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The Role of Management in Avoiding Financial Crisis Comparison Study: Lehman Brothers and Goldman Sachs Banks

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ABSTRACT:

This research explains the various milestones during the previous period that led to the 2007-2009 financial crisis, and considers choices of management practices that contributed to the failure or success in avoiding such events.

The problem of this research is determined in the following question: Does crisis management have role in avoiding financial crisis? And how we can prove this role?

Then, we used case study analysis approach as a method of this research and it required the selection of two special cases studied in order to analyze and make our final decision about research hypothesis to answer the research question. In general, we have an in depth study and interpretation of already existing data obtained from various books, literatures, information on websites …etc, and the main focus was on the careful selection of sources according to both their content and methodology.

Finally, the main conclusion of this research is that good and effective crisis management have greater role in avoiding financial crisis through dealing with pre-crisis management to achieve crisis preparedness and crisis prevention, and crisis management to achieve crisis event management and post-crisis management.

INTRODUCTION:

This research is divided into four chapters. In chapter one we discuss the research methodology by discussing its problem, its importance, its objectives and hypothesis, as well as the research method.

The second chapter is the theoretical section which covers the concept of crisis and its management, and provides a concise overview of the emergence of the crisis and critical examination of selected issues that are fundamental to effective crisis management. While, we cover the empirical section in the third chapter, we attempt to examine and analyze two cases conducted about two of the most popular banks in the United States of America, which had faced the same crisis situation, and compare the management tools used within each bank in order to assess the role of crisis management in avoiding crisis situation.

The forth chapter includes research conclusions, in which we introduce the main findings and results on how to best manage a crisis situation.

Finally, we introduce a list of references used within this research.

RESEARCH METHODOLOGY:

In this chapter we will discuss the basic ideas related to the research methodology by discussing the research problem, its importance, objectives, hypotheses and model.

Thus, this chapter will represent the background of our research which will give a clear description about the direction of the research in all levels.

RESEARCH PROBLEM AND IMPORTANCE:

RESEARCH PROBLEM:

Financial crisis have been a phenomenon studied for many years, perhaps because of its large impact on society and its unpredictable nature.

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In the last two decades, developed and developing countries have experienced significant episodes of systematic banking crises, which have been more costly in developing areas than in industrial economies. Thus, the prevention of such recurrent events has become a priority. However, crisis can be fertile opportunities for learning and change if an organization is equipped with the right tools to handle them, and there are many different ideas or theories on how to best manage a crisis situation.

From the above discussion, we can determine the problem of this research by studying the role of crisis management depending on analysis of two especial cases studied, in order to discover whether it has significant role in avoiding financial crisis.

In other words, we can explain the problem of this research through the following question:

Does crisis management have a role in avoiding financial crisis? And how can we prove this role?

RESEARCH IMPORTANCE:

The importance of this research comes from the following issues:

1. Managing crisis has great importance especially for the financial and banking sector in the world. Thus, this research will highlight the concepts of crisis and its management role to explain the modern alternatives and methods which can be used by crisis management to avoid crisis in general and financial crises in particular.
2. The knowledge provided within this research about the role and importance of crisis management in the stability of the banking systems as part of a financial systems, as well as an economic systems.
3. The importance of the ability to manage crisis as a significant tool for all managers in organizations to their jobs in planning for or dealing with actual crisis situations, since crisis maybe anywhere.

RESEARCH OBJECTIVES:

This paper aims to address the fundamental causes of financial crises, and introduce ways to prevent it through effective managerial practice and to indicate the lessons that could be learned from the financial crisis.

The objectives of this study can be summarized through the following points:

1. Illustrate the importance of crisis management in Preparing for crisis situations and responding appropriately to them if they occur.
2. To know the nature of crisis management and procedures adopted at the level of the banking sector, and their compatibility for economic development in order to increase their effectiveness in reducing the negative effects of financial crisis.
3. To draw attention to all factors related to financial crisis and specify its reasons and consequences on society and economics, and the role of good management practices in reducing them.
4. Illustrate the role of crisis management in the stability of banking system and avoiding the financial crises.

RESEARCH HYPOTHESES:

According to research problem and its targeted objectives, we can introduce its hypothesis in the following paragraph:

Good and effective crisis management have greater role in avoiding financial crisis by dealing with pre-crisis management to achieve crisis preparedness, prevention, and crisis management to achieve post-crisis management and crisis event management.

RESEARCH MODEL:

In general, this research follows an in depth study and interpretation of already existing data obtained from various literatures, books, information on websites…etc. Great caution has been exercised to critically reflect content rather than to merely accept the stated information as facts. Thus, the main focus was on the careful selection of sources according to both their content and their methodology.

In order to examine the research hypothesis and achieve its objectives, the researcher will use a special model which can be described in the following manners:

1. Establishing theoretical coverage of crisis management as a basis for this research by collecting data from various related sources.
2. This paper will depend on the analysis of two cases studied, each case about different banks, Lehman Brothers and Goldman Sachs, both faced the same financial crisis.
3. Use the model depicted in figure 1 as a tool to test research hypotheses and make our judgment about the role of crisis management within each of selected case study. That means we will identify, analyze, and use the real information about each case study to show how different organizations may manage the financial crisis. This empirical section will give a brief description of the crisis faced and will attempt to explain how crisis management within each studied bank reacted to the event

CRISIS AND ITS MANAGEMENT:

While crisis began as a negative/threat, crisis management provides individuals, governments, institutions or companies with the knowledge and skills necessary to avoid their occurrence and to reduce the harmful effects and consequences. Although, it is difficult to distill, all that is known about crisis management into one concise entry. This chapter introduces the best practices and lessons created by crisis management researchers and analysts, it also shows that effective crisis management can minimize the damage and in some cases allow an organization to emerge stronger than before the crisis and provides a number of ideas that can be incorporated into an effective crisis management programs.

DEFINITIONS AND TYPES OF CRISIS:

DEFINITIONS OF CRISIS:

In the following points we summarized various definitions of crisis and its management:

1. The previous U.S. President Richard Nixon defined crises as an accidental or sudden disaster that may cause heavy losses of lives or money or both, and must be addressed properly and in the required speed (www.nabanews.net).
2. Vennette argued that crisis is the process of transformation where the old system can no longer be maintained (Vennette; 2003; 33).
3. Crisis is a situation out of control requires reactive management discipline focusing on the situation after a crisis has occurred (Benedict; 1994; 22).

EMPIRICAL SECTION:

The purpose of this chapter is to examine cases studied concerning about two of the most popular banks in the United States of America; Lehman Brothers and Goldman Sachs. Then, discover the role of crisis management in avoiding crisis situation faced each studied bank during the 2007-2009 crisis by analyzing and describing different management actions considered as a tool to deal with this situation.

The starting point would be Lehman Brothers case study in order to test whether the wrong crisis management practices led to the failure case of this bank in handling with 2007-2009 crisis. On the other hand, we will analyze and examine the second case (Goldman Sachs) in order to prove how good and effective crisis management practices within this bank give it the required capabilities to avoid the same crisis situation.

BACKGROUND OF BANKS STUDIED:

In order to achieve the objectives of this chapter we will initiate our discussion with an overview regarding the historical data for each bank studied in the following manner:

1. Overview of Lehman Brothers: Lehman Brothers Holdings Inc., former New York Stock Exchange (NYSE) ticker, was the 4th largest investment bank in the USA behind Goldman Sachs, Morgan Stanley, and Merrill Lynch. It was a global financial services firm until declaring bankruptcy in 2008, participated in business investment banking, equity and fixed-income sales, research and trading, investment management, private equity, and private banking. It was a primary dealer in the U.S. Treasury securities market and it had subsidiaries included Lehman Brothers Inc., Neuberger Berman Inc., Aurora Loan Services, SIB Mortgage Corporation, Lehman Brothers Bank, FSB, Eagle Energy Partners, and the Crossroads Group. The firm's worldwide headquarters were in New York City, with regional headquarters in London and Tokyo, as well as offices located throughout the world (www.library.hbs.edu).
   In 1844, 23 years old Henry Lehman immigrated to the United States from Rimpar, Bavaria and settled in Montgomery, Alabama, where he opened a dry-goods store, H. Lehman (Bernhard; 2007; 1; and Wechsberg; 1966; 233). In 1847, following the arrival of his brother Emanuel Lehman, the firm became H. Lehman and Bro. With the arrival of their youngest brother, Mayer Lehman, in 1850, the firm changed its name again and "Lehman Brothers" was founded (Bernhard; 2007; 5).

2. Overview of Goldman Sachs: the Goldman Sachs Group Inc. Is a global investment banking and securities firm which engages in investment banking, securities, investment management, and other financial services primarily with institutional clients. Goldman Sachs was founded in 1869 by the German born Marcus Goldman and is headquartered at 200 West Street in the Lower Manhattan area of New York City, with additional offices in major international financial centers.
   The firm provides mergers and acquisitions advice, underwriting services, asset management, and prime brokerage to its clients, which include corporations, governments and individuals. The firm also engages in proprietary trading and private equity deals, and is a primary dealer in the United States Treasury security market (www2.goldmansachs.com).

HOW GOLDMAN SACHS OVER CAME THE CRISIS :

Goldman Sachs has dealt with both the challenges of navigating the crisis itself and with actions before and during the crisis. Their risk management and business practices in the mortgage market have received much attention. In that connection, we can introduce the following points: (www2.goldmansachs.com)

1. Goldman Sachs did not take a large directional bet against the U.S. housing market Goldman Sachs was not a dominant participant in the residential mortgage-related products market. The firm’s net revenues from residential mortgage-related activities were very small. In fact, from 2003 to 2008, annual net revenues attributable to mortgage-related products, commercial and residential, never exceeded approximately 2% of the firm’s overall net revenues. In fiscal year 2007, the firm had less than $500 million of net revenue from residential mortgage related products approximately 1% of the firm’s overall net revenues. Goldman Sachs did not engage in some type of massive bet against their clients. The risk management of the firm’s exposures and the activities of its clients dictated the firm’s overall actions. Goldman Sachs maintained appropriately high standards with regard to client selection, suitability and disclosure as a market maker and underwriter. As a market maker in the mortgage market, the firm primarily engaged in the business of assisting clients in executing their desired transactions. As an underwriter, the firm assisted the issuer in providing an 11offering document to investors that discloses all material information relevant to the offering.
2. Goldman Sachs’ risk management decisions were motivated not by the view of what would happen next, but rather by fear of the unknown. The firm’s risk management processes did not, and could not provide absolute clarity; they underscored deep uncertainty about evolving conditions in the U.S. residential housing market. That uncertainty dictated their decision to attempt to reduce the firm’s overall risk.

3. Goldman Sachs sold Collateralized Debt Obligations (CDOs) principally to large financial institutions, insurance companies and hedge funds with a focus on this type of product. These investors had access to highly detailed information that allowed them to conduct their own independent research and analysis.
4. Goldman Sachs never created mortgage-related products that were designed to fail. It is critical to remember that the decline in value of mortgage-related securities occurred as a result of the broader collapse of the housing market. It was not because there were any deficiencies in the underlying instruments. The instruments performed as would have been expected in those unexpected circumstances.

PROVE OF THE ROLE OF MANAGEMENT IN AVOIDING CRISIS:

As Goldman Sachs bank, Management behavior is critical in dealing with and avoiding catastrophic events. As well as bounced back without damage to the bank's performance, and more it was capable of making profits during the crisis. While, Lehman Brothers in comparison suffered greatly by losing money, and having to witness their organization name being sullied by the media. Also, their share price took a dive during the respective crisis, and finally it went bankrupt.

Careful management of the crisis can help avoid the harmful effects and may enhance the reputation and performance of the company, but poor management can be damaging. Then, we can easily agree with the idea that Lehman Brothers would have been able to achieve best results if they followed the example of Goldman Sachs in their management of the crisis situation, which may lead to suffering less and may well over come the crisis successfully.

From previous paragraph, we can determine that the basic reason behind Goldman Sachs success was an effective crisis management that comprises a cluster of related and integrated activities which was consistent with the crisis management model introduced earlier in this research as a research model:

1. Goldman Sachs focused in general on pre-crisis and post-crisis management activities. We prove this by stating that Goldman Sachs risk managers' decisions dependend on pre-crisis management and were motivated by the fear of the unknown, they recognized the risk inherited with the sub-prime lending activities, and as a result they did not take a large bet against the U.S. housing market.

   On the other hand, for a post-crisis management, when the crisis worsened the managers of the bank came up with a solution of transforming Goldman Sachs into bank holding company in order to obtain cheap money from the Fed.
2. The crisis management teams worked skillfully depending on their previous training and their ability to simulate the real situation to introduce the basic systems required to deal with crisis. Then, their preparedness activities included effective planning processes which demonstrated a critical element to success, because when a crisis hits an organization which has no operational plan, the crisis last much longer. As illustrated above Goldman Sachs understood the uncertainty about the evolving conditions in the U.S. residential housing market and made decision to reduce the firm overall risk engaged in that business area. They also did not engage in some type of massive bet against their clients, where the risk management of the bank's exposures and the activities of its clients dictated the overall actions taken by managers of the bank.
3. The managers of Goldman Sachs also focused on crisis prevention including early warning and scanning, good risk management, and effective emergency response. They predicted the occurrence of a crisis, and therefore they made their decisions based on what might happen if a crisis hits, the bank never created mortgage related products that were designed to fail. In addition, they were not a large participant in the mortgage market, as illustrated in figure 2 Goldman Sachs had a market share of less than 4.2% in credit derivatives such as Mortgage Backed Securities and Collateralized Debt Obligations that were two of the most risky derivatives which contributed to the aggravation of the crisis.

RESEARCH CONCLUSIONS :

There are valuable lessons to be learned from the financial crisis in general and the collapse of the mortgage market in particular. It is critical to learn the right lessons, if we are to avoid future crises in the financial system.

Having done this research and written this paper "the role of management in avoiding financial crisis" we came to the following conclusions:

1. Crisis is an accidental or sudden disaster that may cause heavy losses of lives or money or both, and must be addressed properly and in the required speed, it is a situation out of control requires reactive management discipline focusing on the situation after a crisis has occurred.
2. We can determine four common elements that are used to define crisis: A threat to individuals and organizations, the element of surprise, s short decision time, and the need to change.
3. Crisis management is a discipline within the boarder context of management consisting of skills and techniques required to identify, assess, understand, and cope with a serious situation, especially from the moment it first occurs to the point that recovery procedures start. It is the process by which an organization deals with a major unpredictable event that threatens to harm the organization, its stakeholders, or the general public.
4. We can classify the types of crisis into three categories based on their severity, frequency, and timing, they are: operational crisis, sudden crisis, and potential crisis.
   In general, we can determine types of crisis in: natural crisis, technological crisis, confrontational crisis, crisis of malevolence, crisis of organizational misdeeds, crisis of deception, political crisis, challenges, mega damage, human breakdown, and rumors.
5. Successfully diffusing a crisis requires previous understanding of how to handle crisis if it occurs. Therefore, we introduce a model to be followed in managing a crisis situation before and after it occurs, and this model comprises a cluster of activities that can be classified into pre crisis management which includes crisis preparedness and crisis prevention and crisis management that includes crisis incident management and post-crisis management.
6. There are certain stages in response to a crisis situation these stages are: developing a communication Strategy, choosing a communication strategy, operational stage, and monitoring and reviewing.
7. The immediate cause of the 2008 crisis was the bursting of the United States housing bubble which peaked in approximately 2005–2006. A host of factors contributed to the event some of these factors are:

7.1. The creation of new credit derivatives like credit default swap, mortgage backed securities (MBS), and Collateralized Debt Obligations (CDOs).

7.2. The lack of regulation allowed the emergence of these highly complex and nontransparent monetary tools that were difficult to control.

7.3. The quick increase of high default rates on sub-prime and Adjustable Rate Mortgages (ARM).

7.4. An increase in loan incentives such as easy initial terms and a long-term trend of rising housing prices had encouraged borrowers in the belief they would be able to quickly refinance at more favorable terms.

7.5. The economic incentives provided to the originators of sub-prime mortgages, along with outright fraud, increased the number of sub-prime mortgages provided to consumers who would have otherwise qualified for conforming loans.

8. Lehman Brothers was the fourth largest investment bank in the United States and went bankrupt during the 2008 crisis due to weakness in crisis management procedures, while Goldman Sachs which had faced the same crisis situation could recover from the crisis and emerged stronger than before because of its successful and effective pre-crisis management and crisis management.

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