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The Failure of Lehman Brothers and Merrill Lynch: A Lesson for the Nigerian Banking Industry

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Abstract

In recent times, the instability that experienced in the financial system and banking sub-sector in particular was as a result of institutional failures. Consequently, banking experts in Nigeria said that, the failure of the two banks was an enough signal to the Nigerian banking industry. Therefore, the study examined the collapse of Lehman Brothers and Merrill Lynch also as a rethink lesson for the Nigerian Banks. However, the study revealed that the two banks were absolutely limiting to the size

and age in determining the future of their banks instead of depending on the effectiveness and efficient management of risky assets. Also the conventional lending procedures were not instituted rather they depend on subprime mortgage arrangement that did not have collateral securities. The declining home prices had made refinancing more difficult as a result of inadequate innovations in securitization. We therefore, recommended that the regulatory bodies should not be over confident and depend on only the conventional tools of bank supervision. They should employ more non-conventional methods of obtaining insider information also the current crops of bankers are sophisticated in recent manipulation as could be seen from the consolidation exercise. CBN should have full autonomy to run the market efficiently. And the supervisory role of CBN should roll up their sleeves to do effective risk management. Finally, government should penalize policy reversal and also allow CBN to have the air of confidence in discharging its responsibilities.

Key words: Failure, Lehman Brothers, Merrill Lynch, Lesson, Nigerian, Banking Industry.

Introduction

According to Babajide (2008), Lehman Brothers was founded in 1850 as a commodity trader and broker, from where it veered into investment banking in 1899. It had a capital base of \$26 billion and assets of \$639 billion with 26,189 employees. Ezeuduji (2006) confirmed that, the company specialized in investment banking, equity, fixed income sales, research, trading, investment management, private equity and private banking. According to Andabai (2008) the bank was a primary dealer in the United State America treasury securities market. Ahimie (2008) stated that, while Merrill Lynch was founded in 1914. It had a capital base of \$32 billion and total assets of \$1.6 trillion. Olugun (2008) observed that, the bank reputed to be the largest securities firm in the world, with offices in over 98 cities and membership of 28 exchanges, the company had about 60,000 staff around the world. In fact, on September 14th and 15th 2008 to be more precise, the raging fire of financial crises in the United State of America as at that period took an unexpected dimension, when the two banking giants were consumed.

Andabai (2008) concluded that, age and size is not an insulator from failure, but management must remain focused and professional he stated that, liquidity and cash management is very important and early recognition of losses of assets and liability. Umoh (2002) discovered that, researches carried out on bank failure indicate that, bank failure means different thing to different people. Ebhodaghe (2000) opined that, some are on the view that bank fails only when it ceases operations even when it has not been officially declared liquidated. Ekpenyond (2010) also confirmed that, others are on the view that a bank has failed, if it has not been able to achieve for which it was formed. On the basis of the above, Ezeuduji (2006) concluded that,

failure is a situation where a bank ceases operation as well as not been able to meet any of its obligations. Emene (2002) further stated that, these obligations include: those it owes to its customers, shareholders as well as the community in which it is established. In his own view, Ogubunka (2003) described bank failure as a situation where there is irremediable bank distress; a bank license is revoked and is subsequently liquidated. Ebhodaghe (2001) also agreed that, a bank has failed when it is liquidated for its inability to meet its obligations to creditors.

Theoretical Concepts

Andabai (2011) asserted that, bank failures in emerging financial system had dramatic effects on their economics, and even when crisis are prevented, the cost of distortion of resource allocation, and restructuring and recapitalization of banks have become a burden on the economies for many years. According to Umoh (2002) “bank failure depicts a situation of complete or close to loss of shareholders’ funds combined with a cessation of independent operation or continuance by virtue of financial assistance. Also Emiaso (2006) noted that, a bank is said to have failed if it has not succeeded in achieving any of the objectives for which it was established. Thus, the above school of thought considered a bank failure as not when it ceases operation but also when it cannot meet its obligations. Emene (2002) stressed that, these obligations are dues, first and foremost, to its customers as well as to its shareholders and even the community in which it operates. The critical importance of banks in economic growth and development explain why each economy seeks measures to prevent such failure.

However, Ezeuduji, (2006) stated that despite preventive measures, every economy experience varying degrees of bank failure at one time or the other. While cessation of operation by banks is always considered as serious, the inability of banks to meet their maturing obligation as they fall due may constitute serious, mild or negligible bank failure depending on the circumstances. Bank failure also means inability of bank to meet maturing obligations, since the inception of banking in Nigeria. Some of the breaches of these obligations include inaccessibility of many Nigerians to banking systems as well as delays and inefficiency in rendering such services thereby encouraging many Nigerians to patronize the informal financial sector and leading to loss of confidence on banks. To this extent the banks could be said to have failed in meeting their obligation or expectations for their establishment. However, the inability of banks to meet some obligations may not be considered serious because the breaches of bank obligations, which include inability to meet depositors, demand for withdrawals, persistent losses and outright liquidation.

Another danger posed by widespread distress among banks is the threat to the development of an efficient payment mechanism and settlement of transaction will become predominantly cash-based with associated risks. Also, the effectiveness of

monetary policy will be reduced in direct proportion to the extent of loss of confidence in the banking system as reflected in the instability that will characterize the demand for money. Because the proportion of money in circulation that will be outside the banking system as banks no longer serve as safe depository. In Nigeria today, it is puzzling that in spite of the global trend towards credit based economies and the growth of this culture in most emerging markets, most economies transactions in the economy are carried out on a cash and carry basis. This phenomenon account for the huge pool of total money supply and a good proportion of this represents idle fund that could have been effectively utilized in the productive sector if the banking system is stable, safe and sound (Sanusi 2009).

Nzotta (2014) stated that the cash based nature of an economy does not only choke the development of the financial intermediation, but it also encourages distortion in money supply and macro-economic management. Also, there will be financial cost to be incurred by the economy in order to resolve the distress problem and this invariably narrowed down to tax payers at large. The implication would even be more severe for a depressed economy that is already on the path of declining growth. In addition to the theoretical implication of bank failure in an economy, some adverse effects have been observed on the restrictions of banks credit as a result of bank failure. According to existing financial literature, the expenditures of economic agents are constrained by the quantity of credit made available to them. Development that reduces the total quantity of bank credit or disrupts the operations of banks as intermediaries will reduce spending and consequently will affect the aggregate performance of the economy. To the extent that bank failures disrupt the process of financial intermediation including, credit granting activities of banks, aggregate economic activities may also be adversely affected (Olugun, 2008).

The Issues and Challenges

Babajide (2008) also observed that, following a string of losses arising from exposure to the trouble United State of America subprime market, on the 15th of September 2008, Lehman Brothers filed for bankruptcy. Andabai (2008) posited that, while on the 14th of September 2008, Merrill Lynch was also acquired by Bank of America in a \$50 billion all stock transactions. Consequently, the failure of the two venerable banking institutions shook the entire world financial market with the New York Exchange going down by 504 points. Ogunbuka (2003) concluded that, in addition to be among the biggest and largest investment banks, the two institutions were also considered to be the oldest and reacting to the demise of the two banking institutions and the implications for Nigeria banks. Sanusi (2008) remarked that, the fall of the two banks confirmed what he had always said that banks are sustained by the quality of assets and prudence management of risky assets and not the amount of capital. Because, no matter how much capital a bank has, poor assets quality will

bring it down one day in fact, he observed that, the two banks were bigger than all the 22 banks in Nigeria.

Ogubunka (2008) observed that, Nigerian banks were not panic about the failure of Lehman Brothers and Merrill Lynch. Because, it will have no effect on our economy or any impact in Nigeria Banks, except when there is direct financial dealings. Sanusi (2008) maintained that, Nigerian banks should be cautious about lending at inter-bank market and also be cautions with consumer credits particularly now that liquidity is poor. The global financial crises initially seem not to have crossed border to Nigeria but in the last few weeks of that period (2008) we experienced rubbles because of the stock market. When the prices in the stock market were buoyant, no one looked at the underlying transactions, the balance sheets and fixed income flows from abroad and these flows were moving out slowly while the domestic market had tight liquidity (Andabai, 2011).

Babajide (2008) confirmed that, the crises that consumed the two banks were popularly known as the subprime mortgage crises that started with the busting of the united state of America, housing bubble and high default rate on “sub prime” and other adjustable rate mortgages (ARM) that made higher risk borrower with lower income or lesser credit history than “prime” borrowers in 2006. Sanusi (2008) stressed that, the term subprime lending refers to the practice of making loans to borrowers who do not qualify for market interest rates owing to various risk such as income level, size of the down payment made, credit history and employment status. Babajide (2008) maintain that, the crises can also be attributed to a number of factors such as: the inability of home owners to make their mortgage payments, prejudgment by the borrowers or the lenders. Kayode (2008) stated that, further declining home prices had also made refinancing more difficult as a result of innovations in securitization and risk related to inability of home owners to meet mortgage payments that have been distributed broadly, with a series of consequential impacts.

Ahime (2008) posits that, loan incentives and a long term trend of rising housing prices encouraged borrowers to assume mortgage, believing that they would be able to refinance at more favourable terms later. However, once housing prices started to drop drastically in 2006 to 2007 in many parts of America, refinancing became more different. Andabai (2008) confirmed that, default and foreclosure activity increased dramatically as ARM interest rate reset higher. During 2008, nearly 1.3 million American housing properties were subject to foreclosure activity up to 79% from 2006. According to Ahimie (2008), the mortgage lenders that retained credit risk were the first to be affected, as borrowers became unable or unwilling to make payments. Major Banks and their financial institutions around the world had reported losses of approximately \$435 billion in July 2008. In summary the major

reason for failure was as a result of compromising with the management of risky assets.

Andabai (2011) stressed that, the demise of Lehman Brothers and Merrill Lynch had further confirmed the historical fact that, no bank or financial institution is too big or too old to fail and this will replete banks that were so big that nobody believed could fail or would be allowed to fail. Ebhodaghe (2001) stated that, Bank of Credit and Commerce International (BCCI), which collapsed in 1991 and Barings Bank which also failed in 1995 are classical examples in this regard. In fact, they could not believe that, the raging financial crises would consume Lehman Brothers and Merrill Lynch as both have survived earlier crises especially the great Wall Street crash of 1920s. However, he also stressed that, the message for Nigerian banks is the fact that, both banks failed due to undue credit exposure to the mortgage sector subprime market through mortgage backed securities. That means, the future of a bank depends on the efficiency and effective management of risky assets and not the size and age of a bank. Therefore, Nyong (2010) emphasized that; Nigerian banks should not compromise with the management of risky assets as experienced by the two banking agents.

Conclusion and Recommendations

However, the study revealed that the two banks were absolutely limiting to the size and age in determining the future of their banks instead of depending on the effectiveness and efficient management of risky assets. Also the conventional lending procedures were not instituted rather they depend on subprime mortgage arrangement that did not have collateral securities. The declining home prices had made refinancing more difficult as a result of inadequate innovations in securitization. We therefore, recommended that the regulatory bodies should not be over confident and depend on only the conventional tools of bank supervision. They should employ more non-conventional methods of obtaining insider information also the current crops of bankers are sophisticated in recent manipulation as could be seen from the consolidation exercise. CBN should have full autonomy to run the market efficiently. And the supervisory role of CBN should roll up their sleeves to do effective risk management. Finally, government should penalize policy reversal and also allow CBN to have the air of confidence in discharging its responsibilities.

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