Preprints (www.preprints.org) | NOT PEER-REVIEWED | Posted: 8 October 2020 doi:10.20944/preprints202007.0006.v3

THE COLLAPSE OF BARINGS BANK AND LEHMAN BROTHERS HOLDINGS INC: AN ABRIDGED VERSION

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ABSTRACT

Bank crisis is mostly traced to a decrease in the value of bank assets. This occurs in one or a combination of the following incidences; when loans turn bad and cease to perform (credit risk), when there are excess withdrawals over available funds (liquidity risk) and rising interest rates (interest rate risk). Bad credit management, market inefficiencies and operational risk are among a host others that trigger panic withdrawals when customers suspect a loss of investment. This brief article makes a contribution on why Barings Bank and Lehman Brothers failed and lessons thereafter. The failure of Barings Bank and Lehman Brothers Holdings Inc was as a result of an array of factors spanning from lack of oversight role in relation to employee conduct the course performing assigned duties to management's involvement in dubious accounting practices, unethical business practices, over indulging in risky and unsecured derivative trade. To guide against similar unfortunate bank collapse in the near future, there should be an enhanced communication among international regulators and authorities that exercise oversight responsibilities on the security market. National bankruptcy laws should be invoked to forestall liquidity crisis so as to prevent freezing of margins and positions of solvent customers.

 doi:10.20944/preprints202007.0006.v3

INTRODUCTION

Background Information

Events chronicling firm failure in the global financial market have become those of case studies, especially in the risk financial institutions (Howells & Bain 2000). It is clear that bank crisis may occur when there is excess expenditure on investment due to unequal generated income from the investment as a result of factors such as bad credit management, market inefficiencies, and operational risk. This situation could lead to liquidity challenges and the inability of financial firms to oblige to customer demands thereby triggering panic withdrawals by depositors who feel insecure for fear of possible bank collapse. Indeed, it will amount to a half-baked discussion on issues of global bank collapse without a mention of Barings Bank, Enron and Lehman Brothers Holdings Inc, as points of reference to emerging financial malfeasance.

History identifies the year 1995, 25 February as a period that witnessed the unfortunate collapse of Barings bank of England. The root cause of the collapse of this pioneer merchant bank (Barings bank) was the over ambitious engagement in a secret derivative engaged in by one of its employees (Nick Leeson). He diverted funds for derivative bets and hid losses thereof from his nefarious futures / options trade activities. Nick Leeson created a hidden account known as the Error Account with a number 99905 and later 88888 to shield losses with trade reconciliations (Drummond 2008).

With an asset base of $639billion and $619billion in debt, the bankruptcy proceedings of Lehman Brothers Holdings Inc were initiated in 2008 September 15, forming the largest ever initiated bankruptcy proceedings in the history of the US. Wiggins, Piontek and Metrick (2014) reveal that at the time of Lehman Brothers' Bank failure, it was considered the fourth largest investment bank with estimated employee strength of 25,000. Lehman Brothers rose to dramatic heights but thereafter witnessed a dizzying distressful situation when it filed for bankrupt in the 3rd quarter of 2008. In fact, the fated financial institution's bankruptcy had a toll on its employees as it brought unimaginable unemployment crisis to families and loved ones. Equally engaged in derivative commercial activities, Lehman Brothers held an estimated 5 percent outstanding of the world's derivative engagement (Wiggins et al 2014; Sarno & Martins 2018). Unfortunately, many are still caught up in abeyance of how such a powerful institution could go bankrupt. What however escaped the puzzling public was that, Lehman Brothers' balance sheet figures did not reveal the type of business entered into, although it showed a concentration of most important instruments.

Empirical Evidence from Barings and Lehman Brothers' Banks

Barings Bank was, as at then (1890), the biggest financial market in Britain (Flores 2005). Besides, Barings had a lot of commercial activities under its umbrella; investment banking, agency trading for clients, proprietary trading among others. This bank was regarded *"too big to fail"* by the global financial sector. This was because, the failure and collapse of this institution would have devastating effect on the generality of the global financial economy, constituting a source of contagion risk. By this singular reason, attempts were usually made to stage bailouts for it each time there was a threat of distress. Barings Bank endorsed as much as 15 % of all bills of exchange in Britain and any bill that bore the endorsement of Barings Bank was regarded authentic (Fores 2014). Leeson authoritatively opened an account designated by the account system as an error account with number 88888 into which losses accumulated from dealings with clients were kept. A pile of £208 in losses was made between July 1, 1992 and December 31, 1994.

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In the case of Lehman Brothers' Bank, it happened to be among the top investment banks in the middle and late 2008 in the US (D' Arcry 2009). Annals of history have it that, Lehman Brothers' crumble to liquidation was regarded the largest catastrophe that hit the US financial sector (Maux & Morin 2011). Lehman Brothers' Bank led the investment market with a $600 billion worth (D' Arcy 2009). It is a fact that by the second quarter of September 2008, Lehman Brothers had recorded a loss of $3.9 billion when they attempted to offload majority of their shares in some subsidiaries. Wilchins and DaSilva (2010) opine that overly engaging in subprime lending made them harvest successive losses which eventually forced the bank into voluntary liquidation.

Causes of the 1995 Barings' Collapse and Failure of Lehman Brothers' Bank in 2008.

Similarities in Causes of Collapse

How were the causes of collapse similar in both cases? First, there was a firm commercial trust in potential gains in derivative trade. Both Banks' management held the believe that by engaging in derivative transactions aside the core business function, was an assuring way to harvesting profits to make for losses in other commodity trading. While Barings engaged in options and futures through Nick Leeson's *"behind scenes operations"*, Lehman Brothers traded in Speculative and Ponzis (Over the Counter) derivatives which were financially fragile as a form of leverage (Minsky 2016). Prior to their collapse, Lehman Brothers ventured into numerous risky unproductive investments besides taking huge residential loans, these undoubtedly played roles in its failure (Murphy 2008; Kimberly 2011). One other revealing cause that appeared similar in the collapse of these banks was liquidity crisis. Inability of the two giants to oblige to claims by creditors with immediacy was central in their distress (Vlukas 2010). For instance, Lehman lost its market confidence as most banks refused them credit facilities in spite of their asset base (D' Arcy 2009). In fact, to this end, the confidence of customers and investors alike got eroded due to high debt to equity ratio

(Mensah 2012). As were the case with Lehman Brothers, Barings Bank equally had serious challenges with liquidity and credit risk. They failed to meet counterparty financial obligations.

It is apparent that, in the quest to achieve expansionary strategies and independent organisational aims, these two banks resorted to unendorsed corporate governance practices, dubious mechanisms and unacceptable accounting practices (Caplan, Dutta & Lawson 2010). As in Barings' situation where Leeson, the rogue trader created a shadow account to hide losses from nefarious commercial activities, Lehman Brothers similarly adopted the use of window dressings and massaging of financial statement figures to portray the bank as performing good and in good standing.

Differences in Causes

- **Lehman Brothers**

One cause that brought Lehman Brothers to its collapse was exorbitant compensation of executives (conflict of interest) and non-adherence to regulatory standards of the institution. An estimated $300 million was paid to the executive director of Lehman Brothers within the span of 9 years (2001-2009) with an increase in executive bonus of $480 million even at the time bankruptcy was eminent (Bebchuk et al 2010). Besides, some financial analysts also identified complex capital structure of Lehman Brothers to have been one of the causes of its bankruptcy (Steinberg & Snowdon 2009). It was again figured out that management of Lehman Brothers illegally applied the purchase agreement (Repos 105) to aid in manipulating and massaging accounting figures in their financial statement so as to look attractive to the investor public. Indeed, this increased the leverage ratio of the institution (Maux & Morin 2011). This was achieved by trading off illiquid assets to Cayman Island Bank with the aim of buying it back to gain high cash possession but failed to disclose the said amount involved

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which contravened Sarbanes Oxley Act (www.accounting-degree.org/scandals/>; Akinyera 2015).

Barings Bank

Unnecessary adherence to bureaucratic procedures of accomplishing daily task of the institution culminated into their failure. Notwithstanding the usage of excessive bureaucracy, management of Barings Bank were notoriously inefficient. This conspicuously led to their inability to detect the nefarious activities of Leeson over such a long time (Samuelson 1996). Actions of employees were not monitored. For instance Leeson had no operational licence and independently worked without oversight supervision. Besides, there was no segregation of duties among employees.

Lessons Learnt from the Bankruptcy

Being a painful crisis, the bankruptcy of both banks provided traders and regulators with the sense of anxiousness. Stake holders then understood that creating a marketplace and a regulatory system better prepares every player to withstand external shocks in the future. Professionals have also come to agree that capital adequacy is a basic prerequisite to protect banks from suffering excessive risk of collapse. It is now obvious that regulators of foreign exchanges need rigorous market surveillance and protection of customer funds. Improved mechanisms that serve to detect and address power concentration held in these markets threaten the market stability. It is clear that there was insider trading going on but shielded with pretence. Management should have adhered to the advice given by the audit team on Leeson’s secrete activities.

Conclusion and Recommendation

Barings Bank's collapse together with the failure of Lehman Brothers serves as memorable bank crises in the history of Britain and US respectively. It is clear that their collapse had a contagion effect on the global bank sector. The bailout given Barings Bank by the British government was justifiable as against the refusal of US government to salvage Lehman Bank due to causes brought by the management of the latter themselves. In fact, the failure of these two banks is attributable to varied factors spanning from non-monitoring of employee activities, dubious accounting practices, unethical practices by management, over indulging in risky and unsecured investments in derivatives. It is recommended that, governments create legal rules to reduce externalities. Activities of employees should be monitored regularly to serve as a check on dubious transactions. Interim Internal audit should be conducted to check the strength of internal control systems. Powers should be segregated so as to avert the tendency of abuse and conflict of interest situations. Similarly, there should be enhancement of communication among international regulators and authorities that exercise oversight responsibilities on the security market. National bankruptcy laws should be promoted to forestall liquidity crisis so as not to freeze the margins and positions of solvent customers.

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