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REPORT

**The Lehman Brothers default:
an assessment of the market
impact¹**

¹ This report approved by CESR has been drafted by the CESR “Lehman Brothers Task Force” chaired by Richard Sutcliffe, Head of Prudential Standards, Conduct and Organisational Policy at the UK FSA. The rapporteur of the task force was Diego Escanero, Senior Officer for investment firms at CESR.

I. Introduction

On 15 September 2008, Lehman Brothers Holding Inc (LBHI) filed for chapter 11 bankruptcy protection, thus becoming the largest bankruptcy in US history. Following LBHI's bankruptcy filing, the UK directors of Lehman Brothers International Europe Limited (LBIE) formed the view that the entity was no longer a going concern; it relied on daily cash provision from its US parent and it was clear that this would no longer happen. Accordingly, the directors appointed four partners from PwC as administrators and filed for administration in the early hours of Monday 15 September.

Lehman Brothers was historically a fixed income house, and therefore had very significant mortgage businesses in the US and the UK. When the credit crisis began, Lehman Brothers held significant mortgage and leveraged loan assets, and more assets continued to be originated because it took time to withdraw from the UK and US mortgage origination business.

Until the final days of Lehman Brothers, its liquidity position had appeared relatively robust. There had been some signs of strain, with some counterparties being nervous and some indication that market sentiment was fragile. However, the overall liquidity position had held up and the firm had access to Federal Reserve and ECB liquidity provision as a backstop.

II. Assessment

The principal cause of its demise was market concerns about the capital adequacy of the firm rather than liquidity, which were focused on the group's ongoing exposure to illiquid assets. With its Q3 2008 results, which were much worse than expected, and an inability to raise new capital, market confidence collapsed and counterparties ceased to process ordinary day-to-day business with the firm (e.g. failed to make inbound payments into Lehman Brothers). Counterparties also imposed collateral requirements for intraday credit that made it increasingly difficult for Lehman Brothers to operate. Ultimately, this massive loss of confidence led to the firm's insolvency.

It may be many months, or even years, before the full impact of the Lehman Brothers default can be understood. CESR has not attempted to elaborate detailed policy proposals, given the short time-scale and wide remit covered, but has made every effort to provide a coherent picture of the challenges that exist on the securities field, regulatory and industry responses to these (both actual and potential), and the principles that should guide further work:

Oversight of cross-border groups

The Lehman Brothers group comprised 2,985 entities globally, spanning numerous jurisdictions, with some regulated and other unregulated; CESR notes that global regulatory responses and effective global co-ordination between supervisors are therefore essential when dealing with such cross-border groups.

Harmonised regulatory conditions

CESR notes that instruments with an equivalent risk/reward profile should be subject to equivalent regulatory conditions in order to create a level playing field across product classes. A Task Force established within CESR will further address these issues.

Effective application of the Prospectus Directive

Cooperation

CESR notes that close cooperation between home and host state authorities is essential where instruments are approved for passporting under the Prospectus Directive; host state regulators lack information on actual sales volumes of instruments offered under an inwards passport in their territories, just as home state regulators lack this information unless they ask firms for it.



Structured debt instruments

CESR notes that the manner in which some issuers and practitioners combine the Base Prospectus and Final Terms concept in the Prospectus Directive and its implementing measures for structured debt does not always meet the requirement according to which the information must be provided in an easily analysable and comprehensible form (article 5 (1) of the Prospectus Directive).

Accessibility of prospectuses

CESR notes that the accessibility of prospectuses for members of the public might in some cases be impeded by the different publication practices of issuers and national regulators.

Acting in concert

In the context of the retail structured products market, it is important to establish whether the issuer of the bond is acting in concert with the intermediary that repackages the bond into a structured product. CESR has conducted work on this space to provide greater clarity as to when an issuer is deemed to be acting in concert with a distributor for the purposes of the Prospectus Directive.

The challenge of regulating for chain relationships²

Regulating distribution chains presents a challenge: they can involve a jigsaw of different clients, different jurisdictions, and different pieces of legislation. CESR notes that the design of European legislation needs to be kept under review to ensure that it takes account of industry structures and the interaction between different pieces of legislation; this will put regulators in a stronger position in terms of ensuring that regulatory objectives, including protection of retail clients, are being met.

Just as important is the recognition that the focus of regulatory action needs to correspond to the relevant outcome being pursued. CESR notes that where that outcome is investor protection, then supervisory effort should be concentrated on the retail link in the chain to make sure that the sales process offers adequate consumer protection.

Some of the points above mentioned should inform the debate on forthcoming review of the Prospectus Directive, whilst others will be addressed by future work of the Review Panel (see draft work programme of the Review Panel for 2009 published on 10 March 2009, Ref. CESR/09-088).

Convergence of application of the Markets in Financial Instruments Directive

Complex / non-complex financial instruments

CESR has encountered varying interpretations of whether structured products should be classed as complex or non-complex in the context of MiFID, depending on the structure of the investment; there is a need for greater clarity. CESR will shortly publish a consultation paper on complex/non complex financial instruments for the purpose of Articles 19(5) and (6) of Directive 2004/39/EC with a view to produce a definitive Q&A document in Q3 2009.

Suitability

CESR commits to further work to clarify the application of the MiFID suitability regime, considering the potential difficulty in determining the dividing line between advised and non-advised sales. As part of this work, the CESR MiFID Level 3 Expert Group will consider case studies and the degree to which an adviser can rely on the credit-rating of an issuer or instrument when making an assessment of suitability. The final Level 3 product should be published no earlier than Q4 2009, and there will be a previous public consultation.

Sales process for structured products

CESR notes that regulators should focus on the nature of the sales process for structured products to ensure that any assessment of suitability or appropriateness is suitably robust.

² The potential complexity of distribution chains can make it difficult to quantify retail exposure to financial instruments.

Re-hypothecation

CESR notes that there is scope for further work at the European level on the subject of asset re-hypothecation, and plans to pursue further work through the CESR MiFID Level 3 Expert Group to establish the differences in domestic regimes and their fitting with MiFID. This is a particularly important issue in the context of Lehman Brothers, as the task of determining the extent of asset re-hypothecation has proved challenging for the administrator, slowing down the process of asset return to clients.

Documentation of investments

CESR notes that maintaining adequate documentation of investments is an essential part of firms' systems and controls, and is particularly important in stressed conditions; those firms with good records were best placed to assess their exposure to Lehman Brothers as the bank entered administration.

Complaints handling

CESR notes that distributors of Lehman Brothers products are typically handling complaints in line with established processes, although the volume of complaints received by certain distributors could put pressure on those processes.

Clearing and settlement: CESR notes that LCH Clearnet's default rules allowed it to handle the Lehman Brothers default smoothly. Indeed, the Lehman Brothers case has not so far revealed any significant issues which would necessitate further regulation of post-trade infrastructures. There are, however, challenges that exchanges, clearing houses and other market participants will need to address in order to ensure that markets continue to operate efficiently during times of stress. Relevant issues include the handling of unsettled transactions and the establishment of a central counterparty (CCP) for standard, liquid CDS products such as indices.

CESR notes that communication prior to and during default events could be improved, as showed in the experience of Eurex Clearing.

CESR notes that minor improvements could be made regarding the risk run by a market member when they introduce orders on behalf of their client without any collateral, as the experience of Iberclear has shown.

Settlement Finality Directive: CESR notes that notifications made under Article 6 of the Settlement Finality Directive should be timely and clear in content. It also notes the importance of maintaining an up-to-date list of SFD contacts (information is registered on the Commission's SFD webpage).

Master netting agreements: Participants in the secondary debt market will have to consider whether to introduce master netting agreements between counterparties in order to allow netting across all debt trades between the relevant entity and the financial institution in question³.

Valuation of structured notes: In the future, it is possible that market participants will be more wary of structures where the valuation agent is an affiliate of the issuer: some notes include terms stating that pay-off will be determined by a named valuation agent, which poses a particular problem where the agent was a Lehman Brothers affiliate, as the terms didn't cover the possibility of both issuer and valuation agent going into administration⁵.

³ As reported by Clifford Chance in their December 2008 newsletter.



Insolvency regime for investment firms: CESR notes that there is no winding up directive for investment firms at the European level, in contrast to the position for credit institutions and insurers.

III. A final comment

It is worth noting that, for the most part, the findings of CESR – including those involving the application of the Prospectus Directive and the interpretation of MiFID – are not specific or exclusive to Lehman Brothers. Rather the case illustrates regulatory challenges that already existed.