The Global Financial Meltdown, Economic Crisis and Implications to Bank Operations

Boom and bust cycles characterize the capitalist system -- the predominant economic system in our world today. Throughout its history, capitalism and the free market enterprise system has seen the best and worst of its dual character: prosperity and growth on one hand, crisis and depression on the other.

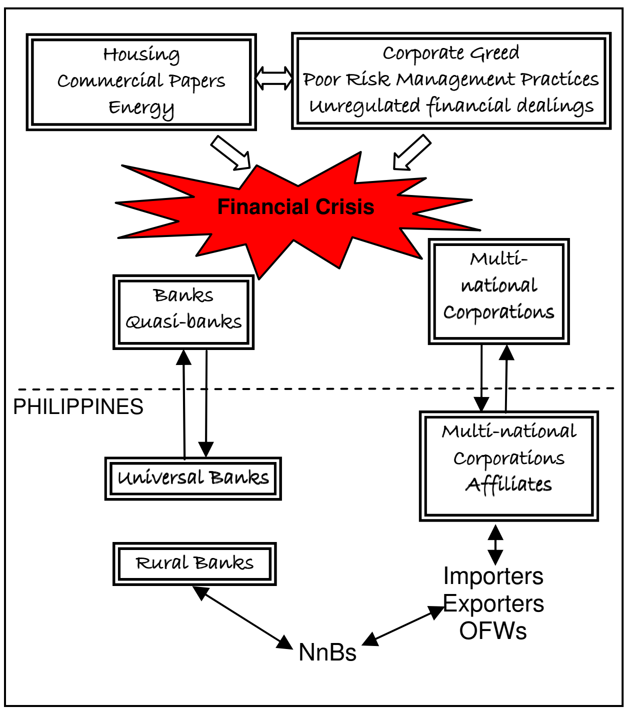
After World War II, the years 1945 to 1975 was a period regarded as the "Golden Age of Contemporary Capitalism".[1] There was rapid growth during these three decades, fueled by the massive reconstruction of war-shattered Europe and East Asia. On the downside, we read about the Great Depression of the 1930s – a dreaded period in US economic history characterized by widespread unemployment and misery. And closer to home, NRBSL was still a young upstart in rural banking when the Asian Financial crisis of 1997-1998 took place. Economic recession was felt throughout East Asia triggered by the "bursting of the real estate and stock market bubble" in Thailand.

Financial Meltdown, New Millennium Edition

The current edition of the financial crisis, which is widely believed to lead to a global economic slowdown or even a recession lasting for years, is a product of several factors. It can be summarized into the following causes: irresponsible lending coupled with unregulated, risky financial and investment packaging and corporate greed. Roughly, this is how it started starting in the mid- to late 90s and thereafter collapsing in years 2006-2008 of the millennium:

1. Coming off from a regime of modest growth and profits, US financial institutions relaxed their erstwhile stringent credit policies particularly in giving out housing loans (i.e., subprime lending);
2. Previously high-risk borrowers or "*Ninjas*" (no income, no job, no assets) became eligible borrowers[2];
3. More and more banks, teeming with cash, lent to high-risk borrowers without much regard to their capacity to pay these loans back;
4. More borrowed (ninjas and non-ninjas) and they found themselves entangled with these loans which initially offered low interest (but adjustable after some time) and carried stiff penalties if these are pre-terminated;
5. Financial institutions like Fannie Mae and Freddie Mac[3] packaged and pooled these mortgages (i.e., commercial papers, consolidated promissory notes and government-backed security papers) and in turn offered these to investment banks for profit and fat margins. They leveraged (*securitized*) these with the massive cash flows streams generated from the housing mortgages;
6. Investment banks and Wall Street firms further repackage these into exotic products (like derivatives) and sold to investors (foreign governments, pension funds, insurance companies, banks, etc);
7. Investors buy and hedge on these financial instruments oblivious and unaware of the inherent risks in them;
8. Massive payment defaults of housing buyers accumulate since the housing market became too crowded, triggering price drops or lower resale values. A number of borrowers also spent the loans for buying bigger houses or acquiring their second cars amid the energy crisis slowly creeping in.

At the start, the liberalization of credit to subprime borrowers seems to be a perfectly good way to help people without credit history to build credit standing, allow them to save and build wealth. For buyers of real estate, isn't it good to buy now, even on credit, since housing is something that can be resold later at a higher value? After all, the value of real estate in the US then, was rising because of increasing demand for houses.



But like a pyramid, this is true only for the early buyers and only as long as there are new buyers building up the base of the pyramid.[4] But increases in value of housing cannot go on indefinitely, especially as more and more high-risk buyers (would-be defaulters) enter the picture.

Banks and quasi-banking institutions "passed-on" the risks to others by way of securitizing these mortgages and selling them through attractive investment packages, thereby diluting and hiding the risks to investor-buyers. This way, they not only created more profits due to the interest rate spread but also increased their portfolio to lend more to subprime borrowers. By the time investors have bought and hedged on these risky instruments, credit defaults, delinquencies and foreclosures have increased. The impact of energy and fuel crisis have also further eroded the repayment capacities of consumers/ borrowers and banks have reduced their lending to each other since they did not know how much money and liquidity each other had.

Bursting bubble after bubble

Such is the nature of creating profits out of unregulated financing and the buy-and-sell of investments instruments based on speculation of future (higher) value. Some real-life examples:

- **Asian Financial Crisis** – overinvestment in real estate and stock market (mid 90s) led to a glut and followed by steep falls in share prices and then the massive flight of capital from East Asian economies in 1997-1998;

- **Technology or Dot-com Bubble** - share prices of internet and internet-based firms rose at all-time high levels in late 1990s only to plunge steeply in 2000 causing a recession in 2001-2002;

- **Real Estate/Housing Bubble** –subprime lending to borrowers without credit history whose origins can be traced back in the mid- to late 1990s increasingly became toxic and risky, leading to a credit crunch:

  - Bear Sterns (an investment bank, later sold to JP Morgan Chase) and Washington Mutual (largest US savings and loan association) went down and bankrupt in 2007
  - Fannie Mae and Freddie Mac – placed under conservatorship (or government takeover) by the US Federal government
  - Merrill Lynch was acquired by Bank of America
  - Lehman Brothers went bankrupt and AIG's share prices fell 95 percent and is bailed out by the US Federal Reserve

Who Are the Investors Affected?

The crash of these investment banks, a number of them have been in the business for more than 80 years (Lehman Brothers is 157 years old), means that the losses they have incurred are huge enough to dry up reserves they have accumulated since their founding. The collapse of these big and reputable financial institutions has eroded overall confidence in the financial markets (Wall Street, etc.) and in stock markets world wide.

The investors who have put their money on these investment banks are foreign governments, foreign corporations, pension funds, insurance companies who buy into highly speculative instruments (promising high returns) and dabble in stocks. A lot of these come from Europe. Of late, new and large investment flows to the US are from Asia, the Middle East and from the economies newly-integrated into the capitalist system--erstwhile socialist China and Russia. In the Philippines, at least three banks have revealed exposure to Lehman Brothers. Fortunately, the total projected losses of these banks are small and can easily be covered by their reserves. Still, stock prices of major local banks, days after the bankruptcy announcement of Lehman, have all fallen for three trading days.[5]

Crisis Creeps Into the Real Economy: From Wall Street to "Main Street"

What should concern us more is the impact of the financial crisis into the real and global economy. The combined effects of the credit crunch, defaults, bankruptcies, foreclosures and overall loss of confidence in the banking system in the US and in linked markets worldwide will lead to an overall slowdown in the real economy: agriculture, industry, trade and services.

As what is now happening in many countries affected, national governments and their respective central banks have allotted bailout, rescue packages and fund provisioning to losing banks to restore confidence in commercial papers and the banking system. In effect, this makes use of public resources/national wealth to rescue private corporations from the crisis of their own making. The US government took over several companies and it is now looking at assisting American automotive manufacturers weather the projected economic slump.

The crisis has affected Europe: UK and Germany are now officially in a recession. China and Russia have adjusted their production targets and Asian economies have followed suit by growth adjustments and institution of financial and economic safety nets. Oil prices have plunged due to weak future demand and global production slowdown.

Effects on Philippine economy and NRBSL communities

The financial crisis in the US itself directly affects Philippine banks that placed investments in beleaguered and fallen investment banks. These are the big universal banks that have links to Wall Street and the international finance markets. This is the reason that the Philippine central bank, BSP, has initiated measures to cushion possible ill effects of the financial melt down. The impact on the Philippine financial system is minimal largely because of limited exposure of our banks and our relatively small financial market.

What should be a serious cause of concern is the negative impact of economic slowdown and/or recession in the US, Europe and other major trading partners of the country. These are in the following areas of the economy:

1. **Imports** – import purchases may be costlier because of the weak peso; imported food like rice may cost higher as nations protect their food stocks in view of the crisis
2. **Exports** –export orders from the US and US-linked markets will be reduced and this may be on a prolonged basis (ex., furniture, garments, gifts/toys/house ware, etc.)
3. **Tourism** -- expect fewer tourist arrivals due to global cut down on leisure, travels and conferences
4. **Overseas Filipino Workers** – uptake of foreign labor may slowdown, existing OFWs may suffer from wage cuts or worse, retrenchments; remittances flows may weaken

Implications to NRBSL Operations

NRBSL and rural banks are not severely affected in the financial crisis. Just the same, we will have to be seriously concerned with the effects of the global financial meltdown on the real economy and on our bank products, resources and clients.

Apart from the vulnerability of our clients and communities to the food and fuel crisis, we now have to take into account their links to the factors outlined above particularly their dependencies on exports earnings, remittances and overseas employment. Internally, NRBSL will have to conserve its resources and diversify its investments in stable institutions.

The following are the immediate plans for the rest of the year:

- Monitor behavior (personal client calls) of loan payments particularly, OFW-related source of repayments
- Continue concentration on loans ranging from P30,000 to P500,000
- Further diversify investments and institute cost-cutting measures
- Monitor macro-economies (national, regional, international)
- Further enhance the credit evaluation process; check loan documents

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Notes:

[1] Walden Bello, Afterthoughts: A Primer on Wall Street Meltdown in Inquirer.net: http://opinion.inquirer.net/viewpoints/columns/view/20081001-163889/A-primer-on-the-Wall-Street-meltdown

[2] Lala Rimando, abs-cbnNEWS.com/Newsbreak in http://www.abs-cbnnews.com/print/21546

[3] FNMA is Federal National Mortgage Association (Fannie Mae) and FHLC is Federal Home Loan Corporation (Freddie Mac).

[4] Cielito Habito, No Free Lunch: The money meltdown and you, Inquirer Money in http://business.inquirer.net/money/columns/view/20080921-162053/The-money-meltdown-and-you

[5] Should We Panic? BDO, Metrobank, RCBC hit by Lehman collapse, 17 September 2008, in http://www.pinoymoneytalk.com/2008/09/17/lehman-brothers-impact-philippines/