Five years after Lehman: how a bankruptcy changed the banking world

Those who study when and how often certain terms are entered into internet search engines will find that the number of searches containing the word “crisis” shot up on 15 September 2008. Web searches for the word “crisis” have remained at a high level ever since. On 15 September 2008, the US investment bank Lehman Brothers filed for bankruptcy; from then on the world was divided into pre-Lehman and post-Lehman. The Lehman failure marked the preliminary climax of a development that had begun in the summer of 2007 as a crisis in the US real estate market. At that time, one thing which had been held together by the financial industry came crashing down: confidence in the solvency of the players involved. This loss of confidence brought the interbank market to a virtual halt. Financial markets were jittery. Within the space of one year, a development that had initially been restricted to the United States turned into a global financial and economic crisis which engulfed all areas of the economy: governments, banks, firms and households were affected.

The Bundesbank, too, has been occupied in a variety of ways by this crisis ever since 15 September 2008.

Bundesbank had to deal with fallout of Lehman bankruptcy

The Lehman Brothers bankruptcy had a direct impact on the Bundesbank. Lehman’s German subsidiary Lehman Brothers Bankhaus (LBB) took part in Eurosystem monetary policy transactions and obtained funding through the Bundesbank. In September 2008, LBB had posted €8.5 billion worth of collateral for central bank loans with the Bundesbank. Following the parent’s bankruptcy, the subsidiary also became insolvent and was unable to repay its loans. The Bundesbank thus obtained the right to realise the collateral in the name of the Eurosystem in order to cover losses from monetary policy operations. In such cases, the assets are usually realised in a timely manner. However, in autumn 2008 it turned out that rapid realisation was not possible because the posted collateral consisted mainly of complex structures of asset-backed securities (ABS).
ABS are created when firms or banks transfer part of their assets to what are known as special-purpose vehicles (SPVs), which then repackage them to form a new security (a process known as securitisation). One particular factor which makes ABS so complex is that often multiple parties are involved in securitisation. Following the Lehman bankruptcy, restructuring measures were therefore necessary in order to realise the assets. The individual claims stemming from the complex instruments were successively sold off.

The collateral has been more or less fully realised. Thus far, a total of €7.4 billion has been returned to the Bundesbank. The Bundesbank is still owed outstanding payments from two bankruptcy proceedings: against Lehman’s German subsidiary and against the parent company. The expected payments will probably be large enough that the Bundesbank will not take any loss on the original assets.

In this manner, the Bundesbank will have dealt successfully with one of the direct consequences of the Lehman failure, five years on; however, what lessons have been learned from this event?

Supervisors now cracking down

The Lehman failure has changed the world of banks and their supervisors. “Banking supervisors today are working differently worldwide”, says Ms Sabine Lautenschläger, Deputy President of the Bundesbank and the Bundesbank’s top banking supervisor; “they are now paying greater attention to stress scenarios when valuing market risk than in the past”. A major step forward, in her view, is also the greater powers assigned to banking supervisors: “they can now intervene at a much earlier stage and far more incisively”, according to Ms Lautenschläger.

In the past five years, banks have been forced to change by a wide array of reforms. These include the Basel III package of reforms, which envisages, above all, tighter capital and liquidity rules which banks have to follow. In addition, international standards for bank resolution have been set, and the regulation of over-the-counter (OTC) derivatives trading has been reformed.

In the meantime, some figures are now available that reflect the outcome of these new requirements quite distinctly: since the Lehman bankruptcy, the tier 1 capital ratio of the 12 largest German banks with an international focus has risen from 8.7% to 15.3%. The percentage of own funds banks need to hold against risk exposures such as loans has thus nearly doubled.

Supervisors networking more strongly

In addition, supervisors’ perspective has shifted in the past five years: from looking at individual entities to a bird’s-eye perspective which recognises systemic dangers to the financial system at large. Nowadays, one of the main causes of the financial crisis and its escalation on 15 September 2008 is considered to be too narrow a focus on the stability of individual institutions, whereas the threats to the system as a whole were not identified in time. In an article for the Central Banking Journal, Bundesbank Executive Board member Andreas Dombret wrote that “One of the main lessons of the financial crisis was the need to complement the existing regulatory framework with a macro-prudential dimension that focuses on systemic risk.”
In order to detect, at an early stage, risks to the stability of the financial system (also known as “systemic risks”), banking supervisors internationally are now pursuing a new supervisory approach referred to as “macro-prudential oversight”. As a case in point, the Bundesbank’s supervisors are cooperating with other German authorities in the Financial Stability Commission (Ausschuss für Finanzstabilität). As soon as this commission sees systemic risk arising, it issues warnings and recommendations and communicates these to public authorities within Germany. In Europe, experts are working together in the European Systemic Risk Board (ESRB) to avert systemic risk; across continental borders, supervisory authorities exchange information and ideas in the Financial Stability Board (FSB). Proposals issued recently by the FSB to supervise and regulate the shadow banking system gained a great deal of attention.

A further step along the road to European banking supervision

On 12 September 2013, the European Parliament approved a legal act establishing a Single Supervisory Mechanism (SSM) under the responsibility of the European Central Bank (ECB). That was the major step along the path to a European banking union and, for many, the most important step towards European integration since the euro was introduced. A Single Resolution Mechanism (SRM) is intended to form the second pillar of banking union, complementing the already existing banking supervisory regime. If supervisors determine that a bank is in distress, the SRM would govern its restructuring and orderly resolution. Bundesbank Deputy President Lautenschläger believes this mechanism has the potential to put the bite back into the no-bailout principle. She noted that shareholders and creditors should share primary and unconditional liability when banks get into trouble in the future; particularly in the years following the Lehman bankruptcy, banks were being bailed out time and again using taxpayer money, thereby undoing the no-bailout principle.

What needs to be done?

Many parameters have been readjusted five years on from Lehman, but there are still challenges awaiting banking supervisors. Above all, outstanding regulatory projects have to be fleshed out and continued. The core problem of the Lehman bankruptcy still remains: no solution has yet been found for resolving systemically important financial institutions (SIFIs) which have the potential to drag other institutions down with them. The G20, a group of the 20 largest industrial countries and emerging market economies, has requested the FSB to develop stricter supervisory measures for SIFIs. Yet, until these proposals have been translated into a functioning resolution regime, the “too-big-to-fail” problem will remain unresolved.

Speech of Andreas Dombret

Five Years after Lehman - Learning from the past, looking to the future