Causes and effects of the global financial crisis of 2007-09, with special reference to the impacts on financial markets and financial institutions

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Introduction:

Global financial crisis refers to a tough situation in which the demand for money is greater than the supply of money resulting in shortage of cash or liquidity crisis. It is a tough situation that creates panic among the common people who approach banks & financial institutions for withdrawing funds for the fear that such deposits might be lost due to bank failure. The recent global recession had occurred during the period of 2007-09 which had affected almost all the economies in the world including the developed ones. International trade was affected as well. The most common impacts of global financial crisis include loss of employments, fall in income level, reduction in consumption level, decrease in purchasing power of consumers, rise in inflation rate and shortage of funds. However, the global financial crisis had specific impacts on the financial markets including banks and financial institutions. The causes for the global recession might also be different if perceived in context of financial markets. The latest global financial crisis had caused bank run, run for repo, bad debts and liquidity crunch for the banks & financial institutions. However, the banks had tried to overcome the tough situation through the use of financial instruments like repurchase agreements, deposit insurance schemes, commercial papers and inter-bank lending. The current study is concerned with the critical evaluation of the causes and effects of the global financial crisis in context of the UK financial markets.

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Discussion:

The whole world evidenced a financial crisis during the period of 2007-09 however it has taken a long-time for many countries to recover from the negative impacts of the financial crisis. The financial crisis was so severe that it had affected even the developed economies like the US and the UK. Scholars, market analysts and industry experts often compare this financial crisis with the great depression that took place in 1930s. A major reason for conducting such comparison is to identify, understand and develop necessary measures to prevent the occurrence of such financial crisis in the future. In this context, Bénétrix, Lane, and Shambaugh (2015) stated that the global recession during 2007-09 had adversely affected the financial markets and financial institutions globally. Low interest rates is often viewed as a major reason for the occurrence of the global financial crisis. As mentioned by Bertaut et al. (2012), existence of low interest rate in the US prior to the global recession had resulted in the bursting of housing bubbles which further led to huge bad debts incurred by the commercial banks. Mortgage delinquencies can be

considered as a key reason for such huge amount of bad debts incurred by the banks. This can be attributed to the poor or inefficient credit checking of customers conducted by the commercial banks in the country before extending loans. Put it differently, the commercial banks did not properly evaluate and verify the loan repayment capacity of the borrowers. This has made the subprime mortgage market a major trigger of the global recession. It does not seem inappropriate to hold the banking system itself responsible for the occurrence of the financial crisis. In fact, conducting proper credit checking along with a strict credit policy could have helped in avoiding the financial crisis. In addition to this, the regulators were also equally responsible for the low level of interest rates that was seen in the market before the financial crisis. The global financial crisis had badly affected a large number of commercial banks and financial institutions. In fact, a commercial bank is a key element of the financial system in which deposit and borrowing of funds take place. In this context, Chor and Manova (2012) observed that banks make use of only a fraction of the total deposits for extending loans to the borrowers and the same is not possible to be sold in the market at a high price.

Table 1: Financial value of leading banks in the UK

Four top British banking groups		
British Banks	**Market capitalization value (as on 3rd may, 2011)**	**Value of total assets (as on 31st Dec 2010)**
	Billion SEK	Billion SEK
HSBC	1765,9[52*]	15850[53**]
Royal Bank of Scotland (RBS)	457,2[54*]	15252[55**]
Lloyds Bank	399,4[56*]	10406[57**]
Barclays Capital	347,6[58*]	15620[59**]

*GBP/SEK rate as on 3rd May 9, 96

** GBP/SEK rate as on 31st December 10, 49

Figure 1: Market Capitalization Value as on 3rd May 2011

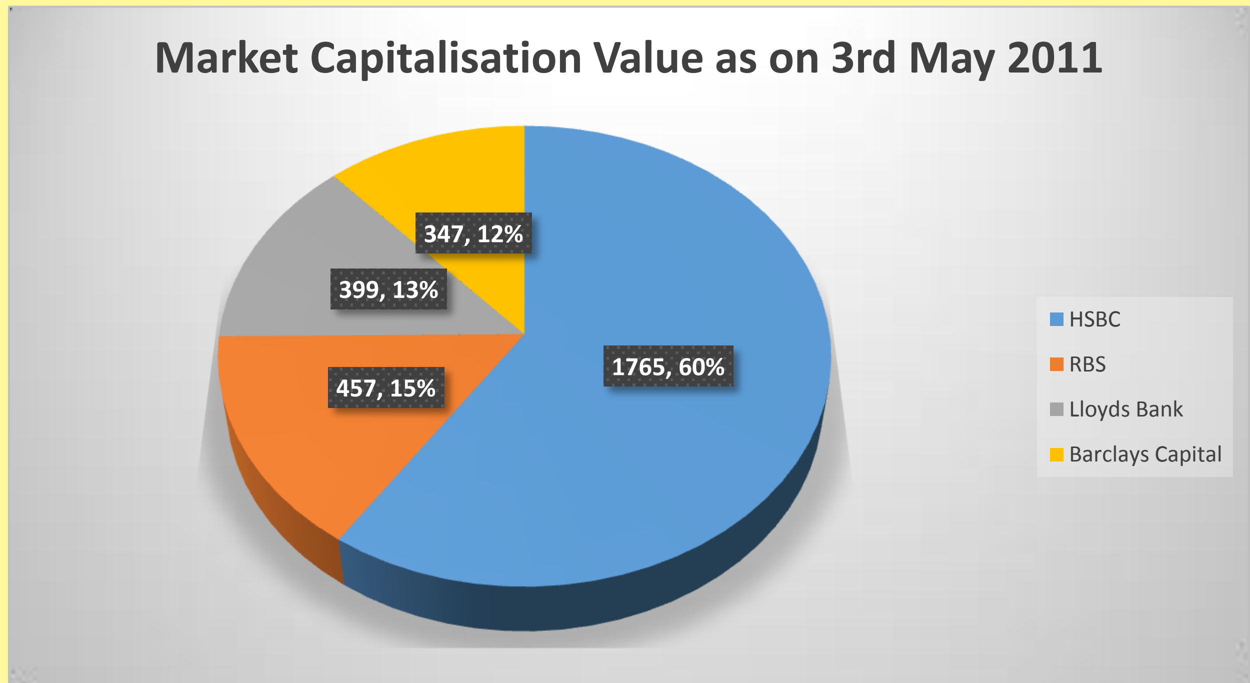

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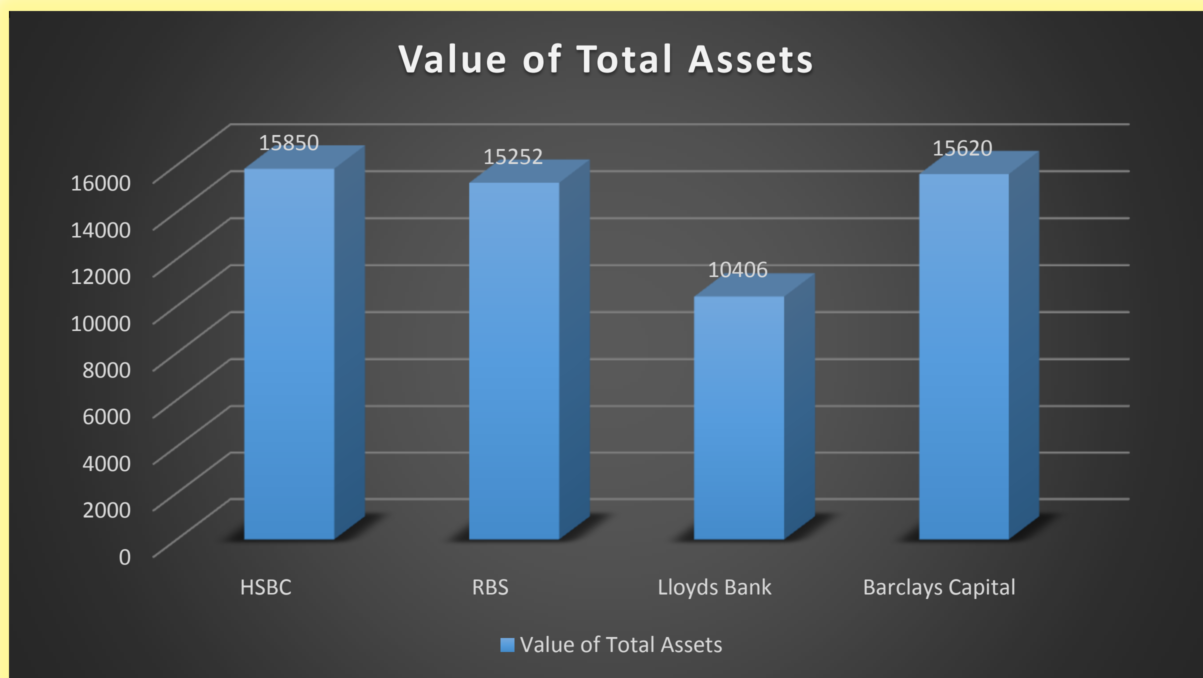
Figure 2: Value of Total Assets of leading banks in the UK



Demand Deposit is one of the key financial tools in context of the global financial crisis which is issued by commercial banks to allow the investors or depositors to withdraw individual assets from banks at the time of necessity. In this context, liquidity indicates the ease with which an asset is subject to conversion into liquid cash at any specific point of time.

According to Eun, Resnick and Sabherwal (2012), bank run is a major cause that triggered the global financial crisis. Bank run refers to a situation in the financial market during which all the depositors approach banks to withdraw individual deposits due to the fear that the banks might fail. Mismatches in which the liabilities or deposits of a bank possess higher liquidity when compared to the assets or loans of the banks leads to bank run. On the other hand, Fratzscher (2012) viewed that speculations about the failure of a bank can be considered as a strong factors contributing to a bank run. However, prevalence of other factors cannot be ignored as well. During the global recession 2007-09, Lehman Brothers, one of the leading banks in the US had also suffered the impacts of the financial crisis which had further increased the fear among the people about probable bank runs. However, it is important to understand that bank run was not the key cause of financial downturn of the Lehman Brothers in the US rather the company suffered the adverse effects of the recession because of withdrawal of high volume of repo or repurchase agreements. Thus, it was a case of run for repo.

Liquidity is often viewed as a major activity of commercial banks. In other words, commercial banks need to consistently focus on creating and maintaining high level of liquidity because the deposits can be withdrawn by the depositors at any point of time. Hence, possession of assets become essential for commercial banks that can be liquidated quickly to meet the demand for withdrawal by depositors.

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Table 2: Credit loss ratio of banks in the UK

Credit loss ratios	Year				
	2006	2007	2008	2009	2010
Royal Bank of Scotland (RBS)	0,3418%	0,2029%	0,7969%	1,8228%	1,4115%
Lloyds bank	0,6793%	0,7341%	1,0625%	2,5173%	1,7583%
HSBC	1,0038%	1,4145%	2,2949%	2,4617%	1,2034%
Barclays Capital	0,6877%	0,7250%	1,0635%	1,7494%	1,2178%

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Bank run is still viewed as the major reason for the global financial crisis during 2007-09. Any rumor in the market about the possible failure of a bank can motivate depositors to withdraw respective deposits from the banks at the earliest. This panic leads to bank resulting in drastic fall of liquidity among the commercial banks and financial institutions. Similarly, a long queue of customers for funds withdrawal in commercial banks is yet another major factor that triggers bank run by creating panic among the other customers that the bank might get insolvent due to such excessive pressure for funds withdrawal.

Thus, the US and the UK governments along with commercial banks & other financial institutions have started developing specific strategies for preventing bank run. Deposit insurance scheme is one of such measures developed for this purpose. A deposit insurance scheme developed by the government provides assurance to the depositors about the security of their deposits and that the deposits can be withdrawn by the customers irrespective of the liquidity pressure on the commercial banks.

Northern Rock was the first bank in the UK that suffered a bank run. The UK government had to take over the bank to protect the existence of the Northern Rock bank and the ensure safety of the deposits of the customers. The bank had taken an aggressive strategy for business expansion and this resulted in the shortage of liquidity and finally a financial crisis.

In the view of Haas and Lelyveld (2014), an increase in the quantum of credit in any economy leads to a financial crunch in the economy. The subprime mortgage market of America have influenced the prevailing banks to make use of short-term liquidity assets for meeting funding requirements related to the long-term ones. This can be explained by the inadequate amount of deposits among the commercial banks to provide loan to the borrowers. Assets backed securities can be considered as a result of credit boom in the economy which is concerned with the development and functioning of shadow banking system. Under this approach, personal funds are used to fund the off-balance sheet finance.

The global financial crisis during 2007-09 consisted of a run on repurchase agreements that are associated with shadow banking. In fact, the increasing competition faced by the banks from the mutual funds operating in the money market had made the traditional banking system less profitable. Here, mutual funds in the money market refer to those financial institutions that enable investors to reduce investment related risks through proper diversification of the risks in suitable investment avenues. A common pool of fund is created by these mutual funds and the same is invested across a wide range of investment assets in suitable proportions.

Commercial paper is yet another major financial tools used during the financial crisis. Financial institutions and banks used commercial papers to meet both long-term and short-term funding requirements. As mentioned by Higgins (2013), Asset Backed Commercial Papers (ABCP) were mainly used by banks during the global recession in the UK to raise funds for long-term requirements.

Inter-banking lending is also viewed as a major tool used by banks and financial institutions during the global recession to meet funding needs. Inter-banking lending refers to the offering of loans by one bank to another for a short-term period at a suitable interest rate on the same. Inter-banking loan is an unsecured one and London Inter-Bank Offer Rate (LIBOR) plays a vital role in determining interest rate on the inter-banking lending.

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A repo agreement reduces the chances of bank run. In fact, a repo agreement are highly secured in nature and thus provides assurance to the banks and financial institutions that occurrence of a bank run is unlikely. A repo agreement is the one which enables a bank or financial institution to provide a loan amount to the borrower that is lower than the value of the collateral security. In other words, a repo agreement refers to a legal agreement between two parties in which one party buys a particular asset from the other at a specific price and the asset is sold as a collateral. However, in case of repo agreements, the concerned party provides promise of buying back the asset on a particular date at a specific price. This price comprises of the original price and an extra amount which is also termed as haircut. Thus, haircut indicates the difference in the value of a particular asset and the amount of deposit however the amount of deposit is generally less than the value of the concerned asset. In this context, Melvin and Norrbin (2013) mentioned that there have been considerable increase in haircuts during the global financial crisis of 2007-09 because of rising uncertainty over the banking sector and rapid changes in the subprime markets. Here, it is important to note that the increase in repo market became highly severe which further reduced the quantum of investment in the concerned repo market. Assets were becoming riskier than ever before in the UK financial market. Though the initiative had been benefitted the invested but at the same time it had increased the financial cost to the borrowers. There had been significant drop in the lending rate in the UK during the financial crisis (Yang, 2012). This can be attributed to the considerable increase in risk level due to which the investors stayed away from making investments. The increase was however backed by the investors in the UK because of the financial risk in connection to the selling of collateral securities which are obtained from the repo market in an illiquid market if the borrower becomes a defaulter.

Conclusion & Recommendations:

The global financial crisis that occurred during 2007-09 had badly impacted banks, financial institutions, financial markets and the corporate world as well globally. Developing nations like the UK had to suffer the adverse effects of the recession as well. The global financial crisis had major impacts on the UK economy like rise in inflation rate, fall in wage rate, job cut, fall in income level, unemployment and liquidity crunch. There are different causes for this financial crisis however two of the major reasons identified for the financial crisis are prevalence of low interest rate and huge bad debts suffered by banks due to poor credit checking of the borrowers.

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However, the banks had used certain tools to recover from the financial crisis like demand deposit, commercial paper, repo agreement and inter-banking lending. Deposit insurance scheme had also played a vital role in this regard.

However, chances of such financial crisis can be eliminated through joint efforts by the government and banks & financial institutions. Based on the current study the following recommendations have been developed that could help in preventing such financial crisis in the future:

Stringent credit policy:

The credit policy of banks need to be made more stringent by lowering the credit limit and raising the criteria level for loan sanctions. Criteria like minimum income level, value of collateral security and similar others can be raised. Intervention of the government in the credit policy of commercial banks is also highly advisable.

Proper background verification of borrowers:

Banks need to make sufficient background checking of the borrowers prior to extending credit. All documents and records furnished by loan applicants need to be verified through concerned authorities. This can reduce the chance for bad debts.

Promotion of deposit insurance schemes:

The government can focus on greater promotion of deposit insurance schemes through Television, Newspapers and Social Media. The campaign needs to make customers aware about deposit insurance schemes by explaining the benefits of the same. This initiative can help in minimizing the chances of bank runs.

Periodic checking of credit volume in the economy:

The government and the central bank of a country need to consistently monitor the volume of credit created by the commercial banks and take necessary quantitative & qualitative measures to control high credit volume in the economy.

Increasing the minimum liquidity ratio of banks:

Banks are required to maintain a certain percentage of the total deposits as statutory liquidity reserves as directed by the central bank of the country. However, this ratio can be increased to ensure that adequate liquidity is available with the commercial banks to meet sudden demand for withdrawal of funds by the customers.

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