

# Untangling the mess



A FASCINATING ACT SUMMER KEYNOTE ADDRESS WAS DELIVERED BY LEHMAN ADMINISTRATOR TONY LOMAS. **PETER WILLIAMS** PASSES ON THE LESSONS FOR TREASURERS.

Ongoing work by bank regulators and supervisors on crisis resolution will be greatly informed by the lessons from the Lehman crisis. But as PwC partner and Lehman administrator Tony Lomas made clear in his ACT summer keynote address, those lessons extend to counterparties, and treasurers should know exactly where their company stands if a bank goes down. They should also ensure that their own house is in good order – and that includes knowing the whereabouts of documentation such as ISDA (International Swaps and Derivatives Association) agreements and custody papers. More importantly it is imperative that, under the deals signed, treasurers know what banks and other counterparties are allowed to do with the assets that they are holding on their behalf.

In his role as Lehman administrator, Lomas has had to explain to countless treasurers and CFOs why they are not getting what they sought from him – the return of their assets.

Lomas was only introduced to Lehman on Sunday 14 September 2008, the day before the bank officially went into administration. “Anyone who takes over as administrator or trustee has to be

independent of it,” he told the audience. “So of necessity we knew nothing about the entity that we were walking into.”

When he passed through the doors on that Sunday with the possibility of taking charge of the UK operations of Lehman Brothers, he walked into an assignment that is set to run for decades. Back then, though, the bank’s management team still thought that a deal with another bank was possible, indeed highly likely, that would save it from a formal insolvency proceeding.

The PwC team was faced with dealing with 6,500 counterparties. As in any type of insolvency procedure all the counterparties wanted to know the answers to the same two simple questions: how much are we going to get back and when?

Simple questions to which there were, and in many cases still are, no simple answers. While Lomas had helped out on PwC client Northern Rock, he told the audience that he “knew nothing about investment banking”. Still, that is really no great drawback. In any administration the aim is straightforward: to secure and realise all the assets and in due course hand them over (in the form of cash) to the creditors. And any assets which the administrator has but which belong to a third party have to be handed back to the rightful owner.

One point Lomas emphasised over the course of the evening was that as an administrator he is neutral. His role extends to realising all of the assets, looking after those assets and paying out what is due to those who can prove they have a legitimate claim.

Lomas also worked on the MG Rover administration in 2005. At the time the Midlands car manufacturer collapsed, 2,000 engines supplied by BMW were sitting in Rover’s stock rooms. BMW, as is standard practice, had a retention clause. So when it proved its claim, the administrator returned the engines to BMW. Whether it’s car parts or financial instruments, the principle remains the same; only the details differ. Lomas has found himself in charge of billions of pounds’ worth of cash and securities that did not belong to Lehman. These assets should have been, and usually were, segregated and handed back. It was, said Lomas, an extraordinarily difficult task.

Lomas was officially appointed as Lehman’s administrator at 7.56am London time, with parallel appointments happening across the globe in different outposts of the bank’s collapsed empire. Other parts followed suit over the next few days. Lehman in New York acted as treasury for the group. On the Sunday it had withheld funds from the UK amounting to \$3bn, telling the subsidiaries that it was going to file for bankruptcy. The



result was that the London company was short of cash. So short, in fact, that Lomas's initial task over his first 48 hours was to raise \$100m of working capital, partly to pay the staff.

As the administrator Lomas – and the other PwC partners involved – became personally liable and needed to control the activities of the 6,000 employees of Lehman UK, especially their interactions with counterparties. When communication with them ceased, those counterparties were left in a very uncomfortable place, as Lomas acknowledged: they did not know what was going on inside the bank and they did not know what the effect would be on them. Worse still, many Lehman clients relied on the bank as a bookkeeper, using Lehman Live to give the bank and themselves an online view of the state of affairs. That service, along with many other cross-group functions, shut down immediately and will take years to rebuild.

**THIRD-PARTY WARNING** Lomas still does not have access to all the information he needs, so interacting with clients and counterparties and coming to a resolution and reconciliation is made more difficult. He warned the audience to be aware of (and careful about) reliance on third parties to provide information. His advice was for treasurers to ensure they had an audit trail so they could carry on running the business. All these factors explained the market volatility just after Lehman's went under because counterparties did not know what the collapse meant for them operationally or financially.

Lomas said that counterparties had an unsecured or a "trust" claim against the bank. The situation was further complicated because it was difficult to assess the value of the claims, many of which derived from derivative contracts. PwC has just produced its fifth biannual report; under the Outcome for Unsecured Creditors heading, it notes: "The administrators are not in a position to give an estimate of the timing or quantum of any dividend to unsecured creditors."

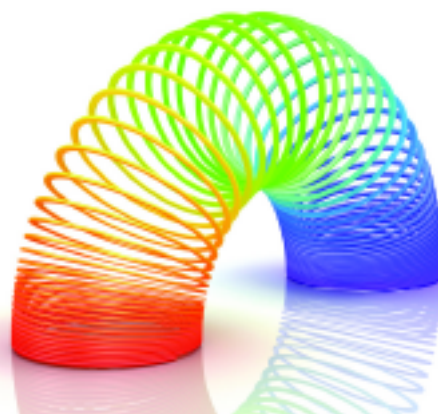
The unresolved issues around value and complexity are so large that at one extreme there may not be any return at all for unsecured creditors. However, Lomas told the meeting that that scenario was unlikely; indeed, if all outstanding issues are resolved in favour of the estate, the eventual payout could be more than 100p in the pound. So far, though, the administrators have been able to do little more than to spell out the uncertainties.

**UNCERTAINTY AND CONFUSION** At the start of the administration process, secured creditors were equally unsure of what was happening. The situation was so confused that Lomas and his colleagues were unable to identify the assets that these counterparties were claiming. He challenged the audience over how much they knew about the operations of the banks they dealt with.

"If you had French government bonds in your portfolio and you were holding them long, you may have placed them in custody with Lehman, which in turn used a French bank as a sub-custodian," Lomas said. Across the globe Lehman had 97 sub-custodians, and PwC had to deduce how many counterparties in total were claiming French government bonds. And all those sub-custodians were dealing with many of the Lehman entities, so they had to check carefully before handing over assets. It is easy to understand the frustration of counterparties who cannot understand why their assets cannot simply be handed back. Wise treasurers will be checking whether they have simple custody arrangements with financial counterparties or something more complex.

#### More active regulation

The Lehman bankruptcy will eventually result in a much more active form of regulation, with the Bank of England being more intrusive in trying to secure better early warning of serious and major problems. One aspect of this will be the creation by banks of resolution plans for administrators to give them clearer knowledge and understanding of the organisation. Some see these plans as central to bank reform while others wonder how in practice they could be kept up to date and therefore relevant.



Client money presented similar problems. Lomas said around \$2bn in cash should have been available for distribution immediately. However, in the normal course of business around \$1bn had been placed with Lehman's German sister company and generally money from related companies under German insolvency law is subordinated – treated as quasi-equity. The court battle over the fate of that \$1bn continues to leave disappointed anyone who expected a quick return of segregated client funds. National interests and local politics as well as claim chasers add to the heady mix of issues facing administrators attempting to get hold of cross-border funds.

In the early days of the appointment regulators took a keen interest in the proceeds. The Bank of England, for example, was greatly concerned over market stability. But this objective is not on the agenda for an administrator, who is there to protect creditors, not markets. It is, however, likely that market stability will be made a priority for administrators of failed banks in the future.

Despite all the difficulties, PwC has returned £13bn to creditors since the start of the process. Lomas said this had been achieved mostly by working extensively with individual counterparties to create a contract which gives the administrator protection by covering off all aspects of a counterparty's relationship with Lehman. Hundreds of millions have been spent on legal and other advice to create solutions, which have enabled payouts to be made. So much money is at stake that resolution takes time. And while Lomas was confident that much of the work would be completed in the next two years, finally closing the estate could take a further two decades.

Peter Williams is editor of The Treasurer  
[editor@treasurers.org](mailto:editor@treasurers.org)

For more on the Lehman's administration, see <http://bit.ly/lwV8i0>