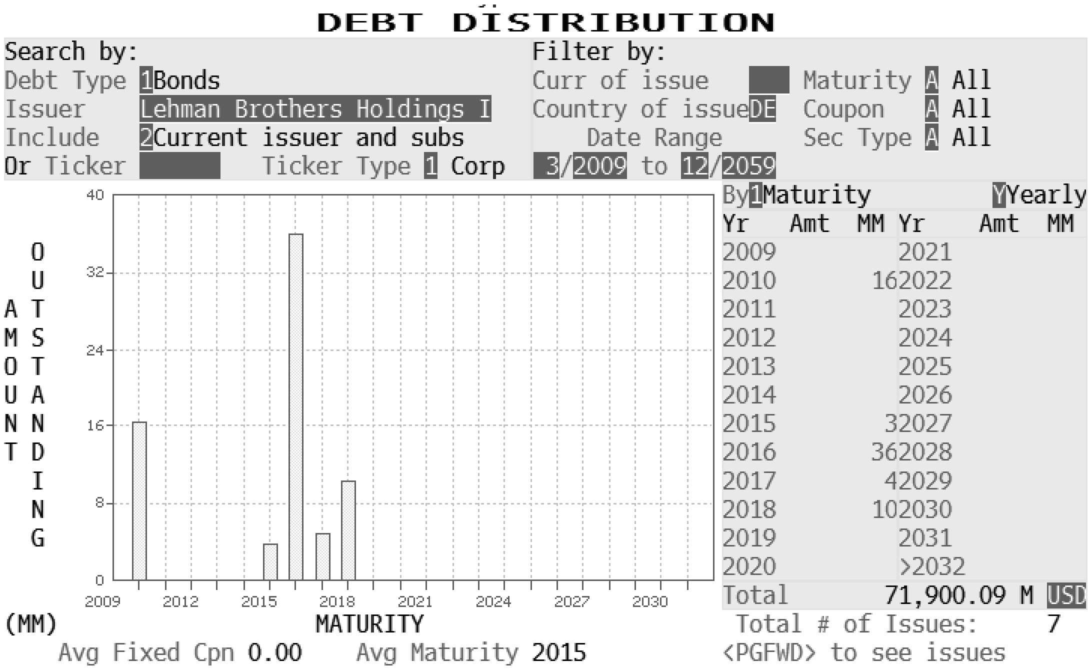
Source: Bloomberg

Figure 7. Lehman Brothers debt issuing at England



Source: Bloomberg

Figure 8 Lehman Brothers debt issuing at German



Source: Bloomberg

The reason for Lehman's failure is that its market value for its level 3 assets dropped a lot and it did not fully reflect on its book. If Lehman Brothers went bankruptcy, the Lehman bond and equity holders would have to take the loss for Lehman's loss on security (RMBS[5], CDO) which are related to American mortgage loans or commercial mortgage loans. The loss for the default of American residence or non-residence loan would be expressed at the market price of RMBS and CDO. At last, part of the cost of sub-prime crisis would absorb by the non-American investors.

6.Conclusion

Lehman Brothers and Bear Stearns were both high credit investment banks. At sub-prime crisis, they both had big loss due to hold of toxic asset.

This article checks with both banks' Balance Sheet and level 3 asset ratio but we can not find much difference except for the country of the origin of bond issuance. There are more non-American bondholders at Lehman Brothers. In such case, this

[5] Residential mortgage-backed securities (RMBS) are a type of bond commonly issued in American security markets. They are a type of Mortgage-backed security which are backed by mortgages on residential rather than commercial real estate.

article concluded the US Ex Financial Secretary Paulson intentionally share the loss of US real estate with the investors outside American through the failure of Lehman Brothers.

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