In Lehman Fallout, Two Stars Are Given Lesser I

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Good Times Left Lehman Unprepared for the Bad

FLOYD NORRIS

HIGH & LOW FINANCE

Sometimes, when you really mess up, it is good to admit you erred.

Unfortunately, no one seems to have gotten that message through to Lehman Brothers, the embattled brokerage house that is now fighting to persuade the financial markets that it will not be the next Bear Stearns.

This week it raised $6 billion in new capital, at the same time it disclosed a $2.8 billion loss in the quarter that ended last month. Such a loss seemed to come as a shock to analysts, and on Thursday the chief financial officer and the president were demoted. But if Richard S. Fuld Jr., the chief executive, knows of any mistakes he has made, he has yet to share them with the rest of us.

The days that followed Monday's announcement were horrible for the firm. Lehman's stock fell as analysts withdrew buy recommendations and worried about the possibility of more losses. The cost of insuring against a Lehman default on its debts went up. That is not what you would expect after a firm raises billions in additional capital.

From the outside, it is impossible to know if Lehman is marking its assets at appropriate levels, or whether it should have taken write-downs earlier than it did. Like other Wall Street firms, it does not disclose its specific assets, or how much it thinks they are worth.

But what is clear is that Lehman's strategy, as the subprime mortgage crisis unfolded and expanded, was to seek to differentiate itself as being so well managed that it would not have the problems other firms might have.

In its annual report for the year that ended last November, the letter to shareholders from Mr. Fuld and Joseph M. Gregory, the president, now demoted, proudly proclaimed that the firm had record profits for the fourth consec-

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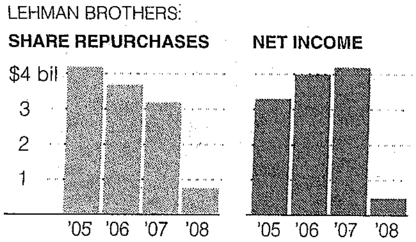
Capital Management

LEHMAN BROTHERS:



Figures for fiscal years ended in November; 2008 is for the first quarter.

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Source: Company reports THE NEW YORK TIMES

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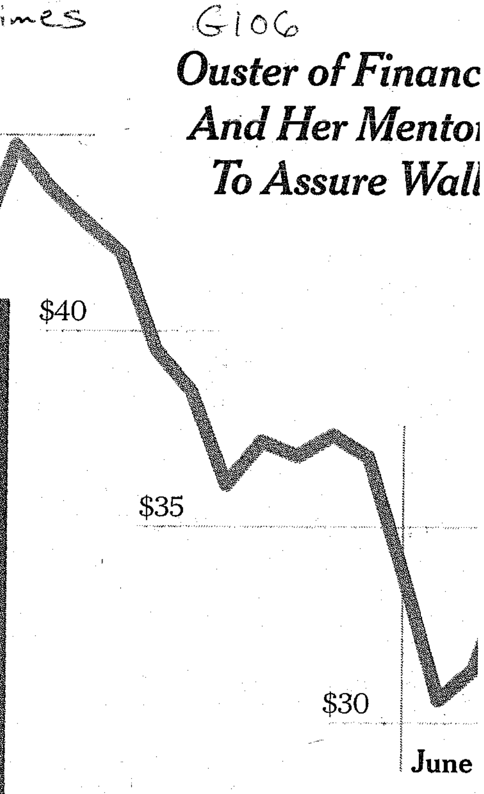

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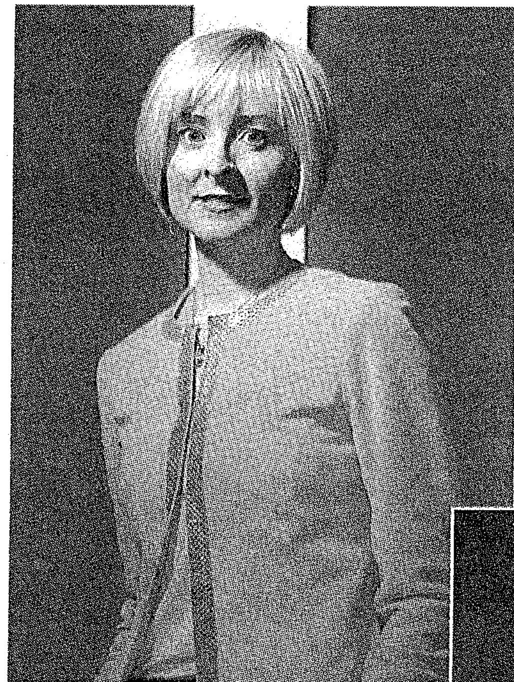
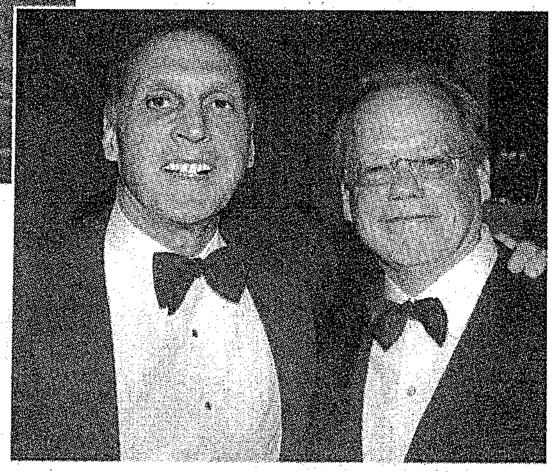


ABOVE, EVAN KAFKA; RIGHT, LEHMAN BROTHERS



Erin Callan, above, took over as Lehman's chief financial officer seven months ago. At right, Richard S. Fuld Jr., left, Lehman's chief executive, and Joseph M. Gregory, who presided over Lehman's push into risky mortgage investments.

By LOUISE STORY and JENNY ANDERSON

After 10 nightmarish days inside the headquarters of **Lehman Brothers**, nerves on the 31st floor continued to fray. By Wednesday evening, the president and chief financial officer were out — a dramatic attempt by Richard S. Fuld Jr., Lehman's pugnacious chief executive, to restore confidence in his beleaguered bank and safeguard his own job.

The move, announced Thursday morning, claimed Erin Callan, whose rise to chief financial officer seven months ago made her the public face of Lehman and one of the most senior female executives in an industry dominated by men. It also brought down her mentor, Joseph M. Gregory, who presided over Lehman's push into risky mortgage investments, with disastrous results.

The announcement capped a tumultuous few days at Lehman, which stunned Wall Street on Monday with news that it had lost $2.8 billion in the second quarter and would raise $6 billion from investors.

That admission, after repeated assurances from Ms. Callan and other executives that Lehman's finances were sound, set off a plunge in the bank's share price that some feared might unleash the kind of panic that brought down Bear Stearns. For Lehman, the slide has been remorseless: 8.7 percent on Monday, 6.7 percent on Tuesday, 13.6 percent on Wednesday. The shares sank 4.42 percent more on Thursday, bringing the total loss over the last four weeks to 47 percent.

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Lehman's Actions During the Good Times Left It Unprepared for the Bad

From First Business Page

utive year.

"Despite this record performance, our greatest disappointment in 2007 was that our share price declined for the first time in five years," they added. "We are more focused than ever on demonstrating to the markets that we have a proven ability to continue to grow our diversified set of businesses, manage risk and capital effectively, and deliver strong results in all market environments."

In January, two weeks after Citigroup slashed its dividend, Lehman raised its dividend and extended its share repurchase program.

On March 18, when the company reported a profit for the first quarter, even as other firms were reporting losses — and just after Bear Stearns collapsed — Lehman had to confront rumors that had sent its share price tumbling. It did so with pride and confidence. Erin M. Callan, the relatively new chief financial officer, now deposed, spoke of "disciplined liquidity and capital management, which we consider to be a core competency."

With hindsight, it is clear that it is specifically in the area of capital management that Lehman has done the worst job, notwithstanding the boasts. Its policy on share buybacks was to avoid the dilution caused by grants of restricted shares and options issued to employees, and that meant it bought back about as many shares as it issued.

It succeeded. The number of shares outstanding at the end of the first quarter was virtually the same as it was at the end of the 2004 fiscal year, after adjusting for a stock split. But with the stock rising for much of that time, those purchases cost a lot of money. In the 13 quarters from the end of that year through this year's first quarter — that is, before the new $2.8 billion loss — Lehman reported net income of $11.9 billion, and spent $11.8 billion on share repurchases.

The net effect was that Lehman built up no cushion during the good times, and was ill-prepared for the bad times. The hubris reflected in the claim that it could "deliver strong results in all market environments" left it with an insufficient capital cushion when the market environment turned hostile.

In that March call, Ms. Callan said the company had already sold all the preferred stock it planned to sell in 2008, when it issued $1.9 billion of such stock in February. Two weeks later, with the stock under pressure, it sold $4 billion in convertible preferred shares.

That sale came off in a relatively normal way. The conversion price was well above what was then the market price, at $49.87, although the coupon of 7.25 percent was high considering the conversion feature. In February, the straight preferred sold with a coupon of 7.95 percent.

This week, the terms were far harsher. The common stock sold at $28 a share. The convertible preferred, with a coupon of 8.75 percent, had a conversion feature with no assured premium. When it must be converted in three years, the conversion price will be $28 to $33.04, depending on where the common is then.

Even if we assume that the company will get the higher conversion price, Lehman will have reaped $6 billion by issuing 203.4 million shares. That does not compare favorably with its share buybacks over the past 13 quarters, when it spent nearly twice as much to buy 189.5 million shares. It paid an average price of $62.19 for shares that dropped under $23 after the shake-up was announced.

On the call Monday, Ms. Callan emphasized that Lehman had taken its gross leverage down to 25 times its equity — meaning that it had $25 in assets for each dollar of shareholder equity, down from more than $30 — and that the firm felt that was far enough. The new capital, she said, would be used "to take advantage of future market opportunities, which are abundant."

There was no sign of institutional humility, no admission of the obvious fact that Lehman had not anticipated the market conditions that now bedeviled it, or that it was possible that it might once again have underestimated the problems it faced.

"From a risk management perspective," Ms. Callan said, "we continued to operate in our disciplined manner we're known for."

On Wednesday night, hours before she found out she had lost the job she was given in December, I asked Ms. Callan about the call. "Trying to strike the right tone, to tell what really happened, what are the facts, and trying to give some confidence to your stakeholders, is a difficult process," she said. "You don't always get it right."

Lehman will have another chance Monday, when it formally releases the earnings numbers that it previewed this week. It must decide how much more to disclose.

"People are telling us they want to know more. They are not comfortable with what they know," Ms. Callan said. "It's a hard thing to figure out what that line is. How can we give a requisite amount of information that is satisfactory?"

And how can Lehman make them believe it? There are prominent short sellers who have made clear they think Lehman has not marked its securities down as far as it should. Short of disclosing actual marks — which analysts could then compare with their own views — how can the firm reassure the doubters?

Banks are not like other businesses. Beer drinkers do not know or care whether the company that sells Budweiser is in better shape financially than the one that sells Coors. But customers of investment banks are trusting them with their money, and relying on their financial advice.

On this week's call, Ms. Callan was left alone to deal with worried shareholders. It may be time for Mr. Fuld, who has been the chief executive since 1993, to start answering questions.

He could begin by telling the shareholders of the lessons he has learned from this debacle. Perhaps he might even want to admit that his previous boasts now look a little foolish.

Floyd Norris comments on finance and economics in his blog at nytimes.com/norris.

Moody's May Align Municipal Debt Ratings With Corporate