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Bank Insolvency and Resolution in European Countries: A Case Study of Lehman Brothers

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ABSTRACT

The 2008 financial crisis served as a cautionary tale that talks about concerns of safety and stability in the finance industry. Financial markets and institutions are vulnerable to periodic issues of significant illiquidity and insolvency, in addition to fraud and other malpractices that, if uncontrolled, can lead to a crisis, system wide. The risk of instability exists both at the individual as well as the aggregate levels of financial institutions and markets, and its realization can result in substantial social and economic costs. Amidst over three decades of struggle to smoothen international financial regulatory and prudential policies, the Basel Committee on Banking Supervision did not address the resolution of a large, complex international bank. The 2008-2009 financial crisis and the conclusion that multiple large and complex financial institutions had become too large to fail propelled resolution towards the forefront of the global regulatory agenda.[1]

Keywords: cautionary, crisis, financial, illiquidity, instability, propelled, regulatory, substantial, vulnerable

INTRODUCTION

In 2008, banks in a lot of countries were having trouble making ends meet. Governments, including the UK's, felt like they had to save the banks. If a big bank had gone bankrupt at that time, it would have caused big problems for a lot of people, businesses, and public services. These banks were "too big to fail."

Amidst over three decades of struggle to smoothen international financial regulatory and prudential policies, the Basel Committee on Banking Supervision did not address the resolution of a large, complex international bank. The 2008-2009 financial crisis and the conclusion that multiple large and complex financial institutions had become too large to fail propelled resolution towards the forefront of the global regulatory agenda.[2]

Instability in the financial sector has historically resulted from a variety of causes.

[1]'Resolution Of Weak Financial Institutions In The OECD Area' [2002] Financial market trends.

[2]'Resolution Of Weak Financial Institutions In The OECD Area' [2002] Financial market trends.

Policy shifts or macroeconomic environment shocks have occasionally triggered problems. In some other instances, accounting and auditing system flaws as well as regulatory and supervisory framework and practise deficiencies have been implicated.

Close ties in between government and the directors of financial institutions, frequently including programs of directed lending or investment, and utter lack of clarity in the exit policy for the financial institutions in trouble were some of the factors that contributed to the financial crisis. Other factors also include unclear and conflicting regulatory oversight, inadequate classification systems for assets, and loan-loss provisioning rules which fell short of standards agreed upon internationally.

INSOLVENCY v/s ILLIQUIDITY

In many cases of system - wide instability, regrettably, numerous factors have been in play, and in the majority of cases, difficulties at financial institutions themselves have been at the heart of the issue, quite often stemming from:

1. Poor management of core risks, which includes weak contract enforcement
2. Perverse relationships in between the institutions and (generally) their corporate clients resulted in ill-conceived, laxly upheld lending limits. Unfortunate internal management and lack of leadership.
3. Inadequate management of operational hazards.
4. Unsatisfactory levels of transparency.

Insolvency can be tricky and comparing illiquidity and insolvency is a complex subject. When a company needs cash, illiquid assets are those that are difficult to liquidate. This category of assets consists of non-core assets. The sale price of such assets may be less than the asset's fair market value. Companies that are insolvent typically cannot pay their debts because their assets are illiquid. However, illiquid companies must quickly liquidate certain assets to avoid bankruptcy.

Insolvency occurs when a company is not able to pay its bills on time. When a company's total liabilities exceed its total assets, i.e. when it has more debt than liquid assets, it declares insolvency. The ability to pay debts, sell assets, and generate cash flow is indicative of a company's liquidity, which is a crucial aspect of its stability. The "Quick Ratio" is a useful indicator of liquidity.

Profitability determines whether an organisation is liquid or illiquid. In contrast to the latter, which reflects a company's ability to meet its financial obligations; insolvent companies may have inherently illiquid assets. Real estate antiques, and private company interests are examples of such assets. A few illiquid assets are not easily available on the market, and there may be few buyers for them.

The insolvency process begins when a business or individual is unable to pay its debts. This method may involve liquidation, voluntary administration, or receivership programmes. There are numerous varieties of illiquid assets, including collectibles, real estate, private equity, and certain debt instruments. Certain illiquid assets are not traded on stock markets and have few buyers.

CHALLENGES FACED: LESSONS FROM CRISIS

So far, there hasn't been much interest in the legal structures that financial companies use to grow around the world. Cross-border banking is mostly looked at from the point of view of competition, especially in the EU. Less attention has been given to the necessary implications of how this kind of market penetration actually happens, which has been shown to have an effect on things like depositors' rights, supervisory control and market stability.

Cross-border branch structures face four significant difficulties. The host supervisors have very less control over branches as compared to subsidiaries. The national supervisory standards vary, which has an effect on the supervision of branches. The branch bank account holders are protected by the home country guarantee programme[3]. As disparities between these national protection schemes emerge, consumer confidence may be affected. The difficulties arise in terms of crisis prevention and management, particularly when taxpayer funds are invested in rescue programmes, as burden sharing is more challenging in case of branches.

Therefore, one can argue that subsidiary structures provide benefits in terms of prudential supervision and consumer protection, as well as that the use of subsidiaries in cross-border banking must be encouraged. This can be accomplished by enacting regulatory measures that encourage the use of subsidiaries instead of branches in cross-border banking (a process known as "subsidiarisation"), thereby regulating the ways wherein financial institutions can expand along borders.

On the other hand, the identified weaknesses in prudential supervision in the branch structure could be fixed with supervision and ad-hoc regulation. To make a number of changes to the rules, this strategy needs a lot of synchronization and a definite political decision at both the national and EU levels.

This European solution requires time and consensus, and the implementation might be challenging. On the contrary, the "national approach" or "subsidiarisation" can be viewed as a threat to the EU single market and a means of restricting the business freedom. We could further determine that "subsidiarisation" would be illegal in the EU law as it violates the principle of freedom of establishment, which is enshrined in the Treaty on the Functioning of the European Union (TFEU) and elaborated in well-known case law, ECJ.[4]

The authorities in EU have already recommended several of changes to the supervisory and regulatory frameworks. The strategy is likely to be well-thought out and discusses the identified vulnerabilities in cross-border branch structures, according to in-depth analysis.

Nonetheless, the effect of these suggested changes on the financial stability will be determined by the inclination of supervisory authorities to apply them correctly and collaborate intently with the foreign authorities.

Given that the majority of issues that afflicted authorities during the Great Recession could have been envisioned based on previous banking crises, the negligence of these cross-border resolution challenges before to the Great Recession is astounding[5] These learnings include the unwillingness of national

[3]Almudena de la Mata Muñoz, 'The Future Of Cross-Border Banking After The Crisis: Facing The Challenges Through Regulation And Supervision' (2010) 11 European Business Organization Law Review.
[4]Ibid.
[5]Richard Herring, *Market Discipline And Banking: Theory And Evidence* (2003).

authorities to discuss un-favorable details with respect the bank, the potential danger of uncoordinated and contradictory actions by the authorities, the sensitivity of markets to unforeseen behaviour even by authorities, and the complexity of resolving an entity with massive international corporate complexity, and the unruly effect of applying bankruptcy practices to institutions that were actively engaged in trading.

Certainly, there is little evidence that all these earlier experiences resulted in significant learning. There were no notable changes in national resolution policies or in the coordination of resolution policies throughout nations. In fact, as more and more financial activity moved into bigger, more complicated institutions, the system became increasingly susceptible to the issues that led to previous crises. Major financial centres began to transform their resolution procedures only following the recent financial crisis.

Prior to its collapse in 2008, Lehman Brothers was the 4th largest investment bank in the US. It was double the size and complexity of Bear Stearns, who said yes to a shotgun merger with JPMorgan Chase in 2008, March when it could not fulfil demands for extra collateral. The Lehman Brothers Group had 7,000 legal entities in 50 countries, many of which were governed by national regulation by host countries and SEC supervision.

BCCI, further, is another cross border financial institution that suffered a similar collapse.

BCCI

In the year 1991, Bank of Credit and Commerce International established the complications regulatory authorities encounter in handling with intricate corporate structures, especially where several subsidiaries are created to evade regulatory oversight and significant activity occurs in lightly regulated tax havens. BCCI was organized to ensure that country where it was chartered was different from its head quarter, which was different from the country where its principal managers lived and where its assets and creditors were concentrated.

It exploited regulatory asymmetries and incentives. BCCI has a Luxembourg banking charter but does no business there. Luxembourg was short of the resources and incentives to supervise a complicated, secretive global bank because BCCI avoided doing business there. BCCI used Luxembourg's confidentiality laws to avoid regulatory oversight.[6] BCCI revealed significant variations in resolution and bankruptcy policies and procedures.

This includes differences in the resolution process's objectives, who initiate it, how foreign creditors are treated, carve-outs, applicable laws, insolvency jurisdiction, and procedural details like the right to set-off. Within the U.S., set-offs are limited to the claims and the liabilities within the same currency and on the same legal entity's books. The British law has allowed set-offs regardless of currency, branch, or country. Luxembourg was much stricter. After a liquidation order, the judge may allow set-offs.

BCCI highlighted the differences between nations that adhere to a universal principle in bankruptcy, in which all assets are collected in the insolvency jurisdiction and distributed to creditors in terms of priority without regardless of the location or nationality of the claimants, and countries (the USA) which abide a territorial theory, where all domestic residents should be completely paid well before assets can

[6] Richard Herring, *Systematic Financial Crises: Resolving Large Bank Insolvencies* (2005).

be handed over. BCCI also highlighted the differences between nations that adhere to a universal principle in bankruptcy and countries that follow a territorial principle. The regulatory authorities in New York State recognised the New York branch of BCCI as a distinct entity and made efforts to collect the company's assets all over the world in order to make payments to its creditors before turning those assets over to the primary bankruptcy jurisdiction in Luxembourg.[7]

USA also hindered bankruptcy proceedings by accusing BCCI under RICO. Foreign authorities despised the unilateral action, but criminal investigative powers amplified the amount of assets available to creditors.

LEHMAN BROTHERS

Lehman applied a high-leverage business plan that required daily billion-dollar capital infusions. In 2006, the company had made significant investments through high-risk real estate and subprime mortgages. Lehman was not able to raise adequate funds to remain in business when these markets declined.

In March 2008, Hank Paulson, secretary of the United States Treasury, and Ben Bernanke, chairman of the Federal Reserve, became worried about the probable potential bankruptcy of Lehman Brothers. This occurred after the Federal Reserve rescued the investment-bank Bear Stearns. Next, it was expected that Lehman would need assistance.

Paulson urged Dick Fuld, the president of Lehman Brothers, to find a buyer comparable to Bear Stearns, and he sincerely asked the Bank of America and the Barclays. He alerted Treasury and the Fed that they were unable to assist with government funds.

Lehman Brothers could not be nationalized like Fannie Mae and Freddie Mac because it is an investment bank. No federal regulator including the FDIC was ready to take control.

The Fed, like Bear Stearns, could not guarantee any loan. Lehman Brothers did not have the necessary assets to qualify for it.

Also, Bank of America wasn't really keen on giving a loan. It requested that the government cover losses that were expected to be $65 billion to $70 billion. To that Paulson conclusively declined. Conversely, he and Tim Geithner, the president of the Federal Reserve Bank of New York, hosted a retreat over the weekend with the nation's top bankers in order to raise funding for Lehman.

The bankers took the next 2 days seeking a solution. However, the Bank of America terminated the agreement before they could. The following day, Barclays said that its British regulators would just not authorise a Lehman Brothers deal.[8] The remaining day was devoted to bankruptcy preparations for Lehman Brothers.

The failure of the Lehman Brothers had 4 main reasons:

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[7]'CORE – Aggregating TheWorld'S Open Access Research Papers' (*Core.ac.uk*, 2022) <https://core.ac.uk/> accessed 23 August 2022.

[8]Henry M Paulson and Dan Woren, *On The Brink* (Hachette Audio 2010).

1. The bank assumed too much risk without sufficient capital. In 2008, its assets of $639 billion exceeded its liabilities of $613 billion. Moreover, selling the asset proved challenging. Lehman Brothers were unable to sell them for financing. Insufficient cash flow led to its bankruptcy.
2. The administration encouraged taking risks. The chief risk officer at Lehman stated that her strategies regarding risk-management were discredited.[9] Four executives desired to remain ahead of high-risk competitors and argued the company was too big to fail.
3. As the market declined, the company relied on complex financial products based on rapid real estate growth.[10]The company's revenue increased by 130% between 2000 and 2006 as a result of mortgage-backed securities. Lehman Brothers acquired five mortgage lenders in 2003-2004, enabling it to originate and underwrite subprime loans. In March 2006, Lehman acquired commercial real estate and risky mortgages and held on to them. The administration believed that owning these assets would increase profits, but real estate prices were starting to fall.
4. The Securities and Exchange Commission as well as other regulatory agencies did not take action. In 2007, the SEC was aware that Lehman Brothers was taking excessive risks, but it did nothing. It failed to inform rating agencies that now the bank had exceeded risk limits.

When Lehman Brothers went bankrupt, it shook up the financial markets. The Dow Jones Industrial Average fell the most in seven years, by 50448 points. The losses kept coming until the Dow closed on March 5, 2009, at 6,594.44. The 10th of October, 2007, saw a 53% drop from its peak of 14,164.53. Investors were drawn to the United States because of its relative safety. Treasury bonds are increasing in value.[11]

Investors knew that the bankruptcy of Lehman Brothers could hurt the banks that held its bonds. The Reserve Primary money market fund "split the dollar" on September 16, 2008. This meant that each of its shares, which usually cost at least $1, was only worth $0.97.9. When the money market fund said it had lost $785 million on Lehman's commercial paper, investors lost faith in it.

The economic collapse spread rapidly on September 17, 2008. A record $196 billion was withdrawn by investors from accounts. If the run had persisted, businesses would have been unable to obtain funds to finance their daily operations. The economy might well have completely collapsed in a matter of weeks. For instance, shippers would not have been able to deliver supplies to supermarkets.

Paulson and Bernanke gathered with congressional leaders on September 18, 2008 to analyse the inevitable collapse of credit markets. Requesting $700 billion to bail out the banks was the quickest way to inject capital into the frozen financial system, allowing the Treasury Department to buy stock in troubled banks.

[9]'Not Too Big To Fail: Why Lehman Had To Go Bankrupt' (*Knowledge at Wharton*, 2022) <https://knowledge.wharton.upenn.edu/article/the-good-reasons-why-lehman-failed/> accessed 23 August 2022.

[10]'The Lehman Brothers Bankruptcy A: Overview' <https://som.yale.edu/sites/default/files/files/001-2014-3A-V1-LehmanBrothers-A-REVA.pdf> accessed 23 August 2022.

[11]<https://home.treasury.gov/policy-issues/financing-the-government/interest-rate-statistics?data=yield> accessed 23 August 2022.

On September 29, 2008, Congress voted down the proposal. The Dow fell 777.68 points in a single day, the most ever in a single day until 2018.[12]

The failure of Lehman Brothers precipitated the financial crisis of 2008 and recession that subsequently followed it. The millennial were the most severely affected because they were just trying to enter the labour force.

The millennial generation took the biggest hit as the unemployment rate rose from 9.9% in May 2007 to a combined total 19.5% in April 2010.[13]

Unemployment among those aged 25 to 54 was 8.8%, while it was 7.0% between those aged 55 and older. Millennial unemployment had slumped to 8.9% by December 2017, but the harm was already done.

The Dodd-Frank Wall Street Reform Act was partially enacted as a result of the collapse of Lehman Brothers. After the passage of the Glass-Steagall Act, this was the most far-reaching change. After the stock market crash of 1929, Glass-Steagall was passed to regulate financial institutions. It was eventually repealed in 1999. That opened the door for the reinvestment of depositor funds by banks in unregulated derivatives such as mortgage-backed securities.

Dodd-Frank established the Financial Stability Oversight Council to identify threats to the financial industry as a whole.

The FSOC will transfer it to the Federal Reserve for faster supervision, If a company becomes very large, the. For instance, the Fed can actually force a bank to significantly raise its reserve requirement in order to ensure that the institution has sufficient funds on hand to prevent insolvency.

The U.S. chose to act on its own by merging Lehman's U.S. broker/dealer arm with Barclays Capital. This gave Lehman's U.S. broker/dealer arm the cash it needed for a smooth resolution, but the U.S. did not help other countries break up Lehman subsidiaries in 49 other countries, most notably the UK's major operations.

CONCLUSION

The current European banking insolvency regime has been shown to have flaws thanks to the banking crisis, which exposed those flaws. Even though there have been a lot of efforts put into banking supervision, banks can still fail. At the national level, there are many different ways that insolvency law is approached, and these variations need to be addressed. Given the wide variety of substantive laws that exist at the national level, the Winding Up Directive is unable to achieve the goal of providing equal treatment for all parties. I suggest that all Member States should adopt Special Resolution Regimes, which would not only be better able to deal with the fiscal challenges that are triggered by financial crises, but would also grant creditors and depositors of banks equitable treatment. It is necessary to address both the procedural and substantive aspects of insolvency law in Europe.

[12]'Search | S&P Dow Jones Indices' (*Spglobal.com*, 2022) <https://www.spglobal.com/spdji/en/search/?query=djia&Search=Go&Search=Go> accessed 23 August 2022.
[13]<https://www.bls.gov/opub/mlr/2018/article/great-recession-great-recovery.htm> accessed 23 August 2022.

Any changes that are made to these laws need to take into account the structure of international banking groups as well as the applicable regulations for subsidiaries. In addition, any revisions to laws governing the insolvency of international financial institutions must make provisions for investment banking as well as each component of the system of shadow banking. The current banking crisis brought to light loopholes in the law that currently governs the treatment of banks that operate in multiple countries. These laws have indeed been put to the test in every possible way. Campbell hypothesised that the efficiency of the Winding up Directive would not be known until a financial crisis occurred and that this would be the only time it would be tested. The most recent crisis has provided a wealth of examples of different aspects of society that require improvement. It is time for Europe to seize the opportunity that has been presented as a result of this and develop a reliable cross-border insolvency system that has the capability of coping with and keeping up with the latest developments in banking structure and form.

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