THE PERILS OF GLOBAL BANKING

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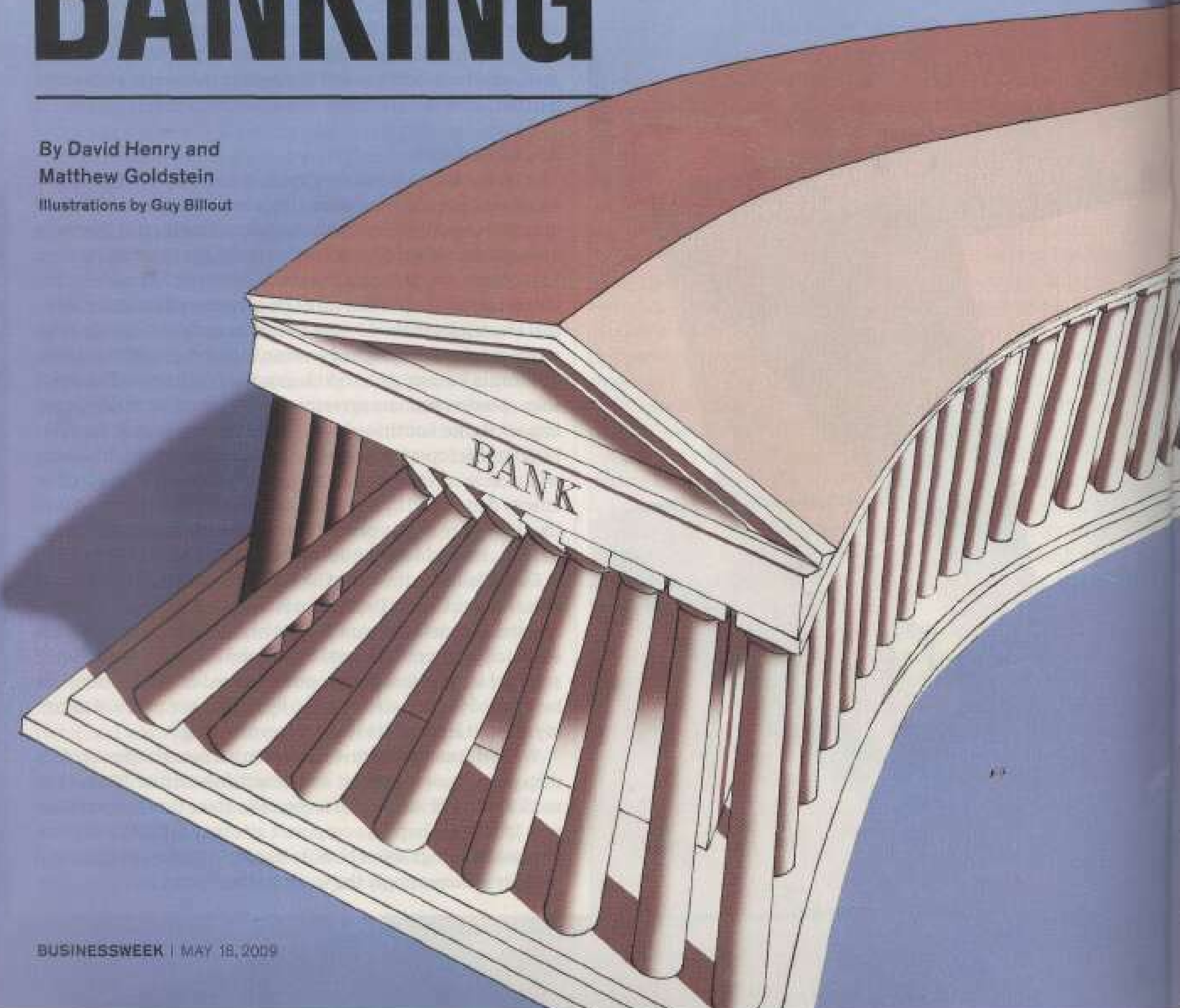
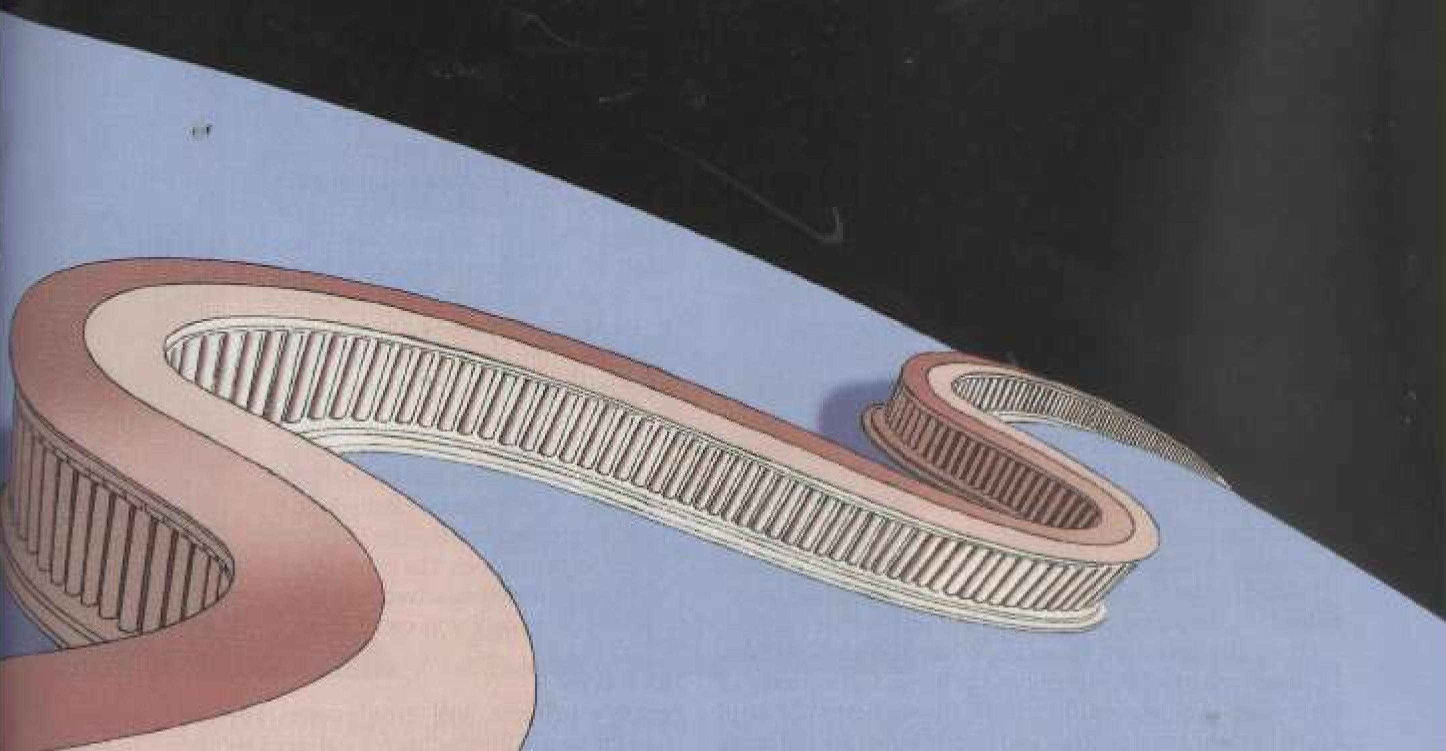




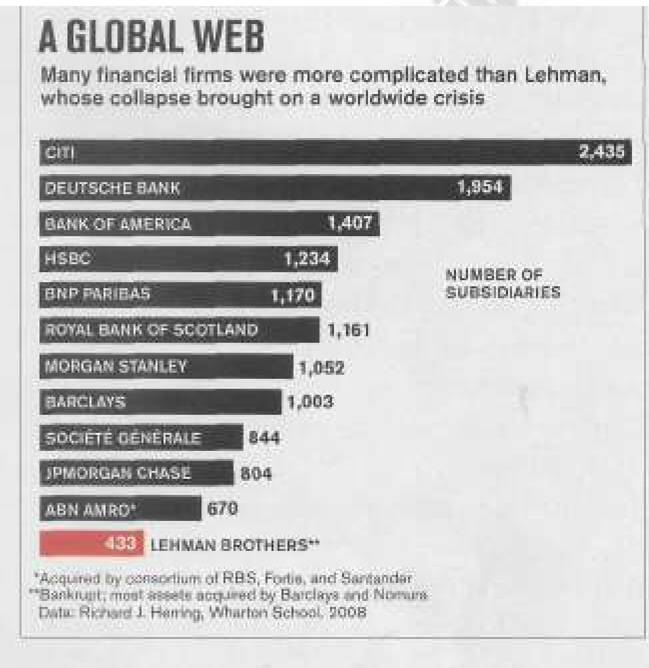
Selling through a web of subsidiaries, banks have left investors across the globe holding potentially toxic bonds. Now governments are moving to restrain foreign financial firms

JA Solar Holdings, a once-thriving Chinese manufacturer of solar-power cells, is getting a rude introduction to the dangers of global finance. So is Peter Howard, a retired British tax official. And so are Cedric Ruber, a Belgian school inspector, and his father, Rene, a retired employee of the U.S. Army. ¶ Each is trying to recoup money from Lehman Brothers, whose bankruptcy in September paralyzed the world economy. They're just a few of the tens of thousands of burned investors around the world complaining loudly that they were sold toxic bonds that were supposed to be safe. In street demonstrations from Hong Kong to Hamburg, protesters are demanding that their governments do something to get their money back. ¶ Now there's a growing fear among economists, policymakers, and business groups that in the name of protecting their citizens from global financial institutions, governments could slow the flow of capital between countries—at a time when the world economy is already contracting. "We're looking at a period of, at best, a pause of globalization, and more likely a period of 'de-globalization,' "Mohamed El- Brian, chief executive officer of bond giant PIMCO, said at a conference on Apr. 27. Governments are already moving to impose new hurdles on foreign firms. Regulators in Britain have started asking U. S. banks selling bonds there to provide hundreds of pages of proof that the mighty U.S. government, which is backing the bonds, could actually repay them.

A revelation from Lehman's bankruptcy illustrates why public confidence has been so shaken. It turns out that during the credit boom, a little-known Amsterdam unit called Lehman Brothers Treasury churned out $35 billion worth of dubious bonds, fully a quarter of the parent company's total bond debt when it went bust. Many of those bonds, baroque in their complexity, were sold to small investors in Europe and Asia—high finance for the masses. In the U.K., at least 6,000 retirees bought in. Brokers in Asia plied small investors, a few of them mentally ill, with free digital cameras and flat-screen televisions. As Lehman fought for its life in its last six months, it pushed harder to sell the bonds, most of which were "guaranteed" by the parent company in New York.

Or so the investors thought. When Lehman Brothers Holdings collapsed in September, the bonds lost virtually all their value. JA Solar ate $100 million. Howard lost $74,000 of his retirement savings. Rene and Cedric Ruber are out some $200,000.

The Amsterdam debacle offers a rare glimpse into Wall Street's relentless drive to exploit foreign markets. Overseas locales provide banks great opportunities for "regulatory arbitrage," the practice of searching high and low for the most beneficial legal environments for particular lines of business. Lehman chose Amsterdam because of the tax benefits there. In recent years Wall Street firms have set up thousands of overseas subsidiaries for various purposes. Among other things, the entities have sold trillions of dollars worth of risky "derivatives" like the ones bought by Howard and the others. Lehman had 433 subsidiaries when it blew up—and it was relatively small. Citigroup has more than 2,400 (chart).



That global tangle of bank subsidiaries is creating bigger problems than anyone realized. The Lehman case shows how hard it can be for burned investors to get their money back in the event of disaster. Its bankruptcy alone has spawned more than 75 insolvency proceedings in 15 countries, each with differing rules. Without coordinated efforts, countries could find themselves pitted against one another. Even Belgium and the Netherlands, two close friends, clashed after the multinational Fortis Bank began to collapse in September. The bankruptcy proceeding quickly devolved into each country looking out for its own citizens.

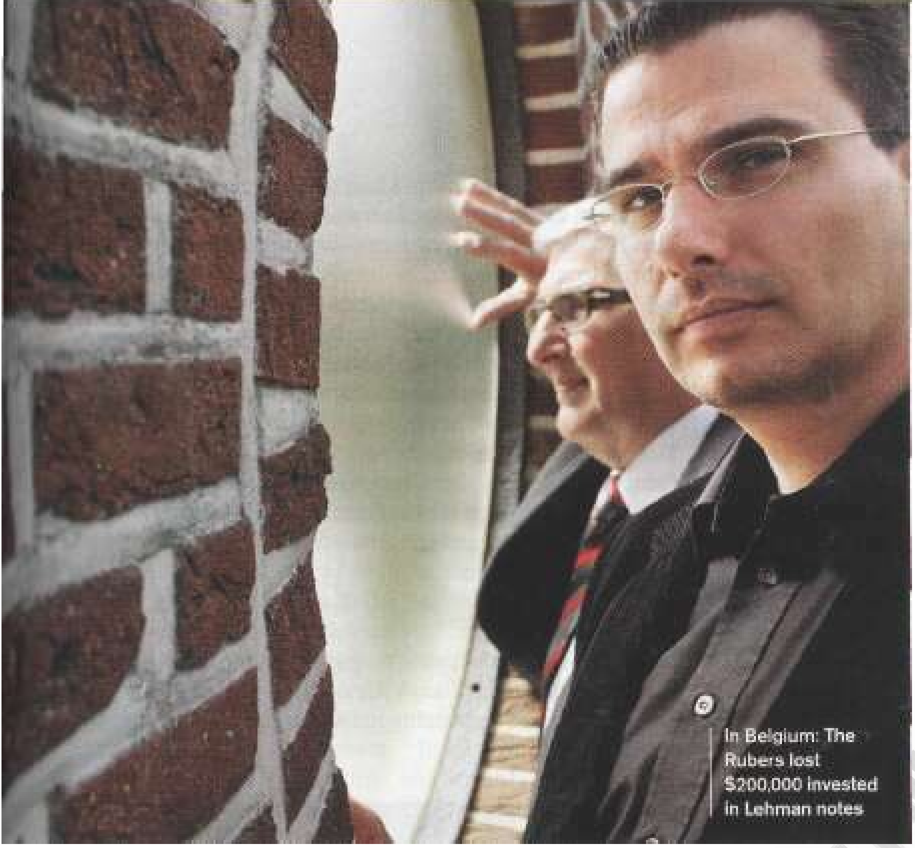
TAX HAVEN

Equally worrisome, Wall Street's embrace of foreign markets makes it nearly impossible for national regulators to keep watch over what's being sold abroad and to whom. Even now, in the thick of the credit crisis, the biggest firms on Wall Street, Goldman Sachs among them, are setting up deals to sell potentially risky investments through foreign subsidiaries. This is one reason why the current financial debacle is unlike any that policymakers have had to confront. "I wouldn't want to be a regulator today," says Fried Frank partner Thomas P. Vartanian, who served as general counsel to the Federal Home Loan Bank Board at the start of the savings and loan crisis of the 1980s. "Some of the buttons on the control panel simply don't work." Prominent regulators concede the point. "A lot of these institutions [that got into trouble] were already regulated," Sheila C. Bair, head of the Federal Deposit Insurance Corp., said at an Apr. 23 industry conference in Washington.

It's no wonder that Lehman's Amsterdam operation is fueling outrage. The operation was created in 1995 to sell "structured notes," a type of derivative that's like a bond except that the payments are tied to the performance of other investments. The subsidiary had an Amsterdam address but was run out of London by Lehman Brothers International (Europe), itself a subsidiary of Lehman Brothers Holdings in New York.

Bankers call such enterprises "special purpose entities," but a more direct term might be "shell company." The Amsterdam unit had no independent staff and was overseen, nominally, by a board of five directors. Two worked for Equity Trust, a Dutch company that provides administrative services for companies and investors—everything from setting up trusts, to serving as directors on boards. Equity Trust counted Lehman as a client. What's more, the Amsterdam subsidiary used Equity Trust's mailing address as its own. In the past, the address was used by a unit of Enron. Equity Trust declined to comment.

The Netherlands has emerged as a haven for companies



In Belgium: The Rubers lost $200,000 invested in Lehman notes

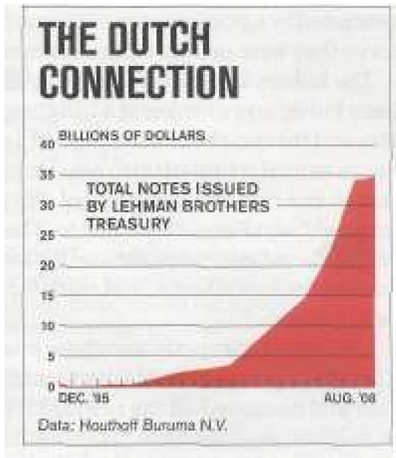
that want to avoid certain taxes on profits. A 2006 report by SOMO, a research group that focuses on multinational companies, found that some 20,000 "mailbox companies" had set up shop in Amsterdam for this purpose alone. That's one reason the Obama Administration is proposing a crackdown on offshore corporate tax havens.

Jeremy Isaacs, head of Lehman Brothers International (Europe), oversaw the Amsterdam unit. He had been something of a wunderkind, embarking on his career in finance at age 18, with a back-office job at a U.K. brokerage. In 1989 he got a job as a derivatives trader at Goldman in London. Isaacs joined Lehman in 1996, at age 31, and within four years had taken the helm of Lehman's entire European operation.

ULTRA-CUSTOMIZED NOTES

From 1995 through 2002 the Amsterdam subsidiary was a bit player in the Lehman empire. But as the global credit boom began, Isaacs turned the operation into a virtual factory, issuing $30 billion in structured notes from 2003 through August 2008. At industry conferences during those years, Lehman executives, including CEO Richard S. Fuld Jr., said the Amsterdam notes were an important source of revenue. Isaacs left Lehman two days before it collapsed.

Lehman's Amsterdam notes were bafflingly complex. In all, the unit issued some 4,000 variations, and the documentation for each type often ran to 600 pages. Lehman tailored the notes in an amazing array of styles to cater to just about any investing need. Would someone like a bond that would pay on the "outperformance" of Japanese stocks vs. U.S. stocks? Lehman created them, along with a "rocket tracker" on the Dow Jones Euro Stoxx 50 index. How about a bond for a thrifty soul



who wanted to guard against inflation in Italy? Lehman had notes tied to consumer price indexes there, and in Spain and Mexico, too. It shipped the proceeds from selling the bonds back to New York.

JA Solar bought $100 million worth last summer, at the urging of its Lehman bankers. It says the bankers pitched the notes (which paid a little interest each quarter if a certain commodity index registered a gain) as no riskier than a money market fund. JA Solar says it was told that at worst the investment would come out flat. "We did not anticipate [the notes'] coming even close to risky," says Anthea Chung, JA Solar's chief financial officer.

Now the company is reeling. It has written off the entire $100 million on its books. Its stock, which is traded in New York, is down 66% since Lehman filed for bankruptcy. JA is becoming one of the pioneers of de-globalization, preferring to keep its financial deals closer to home. "For the near future, we are quite comfortable with Chinese banks," says Chung. "They are backed by the Chinese government."

Lehman also tapped retail banks, including Citigroup and UBS, to hawk the Amsterdam notes, which were part of an enormous market. All told, Wall Street has sold more than $640 billion of structured notes to small investors around the world, according to StructuredRetailProducts.com—most of them from overseas units. That's about the size of the market for subprime collateralized debt obligations (CDOs), which brought on the global crisis. "[Lehman's notes] were sold directly by the banks to their retail customers," says Erik Bomans, a partner at Deminor, an advisory firm specializing in investor protection. Deminor, based in Brussels, is working with attorneys representing buyers of Lehman notes sold in Belgium, Italy, and the Netherlands. To date, the firm says, it has been

BURNED LEHMAN INVESTOR JA SOLAR ILLUSTRATES WHAT MAY BE A DE-GLOBALIZATION TREND: NOW THE CHINESE COMPANY IS STICKING WITH CHINESE BANKS

contacted by 1,600 investors. "You can't even call them investors—they were savings bank customers," says Bomans.

The Rubers are among those who claim they were misled. Rene Ruber says a banker at a Citigroup office in Belgium sold him and his son about $200,000 of Lehman notes, promising an annual return of up to 6%. He says the notes were presented as a risk-free savings tool. "In plain English, we were screwed," says Rene. "I was lied to. They are not honest bankers." His son Cedric says some of his lost money had been earmarked for a new home, and some for college savings for his two children.

UBS says it "properly sold these investments to its clients. The offering materials clearly identified Lehman as the issuer and discussed all the relevant risks." A Citi spokesman in Belgium says the bank "is committed to helping affected customers retrieve as much of their original investment as possible through Lehman's bankruptcy proceedings in the U.S. and the Netherlands."

In Britain it's a somewhat different story. Most of the notes sold there were marketed under the names of various London-based brokerages. Investors say they never knew that Lehman originated the bonds or guaranteed them. "If people knew it was Lehman, many wouldn't have bought them," says Howard, the retired British schoolteacher, who purchased notes in February 2008. "Many [American banks] were having a sticky time back then."

Howard, 58, is trying to organize U.K. investors to recoup their money. Working from his home in Wantage, in Oxfordshire, he has spoken with about loo people so far, he says. "The average age is 65," says Howard. "Most of them took some of their pension money and invested in these notes." He says he has been talking to members of Parliament to get them to pressure brokerages to reimburse investors. In the next few weeks, his grassroots group, SPIRIT—short for Structured Products Investors Recovery & Information Team—plans to launch a Web site to draw more attention.

Similar stories abound in Asia, where investors have taken to the streets in Hong Kong several times since Lehman collapsed. The government says the Hong Kong Monetary Authority received more than 20,800 complaints about the notes, called minibonds there. Government officials on Apr. 28 alleged that some banks sold minibonds to mentally ill investors, although more details couldn't be obtained.

The minibonds were similar to the Amsterdam notes except that they weren't "principal protected." Instead, a marketing leaflet said the minibonds were "credit-linked to a basket of well-known international financial institutions," such as JPMorgan Chase. In fact, they were tied to a CDO. The leaflet said the minibonds were safe and that returns "may reach 48.4%." But they were no more secure than Lehman's ability to pay back the cash. That risk was buried in the fine print, below icons for gifts—digital cameras, LCD TVs, even grocery coupons.

GORDIAN KNOT

Now investors are trying to get their money back. "We feel totally cheated," says Alex Chow, 51, who lost about $130,000 and is organizing more protests. "The bank stole

BATTLING TOO BIG TO FAIL

How the U.S. could avoid future giant bailouts

By Theo Francis and David Henry

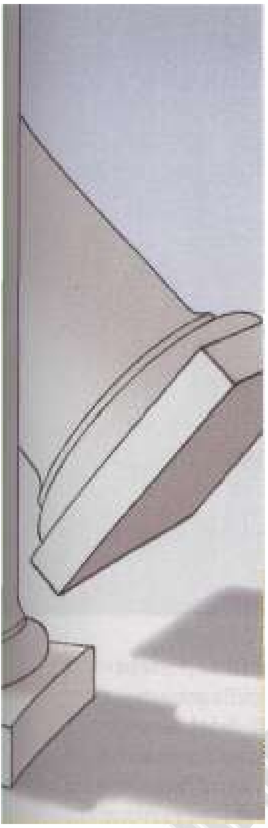
When Lehman Brothers collapsed, Washington learned that some firms are too tangled up in the global financial system to fail. But unless the White House figures out a way to shrink the global giants, U.S. taxpayers will likely have to bail out more big firms in the future.

To combat this problem, the Obama Administration is asking Congress to broaden regulators' powers to seize failing banks. It wants the feds to be able to take over such diverse financial giants as insurance-based conglomerate American International Group, as well as big holding companies, such as Citigroup, that own both traditional banks and securities-trading units.

But that wouldn't address one key problem laid bare by Lehman: the byzantine profusion of rules different nations have for handling failed financial firms. Without more coordination, countries could find themselves pitted against our money," he says. Two firms that distributed Lehman minibonds have agreed with regulators to repay investors. About 6,000 investor claims are being settled, says the Hong Kong government.

Meanwhile, in Amsterdam, the untangling of Lehman Brothers Treasury is just beginning. Rutger Schimmelpenninck, a partner with law firm Houthoff Buruma who is serving as the bankruptcy trustee, is daunted by the task. His exasperation came through in an Apr. 16 report in which he complained that "almost all the notes are governed by English law, while the validation of debt.. .is under Dutch bankruptcy law.... Obligations under the notes are governed by New York State law [and claims] have to be calculated and filed in accordance with the bankruptcy law of the United States." There's no clean way to slice through the Gordian knot of contracts, he tells *Business Week:* "The legal practices for resolving disputes in bankruptcy situations around notes with embedded derivative elements have not yet developed."

Regulators have worried about that sort of problem for years. "Insolvency proceedings from one country to another are completely different," says Michael H. Krimminger, special adviser for policy to FDIC Chairman Bair.



Despite the mess in Amsterdam, new deals are hatching in Europe. On Feb. 11 Goldman registered a plan in Ireland to sell notes that seem similar in structure to the ones sold by Lehman in Amsterdam. The notes will be issued by an Irish unit called Goldman Sachs Financial Products Europe, according to the prospectus. Like Lehman's notes, some of Goldman's will be backed by the parent company in New York. Goldman declined to comment.

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End Life Support for Troubled Banks
Propping up failed banks isn't working, says Thomas M. Hoenig, president of the Federal Reserve Bank of Kansas City. Despite billions spent, markets haven't recovered, he wrote on May 4 in the *Financial Times.* Hoenig has argued for the forced liquidation of assets of failing banks.

To read Hoenig's column, go to **http://bx.businessweek.com/banking-industry/reference/**

Ireland, like Amsterdam, has become a favorite place for global banks to set up subsidiaries to sell financial instruments. A recent Government Accountability Office report listed Ireland among more than 30 nations where U.S. companies have established units to take advantage of easier regulation.

Goldman's operation is similar to Lehman's in another way. Two of the subsidiary's directors are executives with Deutsche International Corporate Services, a unit of Germany's Deutsche Bank that provides trustee and securities services to scores of investment vehicles set up by Goldman and others. The mailing address for Goldman's Ireland subsidiary? It's the one used by the Deutsche operation.

If more structured notes go sour or if bank bailout burdens grow, the biggest loser could be globalization itself. Josef Ackermann, chairman of Deutsche Bank, warned of the consequences of financial protectionism in a recent speech at the London School of Economics. "Market integration, for goods and services and for capital, is the bedrock of our prosperity," he said. But by selling risky instruments to unwitting investors around the world, Wall Street is placing that prosperity in jeopardy.

-With Theo Francis in Washington and Bruce Einhorn in Hong Kong

one another. "There's a lot of work to do," says Sheila C. Bair, chairman of the Federal Deposit Insurance Corp.

Another option would be old-fashioned trustbusting. Regulators could break off chunks of firms until those entities fit neatly inside national borders. "Banks that are too big to fail must now be considered too big to exist," says Simon Johnson, a former International Monetary Fund chief economist.

One step would be to revive the Glass-Steagall Act, the Depression-era law that barred commercial banks from owning investment banks and other firms. The 1999 repeal of the law permitted huge amounts of risk to be concentrated in a handful of giant banks. "The original Glass-Steagall wasn't just a banking law; it was also a very good form of antitrust law," says Charles Geisst, a finance professor at Manhattan College and Wall Street historian.

But even a new Glass-Steagall might not solve the risk problem. Many small firms that rely on the volatile capital markets for money could fail just as Lehman did.

One approach gaining favor is akin to a living will and would require big firms to plan for their own demise much as many terminally ill people do. The banks would prepare to unwind derivatives, move assets to healthy firms, and settle up their estates. If regulators knew such plans were in place, they could better judge the risk of a failure and then, perhaps, let some firms fall. Says Richard J. Herring, professor at the Wharton School: "You've got to make global companies think about how they can gracefully leave the scene."

-With Matthew Goldstein

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