International Journal of Advanced Research in Management and Social Sciences ISSN: 2278-6236

GLOBAL FINANCIAL CRISIS AND HOVERING DARK CLOUDS AROUND GLOBAL BANKS

Dr. S.N. Ghosal*

Abstract: *The global financial crisis has happened mainly due to excessive dependence on mathematical models to develop financial products and services. However the crisis is two-fold- liquidity constraint and insolvency. An attempt has been made in this paper to highlight the nature of crisis, its impact, the prognosis of the same, causal factors, severity of impact both global and in India. Further after due analysis some attempts have been made to identify plausible remedial measures. However such remedial measures would have impact over a period of time and therefore the first attempt should be to develop sustainable models that would help overcome the fatal impacts and thereafter to provide a shield so that severity of such crisis could be lessened . This is because one cannot avoid its occurrence altogether but definitely one can reduce the damage that may happen to the economy of a country.*

*NICCO Financial Services Ltd, Kolkata, West Bengal

INTRODUCTION

It is obvious now that the present global financial crisis has happened largely due to overplay of mathematical models for risk management and also perhaps due to lack of adequate transparency in deals and sophisticated instruments developed by banks, particularly investment banks that generated constant flow of very high level of returns on investments in those instruments for quite some time and that obviously lead to high degree of greed in both investors and bankers leading to reckless investments over and over again and ultimately reaching a position of no return.

NATURE OF CRISIS

However an in depth study of the present financial crisis would reveal that the crisis is two fold i.e. liquidity and solvency but these are interrelated and perhaps could be resolved by developing appropriate strategy to solve any one of them particularly the liquidity crisis. But what is important to note is that the crisis has reached to a level and spread out so much that there would be no easy solution to salvage this worldwide growing problem. The worst hit is in USA and European countries. In fact most of the globally reputed investment banks in these countries have almost reached the stage of bankruptcy and one of them already has been declared bankrupt and that one is one of the oldest and reputed investment bank-- Lehman Brothers. Some others equally reputed global investment banks are either waiting for a bailout by some commercial banks or sovereign wealth funds or even by the treasury. For example Bear Stearns and Merrill Lynched have already been taken over by commercial banks and Goldman Sachs as well as Morgan Stanley has been transformed as commercial banks. Thus the golden era of free investment banking totally effaced from the financial markets of the world. This of course was almost unthinkable even in recent past but now it has become clear that unbridled financial institutions even in highly capitalist country where free market is glorified and intervention is considered as sin; financial institutions should be guided and supervised by independent statutory regulatory authorities at least. In fact the whole financial system is perhaps passing through a stage of ‘de-leveraging’ as rightly observed by Abheek Barua of HDFC Bank due to lack of appropriate guidance and supervision of independent regulatory institutions.

SPREAD EFFECT OF CRISIS

Hank Paulson of USA has rightly observed that the crisis is no longer confined to US only, it has become global and therefore it would require strategic and financial support at global level to rescue the growing downfall of investment banks and mortgage banks like nine pins. It is US where bail out activities has started with due importance and appropriate gravity. Similarly some efforts could be seen in UK particularly by some the banks making efforts to bail out their distressed mortgage banks have already collapsed and that has compelled both UK and European governments to come out with variety of rescue plans. In fact it has become imperative for all developed countries to bring out their bail out plans to avoid adding further fuel to the growing catastrophe in their countries. It would be necessary for other nations also to activate their surveillances on financial institutions and be ready to fuse the crisis that may happen anytime over there as spread effect of globalization.

PROGNOSIS OF CRISIS

It would be interesting to know that about six months ago when IMF in their study revealed that in financial sector losses amount to more than $1000 billion and also predicted that there would soon be a sharp slowdown in the global economy most of the regulators and bankers thought that this estimate of IMF is highly pessimistic and therefore need not be taken seriously. This provides a proof of the fact that banks and corporate bodies were so much enamoured with the rising flow of returns from arbitrage and hedge operations that they totally ignored this timely warning of IMF. It would not be wrong to assume that equally guilty were the treasury and regulators. In fact the present crisis originated from the housing mortgage credit spread and evolution of innovative subprime lending models/ instruments by packaging standard and substandard loans and getting those rated with emphasis on the trend of rising home prices and prospects of better employment and or wages. It would be interesting to note as observed recently by Mr. Percy that one gardener was given loan with the assumption that he would soon become an architect by profession. It has also been brought out that the crisis has not yet ended and more may be revealed in near future as most of these transactions are opaque and not revealed in the financial accounts of banks and corporate bodies.

CAUSAL FACTORS

Since the financial crisis is acute and its total impact is still in dark it would be necessary to comprehend the same with more details and in depth. However it is clear that the crisis has arisen largely due to systemic failure in the financial market and hence any solution that would be looked into should be to look to systemic solution so that it could take care of not only the immediate crisis but to address the root causes that has led to this global crisis. To develop such solution it would be necessary to fathom out the causes much more elaborately and also to study the extent of its heat experienced by other countries like UK and Europe. It need not be emphasized that the present economic turbulence is far more demoralizing than that what has been experienced in the past. This obviously due to ignorance and perhaps almost negligence at all levels and all quarters for considerable period of time despite the overcast cloud of crisis in the financial market could be seen looming large globally. It has spread over the years faster than comprehended due to the fact that national economies are interlocked with each other in such a manner that it would be very difficult if not impossible to comprehend and therefore to come out of this turbulence easily even if big doses of bailout packages as announced by the USA and soon to be announced by European countries are implemented, on the face of it the crisis appears to be liquidity crisis but as has been analyzed above mere induction of funds would not help to restore normalcy in the market but it would be necessary to make an in0depth study of the existing systems and technology that has been pursued overzealously so long by most of the financial institutions. An in-depth analysis of the causal factors would reveal that beside the primary reason as stated above there are some other factors that have generated this crisis. These factors could be summed up as follows:

- An emerging trend of global saving slowdown;
- An overflow of liquidity arising from two leading central banks (Federal Reserve Bank and the ECB}as a response to the Keynesian strategy to counter demand weakness;
- Securitization technique that helped banks to liquefy the illiquid loan portfolios resulting the innovative model of 'originate and distribute' and creating mechanisms of spreading and sharing the risk without getting oneself burnt at least in the immediate future.;

- Evolving process of 'tranching' i.e. issuing of instruments against a pool of assets of mixed varieties- low and high risk- and getting those rated by acknowledged rating agencies to help marketing at an attractive rates;
- Another way that has been evolved is providing insurance cover against default risk that are offered by some of the newly created specialized financial institutions known as 'Monolines'.

THE SEVERITY OF THE IMPACT

The impact of the present financial crisis is going to be much more devastating and affect the developed countries more than emerging developed countries of the world. In fact the technological revolution where from highly unintelligible but considered highly sophisticated mathematical models to assess risk and help to develop appropriate strategies to minimize if not mitigate risks arising from complex financial transactions and or instruments based on assessments made under such models of financial risks. In all these perhaps two things were ignored and those ultimately resulted in chaos. These are asymmetry of information availability and total dependence on newly inducted executives having highly specialized knowledge in risk analysis and management. In fact most of the senior executives did not intervene and almost avoided supervising and providing guidance on prudential banking norms as because they found their young executives by following the newly acquired technology are doing well by developing innovative instruments and deals based on risk analysis through highly sophisticated mathematical models considered full proof. The increasing flow of revenue obviously created more and more dependence on such models and as is obvious this ultimately led to increasing dependence on young executives and almost allowed them to function without any surveillance.

MACRO ECONOMIC IMPACT

The effects of this financial turbulence are highly comprehensive as it would affect on employment, trade and business and ultimately each and every member of the family in both developed and developing countries. In fact it would be difficult to assess the extent of its impact particularly on employment and business growth of emerging service industries. The impact also would be seen in financial regulation and supervision and there is perhaps already a move to completely revamp and rebuild the system to match the need of the present day market complexity and global spread. The need of the hour is to recognize the changing pattern of market operation so that appropriate strategy and institutions could be developed to address the emerging complexities in financial markets all over the world due to highly interlinking and innovative deals and instruments are evolving these days.

IMPACT ON INDIA

Ila Patnaik has rightly observed that 'while India did not have a financial crisis of the dimensions that the US did, the real economy did not go unscathed. IIP growth crashed from pre-crisis peak of 15 per cent annualized to a bottom of -5 per cent annualized.' However India could recover faster than most of the other countries. However this has happened all over East Asia and also in Canada and Mexico. However Patnaik has further observed that 'it is important to recognize that India is a very poor country. We know very little about how to establish institutions or regulate markets that can support a sophisticated economy where a billion people can enjoy high productivity. Nobody in the world wants Indian-style monetary or financial policy making. Our path ahead lies in learning how fiscal, financial and monetary institutions work in countries where per capita GDP is many times bigger than what we have in India'. This may appear to be very hard hitting observations on Indian monetary and fiscal policy makers and regulators. But no one could deny that there is some lurking fear about the apparent and much publicized sound health of our economy and economic institutions like banks and financial companies. It would be interesting to note that in the recently released Global Finance, in its latest ranking of the top 50 safest banks in the world, does not include any Indian entity. It would be unwise to remain complacent and glorify our rate of growth of GDP and or pumping in liquidity and stabilizing exchange rates. No doubt in India to make a mark in world economy the need is innovative economic thinking within the country first. Perhaps the stress on Inclusive growth and universal financial accessibility is one such policy emphasis recently introduced as a policy measure to outreach far flung villages and habitats in India

IMF's WARNING

International Monetary Fund has also warned in its latest Global Financial Stability Report that emerging economies such as India faced an abrupt reversal of capital flows from foreign countries which would obviously adversely impact the economic growth rate of the country. As per the Report, the behaviour of investor, particularly in public and private pension funds and insurance companies would undergo a radical change in the coming years and that would result in heavy withdrawal from all such funds as these are now perceived as risky assets. In fact it has been rightly observed in the report that 'the main determinants for foreign investment sentiment are strong prospects of economic growth and lower perceived country risk rather than interest rate differentials'. As India till date is one of the fastest growing economies of the world it could attract 1.4 trillion rupees till 2010 foreign institutional investments in equity. But the position in 2011 appears to be gloomy as this year it could attract only 607 million dollar as compared to 29.36 billion last year as stated by SEBI of India. IMF in fact has very timely signalled the failure of prudent economic and fiscal policies. Christine Lagarde, the newly appointed M.D. of IMF has very aptly summarized that "The set of solutions and methods to address the situation are quite well known. What is needed and what certainly hope to be able to help generate is the political leadership and the degree of synchronization that needs to happen for the path to recovery to be made possible."

GLOBAL BANKING SCENE

In a recent Mc Kinsey study to develop a Sustainable Model for Global Banking it has been very pointed observed "that despite a strong global profit performance in 2010 and also in the first half of 2011, the return on equity (ROE) of banks in Europe and US has still not recovered to the point where it covers their amount of equity. The gap is set to widen in the wake of new regulatory requirements. Without radical action to strike balance sheets, cut costs and increase revenues, banks will be unable to attract sufficient new capital from the investment community and to play their critical role in underpinning economy and growth."

INDIAN BANKING SCENE

It is true that Indian banking has grown over the years at a reasonable rate and also played a vital role in underpinning its economic growth but it would be wrong to assume that are in pink of health. In recent years these banks despite most of them are state run and state funded have already started experiencing serious jolt in retail banking particularly in housing and education loans. Besides this, another telling statistics is that half of India's 1.2 billion people do not have access to banking and to outreach them would burden them heavily. It is obvious therefore to introduce some radical change both in policy and governance of these banks.

SOME INSIGHTFUL SUGGESTIONS

It is time to conceive a new structure to counter the emerging challenges in the financial markets all over the world. Bismarck once rightly said that a statesman is judged by the fact how he rushes to change his cloak when calamity (fate) rushes by. The World Bank alerted the financial institutions of course in some other way to avert the present crisis by asking developed countries to focus attention to middle income countries to invest in their emerging markets and constantly make efforts to upgrade their knowledge and technology as that way only they would attain higher rate of growth both for their own countries but also help inclusive growth of developed countries and sustainable instead of creating such a catastrophe all over the world. However some specific steps have to be taken immediately to ease the present turmoil in the financial market. These could be summed up as follows.

- To give re-look to securitization strategy adopted almost by all banks all over the world to reduce non performing assets that they have been building over the years either due to political compulsions or even to spread the risk to others who have better risk taking capacity;
- To ensure that originator of the loan should not get away fully from the ultimate risk that may arise due to defaults;
- To improve the rating system to make it more reliable and to develop adequate information to enable such systems to help give appropriate rating that could build confidence on such rating agencies both by investors and invested;
- To remove the quasi-regulatory role of the rating agencies in Basel II;
- To make changes in internal risk models and avoid the present policy of garbage in and garbage out strategy as that makes the quantitative models based on past observations inaccurate.
- To remove entry barriers and allow foreign banks to play larger role in economic growth;
- To allow regulatory authorities to close such banks that are beyond repair;
- To pay more attention to Human Resource and Technical Resource Development; and
- To consolidate and amalgamate banks to become big and strong to withstand market jolts and reap the benefits accruing from higher technology.

BIBLIOGRAPHY

1. "In Search of a Sustainable Model for Global Banking," *McKinsey Quarterly* (2011)
2. "Lagarde Urges Strong Leadership to Put World on Firmer Footing," International Monetary Fund.
   http://www.imf.org/external/pubs/ft/survey/so/2011/new092211b.htm
3. "Global Financial Stability Report: A Report by the Monetary and Capital Markets Department on Market Developments and Issues," International Monetary Fund,
4. Ila Patnaik, "No one like us," *Indian Express*, 31 August 2009
5. Gabriel Di Bella, "The Impact of the Global Financial Crisis on Microfinance and Policy Implications," International Monetary Fund (2011)
   http://www.imf.org/external/pubs/ft/wp/2011/wp11175.pdf
6. "Gut-wrenching stuff," The Economist ,Feb 4th 2010
   http://www.economist.com/node/15450506
7. Abheek Barua, "The tale of two giants: America's economic prospects are ominously reminiscent of Japan's in the 1990's," Business Standard Jul 16th 2012-07-16
   http://www.business-standard.com/india/news/abheek-barua-the-taletwo-giants/448269/