Sample Essay:

"The demise of Lehman Brothers has led the governments in Western countries to bail out their banks. Such measures clearly reveal the advantages of nationalising the banking sector, or at least parts of it". Critically examine this notion.

*words and length of this essay are deliberately altered

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Numerous governments in Western countries have been spending billions of taxpayers’ money to bail their banks out in the 2008 financial crisis. In trying to examine if partly or fully nationalising the banking sector is clearly advantageous, the essay will discuss on historical cases of nationalisation of the banking sector, including bailout plans and stimulus packages. The reasons behind Lehman Brothers demise will also be looked at, before the advantages and disadvantages of nationalisation of the banking sector will be scrutinised.

Many countries around the world have been nationalising their banks for different reasons. While most countries did so at a time of instability, many nationalisations also occurred during the development phrase of a nation to help achieve development goals (La Porta et al., 2002). Douglas (2009) mentioned that nationalisation can be categorised into several different extents. Firstly, it can be full or partial, where the government either hold total ownership or a majority stake. Next, nationalisation can be categorised as temporary, where the government seek to achieve their purpose as soon as possible, or in extreme cases, permanent ownership.

Following the World War II, the French government increased their nationalised sectors to include the biggest banks in France then. More than just to redevelop the nation after the destructive consequences of the World War, the nationalisation of the bank sector also help to prevent the failings of a series of banks that occurred in 1930 (Myers, 1949). The nationalisation of the Indian banking sector in 1969 is another case where the Indian government controls the top 14 banks of the country which accounted for 85 percent of bank deposits in an attempt to expedite growth of the Indian economy (Austin, 1999). This was mainly due to the inability of the private commercial banks to realise social and developmental goals vital to India at that time.

Although the cases mentioned above are by and large successful, there are instances where nationalised banks fail badly. Crédit Lyonnais, the biggest bank in the world in 1900, almost self-destructs due to poor management by the government in the late 80s leading to the 90s. Despite this, historical evidences like the cases stated above still prove that more often than not, a nationalised bank is successful in achieving the objectives that the nationalised banks are set to accomplish.

While nationalisation worked for developing countries or countries at a time of instability, the USA and several developed countries thrived on having a privatised banking sector. A privatised banking sector not only brings about efficiency and profitability, it also helps to increase the rate of economic growth in a competitive industry (Nellis et al., 2002). However, in 2008, pursue for profitability and growth ultimately leads to the downfall of Lehman Brothers and some of the biggest banks in the USA and other developed countries.

The downfall started back in April 2004, when the U.S. Securities and Exchange Commission (S.E.C) decided to loosen the debt regulation of the top five investment banks due to pressure from these same banks. This decision allowed the banks to increase their leverage ratio to a dangerously high level (Zingales, 2008). Even more worryingly, this money was loan to “subprimes”, people with low income or poor credit ratings, for

mortgages on their real estate. According to Mian et al (2008), this rush to take advantage of the highly lucrative but risky subprime mortgage market stemmed from low interest rates, as well as restrictions in government regulations that have inflated demand for subprime mortgage products. Consequently, numerous “subprimes” over-borrowed with their income and find themselves unable to repay their mortgages.

Despite all these, the S.E.C. did not enforce on any preventive measures to stop excessively borrowing (Lebaton, 2008). When mortgage delinquencies sharply increased, it caused a significant oversupply of real estates. This in turn resulted in the property crash, shortly a year after their peak in 2006 (Simkovic, 2011).

The five biggest investment banks in the U.S. at that time, Bear Stearns, Merrill Lynch, Morgan Stanley, Goldman Sachs and Lehman Brothers, all held on to large positions in the subprime mortgage market when it crashed. Lehman Brothers in particular, loss nearly $4 billion in the fiscal third quarter in 2008, and had to write down nearly $7.8 billion worth of asset. Many European investment banks involved were not sparred either as their U.S. subsidiaries had similarly held on to large positions in the subprime mortgage market.
In order to prevent a financial meltdown with all of the top U.S. investment banks likely to go bankrupt, the U.S. government passed a $700 billion bailout bill to bailout numerous corporations in the U.S. With the help of the bailout plan, Bear Stearns and Merrill Lynch were bought over by competitors while Morgan Stanley and Goldman Sachs received $10 billion each. Lehman Brothers however, was left unsold and refused a bailout by the then U.S. Secretary of the Treasury, Henry Paulson, on basis that the risky financial policy of Lehman Brothers was a moral hazard.

Similarly in Europe, countries were making state fund available to bail out their banks, effectively nationalising many of the banks involved. France had a 360 million euros plan installed on October 2008 to bailout, amongst others, the three listed banks in France namely, Credit Agricole (three billion euros), Societe Generale (1.7 billion euros) and BNP Paribas (2.6 billion euros). Germany passed a 500 billion euros bailout package which bailout banks such as Commerzbank AG (18.2 billion euros), Hypo Real Estate Holding AG (7.7 billion euros), WestLB AG (3.0 billion euros) and Aareal Bank AG (380 million euros). Britain, one of the earliest to come up with a bailout plan in Europe, had 500 million euros made available with Royal Bank of Scotland (20 billion pound) and Lloyds TSB (17 billion pound) amongst the recipients. Prior to the 2008 Britain bank rescue package, Northern Rock had received a loan of £27 billion.

Amongst the banks that were nationalised, Northern Rock is one of the banks that achieved its target. While it incurred an eventual loss of £2 billion of the taxpayer’s money, the UK government has successfully repaid savers and investors money, and selling the bank back into private ownership, albeit through fire-sales. Other temporary nationalised banks such as Bank of America and Morgan Stanley avoided bankruptcy and had repaid all of the money the U.S. Treasury had loaned them.

Even though nationalisation can help banks avoid immediate insolvency, some of the biggest banks in Europe affected by the subprime mortgage crisis refused any bailout money. Deutsche Bank (USD4.2 billion writedown) and HSBC (USD17.2 billion) in particular opted out of their respective country’s bailout program. So why do they decline being nationalised even if it was temporary? To understand, one has to weigh in the advantages and disadvantages of being nationalised.

One of the main reasons for nationalising banks is to take over control of the banks from their management that have lost credibility and is highly likely to go bankrupt. This was particularly glaring during the subprime mortgage crisis with many of the investment banks willingly putting themselves in high-risk positions and continuing doing so to salvage the bank. The management of these banks were also reluctant to take drastic actions to close down on high-risk departments as this meant huge immediate loss to the bank.

Another reason for nationalising banks is of course to help these banks to avoid immediate insolvency. Not only will this directly help the shareholders of the bank from losing all of their money, it also prevented a widespread panic of the public customers, who are effectively the creditors of the bank. This was seen in the case of Northern Rock, where customers crowd branches and withdrew nearly £2 billion from their deposits after news of Northern Rock struggle became public. This stopped only after the government stepped in and promised to assure the deposits.

Looking over to reasons against nationalisation, a nationalised bank will almost always have a socialism approach to doing business and put the interest of the country ahead of its shareholders. While this is beneficial for the country, the bank will suffer as a business entity. Moreover, nationalised banks are rarely as well managed in the long run as compared to a bank managed by the private sector. When Mexico nationalised 58 private banks during the 1982 economy crisis in the country, it severely strained the government capacity and all of the banks were so poorly managed that by 1990, only 18 of the banks remained (Banco de Mexico, 1992).

Likewise, nationalised banks usually foster a low spirit of competition resulting in low efficiency and therefore low profitability (Florence & Walker, 1950). A study by Sathye (2005) on the performance of nationalised banks compared to banks in private ownership further revealed that fully nationalised banks are severely lacking in several financial performance and efficiency indicators, while partially nationalised banks are performing much closer to fully privatised banks. In free market economies such as the U.S. and Britain especially, poor efficiency and financial performance will curb the growth of the economy at a time when growth of these large banks is essential in helping the economy recover.

Furthermore, nationalised banks typically have less attractive monetary remuneration especially during crisis period where there is consensus public disquiet at the award of bonus payments at the banks. As such, many capable managers may head off to the private sector, making the banks more prone to poor decisions that may further affect profitability (Elliott, 2009) and future survivability. This case is illustrated recently in the nationalisation of Britain's RBS and Lloyds Banking Group where the banks have to abide by a remuneration policy in consistent with the government code of practice. The changes include a first of its kind, full deferral of bonuses and even so, most of the paid bonuses are in capital rather than cash.

By comparing both the advantages and disadvantages of nationalising the banking sector, it is clear that a balance has to strike out in between full nationalisation and full privatisation. It is vital that some of the banks in dire situation receive a boost from the government bailout fund to stay afloat. However, the government should take over management control only on matters that matter and as non-intrusive as possible. The government should also seek to privatise the banks as soon as conceivable so as to maintain the kind of efficiency and performance the banks enjoyed in private ownership.

Also, while it is important to cut down on remuneration packages spending, it is important to award bonus payments as per normal to retain and recruit talented staff who were crucial to the bank's recovery and might otherwise leave. Staff on low wages and have no responsible with causing the downfall of the banks should also be awarded bonus normally. All of these ensure that the bailout funds are used effectively and efficiently and that the government will not be strained in terms of capacity by having to manage so many banks on such a deep level.

This essay set out to discover whether nationalising either full or part of the banking sector is clearly advantageous after the fall of Lehman Brothers. However, the financial system is in such bad shape that none of the options is good or clearly advantageous. Rather, a least bad solution has to be selected. By not practicing prudent strategies when it comes to the subprime mortgage market, many of the U.S. and European banks have put the entire corporation to the sword. Many of these banks were in such dire situation that the government had to bail them out or face insolvency. Through researching historical cases of nationalisation and comparing the advantages and the disadvantages, a part nationalisation of the banking sector that seek to reprivatise it as soon as possible is the most feasible and therefore, least bad option.

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