Global Financial Turmoil: Lessons from 2007 crisis

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It is 10 years in August 2017 (the 9th to be precise) that the world sleepwalked into the most pernicious global financial crisis since the Great Depression in 1930, with the developed world still reeling from a credit crunch, a Eurozone debt crisis and the effects of recession.

Has the world learned the lessons of the crisis? Are there any oversights that have been overlooked? Is the global financial system fit for purpose? Is there a danger of such a crisis happening again?

On that fateful day in August 2007, French banking giant BNP Paribas admitted that it could no longer price its funds and shut off access to three of them, which invested in United States sub-prime mortgages through securitised CDOs (collateralised debt obligations).

The CDOs were in fact junk bonds issued against mortgages held by people who could ill afford the monthly payments and which astonishingly were given AAA ratings by the major credit agencies.

That market went belly up causing a liquidity crunch, with BNP Paribas the first to come clean, thus precipitating the crisis. This admission is regarded as the start of the credit crunch.

Bankers and regulators were complacent thinking that the crisis would burn itself out by Christmas 2007. The reality was that banks in the developed markets were all at it and the liquidity crunch soon came home to roost.

The International Monetary Fund (IMF) and the Basel Committee for Banking Regulation (BCBR), the two gatekeepers of the global banking system, run by the central bank governors of the G7 industrialised countries, were embarrassingly side-footed.

The blame game started — the greed of bankers, the laxity of regulators, the connivance of rating agencies and even the hapless consumers for overextending on credit, which they could not pay back.

The crisis took the scalps of Lehman Brothers in the US and Northern Rock in the United Kingdom, which saw a run on its money — the first time for a British bank in 150 years.

In the UK, Lloyds and Royal Bank of Scotland, like counterparts elsewhere, including Bear Stearns in the US, were on the verge of bankruptcy with even banks refusing to lend to each other in the interbank market.

Regulators were scurrying around to bail out their banks putting paid to the notion of banks being “too big to fail”. “Quantitative easing” came into the financial lexicon — effectively central banks inventing electronic money on their books to guarantee the bad debts of banks, some of whom preferring to raise money from private investors in the Gulf countries, only to be fined later for various shenanigans by their regulators.

They were all at it — the European Central Bank injected €95 billion into the banks; the Federal Reserve and Bank of England even more.

The impact was devastating — diving world commodity prices causing huge budget and current account deficits, precipitating recession and almost zero per cent interest rates in the West and leading to a credit crunch and thus, falling growth rates.

China’s double-digit growth took a battering. While the crisis was manufactured in the West, no country was spared. Emerging countries, including Malaysia, felt the economic impact of the crisis and its recession as many of their trading partners in the West embarked on austerity measures.

A decade on, analysis about the credit crunch tends to concentrate on gross domestic product growth, interest rates, share prices and exchange volatility, financial stability of countries and banks.

The G7 established the Financial Stability Board in the aftermath of the crisis managed by IMF and BCBR, with the mandate of effecting a global financial reform agenda complete with new capital and liquidity buffers for banks under Basel III, a gamut of measures including stress testing, compliance, safety nests such as Lender of Last Resort and bank deposit insurance.

Some strides have been made on various fronts, but the reform agenda remains “work in progress” and is in danger of being undermined by ideologues and lack of cooperation.

US President Donald Trump is in the process of repealing the 2010 Dodd-Frank Act, the very legislative response by the Obama administration to pre-empt another financial crisis.

The discourse has failed to acknowledge the devastation on the lives of ordinary citizens through austerity and the ethics of the capitalist financial system.

One of the few people to predict the financial crisis is Dr Catherine Cowley of Heythrop College, London University. In her book, The Value of Money: Ethics and the World of Finance, published two years before the crisis, she warned that “nothing had been learnt from the Long-Term Capital Management collapse in terms of risk volatility, derivatives and hedge funds”.

Her analysis, as she once confided to me, was informed by the 1997-98 Southeast Asian financial crisis, but also emerging subprime mortgages and concentration of risks.

Cowley is an ex-investment banker who became a nun and subsequently an academic, specialising in ethics and finance. While bankers, regulators and rating agencies have borne the brunt of the opprobrium, Cowley is equally critical of faith communities who “bought into the materialist consumerist mindset, which assumed that more and more had to be better” and “were quite prepared to lap up the cheap credit to bask in the ‘benefits’ of ever-rising house prices. We voted in a way which reinforced the economic model that came to be so dominant”.

This included deregulating the market — ‘light touch regulation’ in the words of then UK chancellor Gordon Brown.

Her recipe for putting ethics back into finance is for faith leaders to learn the complexity of modern finance; engage with bankers and regulators; to counter concepts such as profit maximisation and individualism.

To pre-empt a similar future crisis, the international community has to acknowledge what happened in the credit crunch, and to seriously question a range of economic assumptions of more being better and what actually is the purpose of finance.

Finance, I reckon, should be at the service of the economy, and not the economy at the service of finance.

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