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Reflection on the Evolving Global Financial Crisis

By

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Abstract

The linkage between financial markets in the world should make actors on these markets aware of the crisis that they may create by their misdeeds, and the far-reaching financial and socio-economic effect that may flow from such acts. In addition to a stricter regulation of supervision by central banks and an international institution, these actors should be subject to codes of conduct.

1. Introduction

The current global financial crisis is not a natural phenomenon; it was created by certain people, who may be described as "actors" on the financial markets. A "crisis" is the result of certain causes. The causes in this case are irresponsible risk-taking, disregard of the rules of regulatory bodies, greed, and social irresponsibility.

There are no natural causes of financial crises. These are not accidental; these are the outcome of deliberate acts. Hence the issues of risks-study, the functions of central banks particularly in respect of supervision and control of commercial banks, and financial institutions, including the stockbroking houses, training of personnel engaged in the financial sector and social responsibility become important.

The crisis originated in the West primarily owing to false money creation and consumerism, but unfortunately extended to almost all parts of the world, because of the linkage between the markets created by borrowing and investments. This raises the issue whether every banking community should join the "bandwagon" of quick profit making for a limited few at the cost of the interests of investors and depositors. The impact of it is serious: depositors and investors will lose confidence in the markets.

In addition to education and training in all its forms including public awareness, invention, innovation, banking and insurance contribute to the development of the infrastructure of a country. In most of the non-western countries or countries that do not follow the Western economic philosophy, banking and insurance still remain rather "not-so-developed" primarily because of the lack of awareness of the general public how banking and insurance may directly contribute to heating up an economy.

2. The Scenario

During the latter part of the 1990s and the early part of the twenty-first century the major financial markets looked rosy and the ordinary people, particularly those who have no knowledge of financial risks, took advantage of the privileges and facilities that the banks and other finance houses offered them. Credit cards, bank loans and a variety of other credit sources became available to them without much effort. Finance houses offering such facilities made a fortune; the beneficiaries of loans and credits became overloaded with debts; in fact, in most cases, the burden of debts proved to be unmanageable.

The sub-prime mortgage technique which originated in the United States and the wave of which struck the British shores also was principally based on what is known as the "self-certification of income" system. Everybody would be lured by this attractive offer especially when the property markets became buoyant and many people lacked the financial capacity to purchase properties under the existing system which was linked to their incomes. Thus, all such lending were allowed to people who would in course of time find it difficult to meet their mortgage liability; the risks must have been foreseen by the lenders and yet lending was allowed.

During the late nineties, credit cards were made available to almost anyone; in most cases, the risks were not properly studied; only credit checks were carried out. Purchasing power of people rose; consumerism spiralled; but in many cases, cardholders could not meet their monthly payments. In England, many started paying off their monthly mortgage instalments with credit cards. Credit crunch was in a way self-induced crunch occasioned by lenders. In the meantime, house prices are decreasing; eventually, there will be negative equity in many of them if the downward price spiral is not halted. Lenders can go for re-possession although they may not recover their money from proceeds of sale; they can hold on to them until the property market improves. If interest rates are raised, there will be fewer demands for property. It is to be emphasised that where an economy is very property-based, all these changes directly affect the ordinary men.

Recently price rise of consumer products or other products, such as petrol, has created another disturbing dimension to the market. The lack of purchasing power will adversely affect the markets of products, consumer or otherwise, and will in turn, affect industries; the social effect of this can be far-reaching.

Incidentally, one is required to recollect that one of the contributory factors of worsening the debt position of the poor countries, in general, during the 1980s was the availability of loans on easy terms at a low rate of interest from banks and/or finance houses.

The financial markets collapsed again the UK during the 1990s for similar reasons, and as a consequence many house owners found it difficult to repay their mortgages, and many properties were classified as properties with a negative equity. The answer to the question why banks and finance houses do so is obvious. Loans when made easily available increases "consumerism" in a variety of forms; consumers purchase goods often beyond their purchasing powers only to become victims of the law – insolvency, which may not necessarily benefit lenders. It is a legal process which many lenders often foolishly wish to complete.

The argument that borrowers and particularly credit card holders should understand the extent of their long term liability and spend money derived from credit cards responsibly is a rather false argument because like drug addicts, credit card addicts hardly use them responsibly, and when consumerism is at its height, any responsible behaviour on the part of the consumers, would be a far cry. It is not a question of binding an individual by means of a credit agreement only; the risks attached to such arrangements must be studied from a pragmatic standpoint. As credit card holders often are unable to manage their expenditures with reference to their incomes, they often take out multiple credit cards which should be regarded as an alarming factor, but unfortunately, it is not regarded so. There are cases to establish that an individual has been allowed to hold even more than five credit cards. Instead of denying the facility altogether, a limit to credit card holding may significantly avoid risks.

The credit crunch in the West has had a "domino effect" whereby the linked-markets have also suffered immeasurably.

3. <u>The lessons that one can learn from this disaster</u>

Depending upon the nature of the purpose, one can derive a variety of lessons from this current financial disaster which has in the West been described as "credit crunch". The following is a list of the general lessons that a banking community could derive from the current phenomenon:

- that banking is an essential element to develop an economy, and that one should not treat it as a "plaything";

- that although financial markets are interlinked, particularly by virtue of inter-bank loans and deposits with banks outside one's own jurisdiction, the risk study should remain “individualistic” by reference to one’s own economic structure and status;

- that on the basis of banking disasters in the 1970s and 1990s, one could say that joining the “bandwagon” for the purpose of amassing wealth by a few at the cost of the international community’s interest must be stopped;

- that the supervision system by regulatory authorities should be made more vigilant, hawkish than what it is now;

- that stockbrokers and financial advisers should operate their businesses on an ethical basis and be subject to codes of conduct;

- that the current practice of unlimited profit-making by stockbrokers should be capped;

- that bankers, stockbrokers or any other actors on the financial markets may not be allowed to perform any act that would be deemed to be socially irresponsible, and if they do so, they must be taken to task;

- that time has now arrived to consider whether stockbroking should be profit-based or salary-based only;

- that the nature of risk-study should be conservative;

- that the staff engaged in banking and stockbroking must work in the interest of their country and the international community and not in their own interest; and

- that community interest is superior to personal interest.

4. Banking and the Economy of a Country

The co-relationship between a less-developed economy and a poor banking structure is co-extensive. A progressively developed banking system which encourages people to deposit money with banks, and if that money is deployed in indigenous businesses, will produce a spill-over effect whereby more deposits may be attracted by banks. Of course, the issue of security against loans may present difficulty, as in most cases, borrowers might not be able to offer security against loans, whether in the form of tangible or intangible property. This hurdle may be overcome by two means: (a) a thorough and well thought-out risk study; and (b) by taking the business as security with the right of supervision. The borrower must remain accountable to the lender. Supervision-based loans to businesses may be less risky.

All economies should place a high priority on the creation of banking awareness and banking habit. Indifference to banking may be occasioned by the following causes: (a) the lack of public awareness of the benefits of banking; (b) a high degree of apprehension of losing money in the event of a bank being closed down; and (c) a rather cumbersome banking system.

Banks are like generators; they generate money-energy for an economy; however, this money must be generated and invested properly and under the close supervision of the central bank of the country concerned. Banks must not be allowed to remain as financial institutions for the rich; central banks are required to bring banking to ordinary people. It is through an active banking system that a domestic economy may be expanded, which, in turn, would create employment, leading to savings and investment. The banking industry in a country should be inviting, customer-friendly and as risk-free as possible.[1]

But, the question remains how the banking structure in a country may be improved. "Banking structure" in this context would mean the financial network and the institutions that the central bank of a country has created. In many countries banks, commercial or otherwise, are controlled by their governments; thus, profit-maximisation may not be their motive – they basically operate as service-providers to their people.

On the other hand, in many other countries financial institutions exist in both the public sector and the private sector, and where this is the case, there should exist a system of co-ordination between these two sectors. Competition between banks may offer profitable services to customers. Financial institutions should create financial opportunities in the form of deposits and

[1] See further The Basle Core Principles for Effective Banking Supervision (2000)

investments; the more investment opportunities banks can create, the more investment banks can make.

However, the banking system in a country may not be pro-active and effective unless it is almost risk-free and is closely supervised by the central bank of the country. Supervision by a central bank entails a host of elements; but it is enmeshed with a degree of vagueness. Recently, the Basle Core Principles for Effective Banking Supervision (Basle Committee Report 1)[2] identified some of the most important elements of supervisions which central banks in all countries may find useful. The Committee developed twenty-five core principles for an effective supervision. These principles stand for the "minimum requirements" and in many cases may need to be supplemented by other measures in order to address particular conditions prevailing in individual countries. The Core principles also state that a suitable legal framework for banking supervision is necessary. The constituent elements of this legal framework, in general, would be: (a) a developed market structure; (b) sound macro-economic policies; (c) competition; and (d) a good banking practice with governmental support. The pre-requisite for satisfying these constituent elements is a sound economic policy. Commercial banks must remain under a strict regime of supervision by central banks, but within that regime of supervision, the laissez faire doctrine must be allowed to play its part in order to ensure that customers have the best deal.

[2] See further C Chatterjee, "The Basle Core Principles for Effective Banking Supervision: An Analysis", 1 European Financial Services Law (2001) at 78

The first principle of the Basel Core Principles entitled Pre-conditions for Effective Banking Supervision states that:

> "An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality for such information should be in place."

Banking must be made attractive to customers by providing protection to their investments from risks, particularly those which are foreseen, unforeseen and foreseeable, and by giving them appropriate advice on investments. Depositors' protection schemes should be established. Central banks' policies must be directed at confidence-building bearing in mind that good banking system "heat up" economies.

Central banks must require their commercial banks to rigidly follow the minimum criteria of good banking: (a) adequate solvency margin; (b) an honest accounting practice; (c) absence of high-risk-exposure; (d) honesty and integrity; and (e) a highly trained human resource. Furthermore, the principles of corporate governance – democracy, transparency, accountability and fairness must be applied to an ideal banking system. Banking must not be initiated by corruption and unethical deals.

In addition to a rigid licensing system, ownership structure must be democratic; no one owner should be allowed undue power of control by virtue of disproportionate share-holding. The ownership structure must be transparent;[3] any change in it must immediately be brought to the attention of the central bank concerned. The supervising authorities must be allowed immunities from prosecution in order to carry out their surveillance over commercial banks.

Bank exposures to single borrowers or groups of related borrowers should be avoided. All commercial banks should have a comprehensive risk management procedure in place, and they must also be subject to internal and external audit. The Core Principles stated that:

> "Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements."

In fact, apparently, no high ethical and professional standards were maintained in recent months by financial markets in consequence of which we are in the middle of what is now known as "credit crunch."

In order to effect appropriate supervision, both the supervisor and the supervised must have adequate knowledge and expertise. This point has also been emphasised by the Basle Committee. Although the Basle Core Principles have been addressed to the Basle Committee members, there is no

[3] See also Basle Core Principles for Effective Banking Supervision, op. cit.,

reason why the recommendations may not be implemented by the non-Basle Committee members.

5. <u>The impact of the current "credit crunch" on the Middle East</u>

It is interesting to note that although neither the Middle East, in general, nor any particular country in the region, contributed in any way to the current credit crunch, yet, they will be victims of it. It is a perfect example of a negligent and unreasonable act of others the effect of which caused harm to innocent parties. Thus, from a strict legal standpoint, the originator(s) of the harm should compensate the harmed, but in this case, unfortunately, that would be a far cry. Hence, the need for maintaining an international surveillance system entailing enforcement measures by an international institution, such as, the International Monetary Fund (IMF). However theoretical this argument might sound, the international community should take action as a "united front" through such an organisation in order to ensure that such situations are not allowed to be repeated. The issue of domestic sovereignty of states should not be played against the acts of an international institution.

Returning to the nature of the impact of the current crisis on the Middle East, it is possible to say that there may be severe adverse effect on the oil producing countries in the Middle East. The demand for oil may decrease in consequence of which the supply of oil will also decrease. If, on the other hand, the price of oil is increased to offset the losses occasioned by a diminished supply of oil, private foreign investments in the Middle East will be adversely affected, and economic conflicts between states and the Middle East may ensue. The ugly face of economic warfare will turn up. This situation presents a severe dilemma for OPEC, of which the Middle Eastern countries are also members, whether to "cap" the supply or to raise the price of oil or both. Another economic warfare may loom large which we all should avoid.

Finally, the value of investments made by the Middle Eastern countries in the West has already depreciated by virtue of the depreciation of the value of currencies of the West. Banking business is predominantly carried out on others' money. What answers may the Middle Eastern financial institutions provide to depositors?

6. <u>Conclusions</u>

Given the nature and extent of the crisis, it would be unwise to maintain that the crisis will soon disappear. It has shaken almost the entire world; the primary and even the secondary effect of the crisis have been far-reaching. When risks are self-created, with recklessness, one can name and punish the perpetrators of risks, but investors cannot recover their losses. The current "financial tsunami" should be seen as an unprecedented act created by certain unethical traders; this "financial tsunami" should not take away the confidence from the banking structure that prevails in many countries. This tsunami did however raise doubts as to the effectiveness of the supervision system operated by central banks or their equivalent institutions in various countries.

The remedies that may be suggested to overcome the adverse effect of the current credit crunch on the Middle East, but over a long period of time, would be:

- that good and sustainable investment incentives be allowed to private foreign investors to increase the flow of such investments in the Middle East; a good "framework policy" would be needed in this regard;

- that more confidence be developed in the minds of private foreign investors by developing a sound banking and insurance market whereby the capital markets in the Middle East may also attract foreign depositors;

- that diversification of economies takes place in a much more effective and planned way whereby dependency on foreign markets and foreign products is diminished;

- that an attractive dispute settlement procedure and institution be developed whereby the fear of judicial risk is minimised;

- that the capital markets in the Middle East need not necessarily be linked to the capital markets in the West, and also that a procedure be adopted whereby the markets in the Middle East are not only governed by legislation but also according to sustainable codes of conduct;

- that in addition to creating a "banking awareness" in people, proactive action should be taken to convince people that banks and insurance can be the most important factors of progressive economic development;

- that a prudential supervision system by central banks coupled with a team of trained personnel be developed and implemented; and

- that banking and insurance as disciplines should be part of curricula particularly in the post-secondary education system.