



# **CURRENT FINANCIAL CRISIS :**

**A Review of Background, Impact & Outlook**

Takaful Gambia Ltd  
& Bank PHB Gambia  
5 March 2009 - Banjul  
(Abdul Khudus Naaim, Malaysia)

# COVERAGE

- Background of Crisis
- Subprime & Derivatives
- Impact
- Outlook
- Going Forward

# BACKGROUND

- In history, financial crashes shared one trait – “excessive expansion of credit” (*Prof Charles P Kindleberger - Panics, Manias & Crashes : A History of Financial Crisis*)
- Present problems caused by 3 excesses : excess credit, excess leveraging, excess greed (*Tan Sri Andrew Shen, Advisor, Central Bank of Malaysia*)
- Current crisis originated from housing bust and subprime mortgage lending

# CREDIT EXPANSION

- Dotcom boom in the USA ended up with a bust in 2000. US Government needed to boost the economy
- US Federal Reserve pushed on monetary acceleration programme by rapidly cutting interest rate
- Credit facility became very easily available. The interest rate was kept too low too long  
*(Tan Sri Lin See Yan, former Deputy Governor, Central Bank of Malaysia)*
- This helped spur consumer and housing spending through credit cards & mortgage financing

# SUBPRIME LENDING

- US banking institutions abandon normal risk standards in financing for demands on consumption & housing mania
- Lending can be for housing mortgages, auto loan, lifestyle financing or credit cards
- Subprime or near-prime or non-prime or second chance lending involved financial institutions (FIs) providing credit to borrowers who are of lower credit worthiness ratings
- FIs involved in excessive fraudulent lending to people with doubtful credit records
- Borrowers are charged at higher interest rates due to higher risk of default in repayment

# HOUSING BOOM & BUST

- Low interest rate result in housing boom
- People could borrow 100% (even higher) of inflated house price without down payment
- Lower grade borrowers started defaulting and house pricing started dwindling
- The housing boom from cheap & easily available credits but risky borrowers ultimately lead to housing bust in 2008 following default payment & house price collapse *(Prof Taylor, Stanford University)*

# RELEVANT DEVELOPMENT

## (USA Banking System)

- 40 years ago, 90% of all loans were backed by bank deposits, today it's 60%
- Regulators remove leverage (debt : equity ratio) cap for financial institutions (FIs) of 15:1 in 2004 without having to raise share capital
- End of 2007, average leverage was 30:1, Lehman Bro's leverage exceeded 40:1 when it collapsed
- Uncontrolled development & packaging of complex financial instruments such as derivatives, options, swaps etc

# TRADING OF DEBTS

- Mortgage loans are packaged in the form of debt papers such as derivatives, bonds etc and sold in the financial markets
- Banking institutions in New York & London which are always liquid readily trade in debt securities created from mortgage financing, securitisation of debts & derivative papers
- FIs sold loan to investment banks (Lehman Bros, Meryll Lynch, JP Morgan etc) as high quality bond
- Debt papers (bonds etc) given good ratings by rating agencies such as S&P, Moody's etc

# DEFAULT GUARANTEE

- Debt papers from subprime mortgage lending are sold as prime quality papers (derivatives, bonds etc) on the strength of default guarantee insurance
- Credit default swap (CDS) – an insurance policy where 3<sup>rd</sup> party (insurance co) assumes risk of a debt and pay the lending bank when the debt is defaulted
- When default occurs, insurance companies failed to pay on the guarantee as asset value backing the guarantee has deteriorated : AIG Insurance, USA

*Derivatives & CDS schemes were created in MIT & Cambridge in 1994 for JP Morgan (investment bank)*

# DERIVATIVES EXPLAINED

- Financial contracts or financial instruments whose values are derived from something else known as *underlying*
- “Underlying” can be asset (commodities, equities), residential mortgages, commercial real estate, loans, bonds), an index (interest rate, exchange rate, stock market indices) or other items (weather conditions, credits etc)
- Main types are forwards/futures, options, swaps
- Used to mitigate risk of economic loss arising from changing value of “underlying”
- Hedging is to mitigate losses due to reduction in value
- Speculation is to increase profit if value moves in the direction as expected

# DERIVATIVES MARKET

- In the USA, estimated at USD62 trillion and came down to USD55 trillion in September 2008
- CDO (credit default obligation) i.e. CDS for corporate debt, in USA is estimated at USD6 trillion
- Entire derivatives market is estimated at USD668 trillion i.e. about 15 times of world economy
- Underlying assets worth is about USD15 trillion i.e. slightly larger than the US economy

# FINANCIAL COLLAPSE

- Credit boom collapse in September 2007 following subprime crisis
- Downgrading of ratings for financial papers and write off of loans due to doubtful collection or un-recoverability
- USA derivative papers lost value about USD7 trillion (12%) 3Q 2008 following downgrading

# IMPACT FINANCE INDUSTRY

- Executives greed and market indiscipline was the order of the day prior to the collapse
- Banking institutions is trapped in toxic assets & inadequate capital (*Tan Sri Lin See Yan, Malaysia*)
- Lehman Bros, Fannie Mae, Freddie Mac, Meryll Lynch, Northern Rock, 14 US banks, Royal Bank of Scotland collapsed, bailed out or nationalised
- Banking institutions in steep liquidity and solvency problems

# IMPACT IN USA

- Subprime losses estimated at USD100 billion, banking institutions run out of capital
- First half of 2008, financial system suffers USD476 billion in credit losses
- USA stock market lost USD75 billion during the crash in September 2008
- AIG Insurance defaulted USD14 billion of USD440 billion it is holding in 2008

# IMPACT IN ASIA

- GDP contraction, growth estimated less than 1% in 2009
- Job loss estimated currently at 24 million 2008/2009 (*Malaysian population 25 million*)
- 140 million could be under poverty level
- Losses in market capitalisation, erosion in property values, huge provisions for bad debts in FIs

# IMPACT IN AFRICA

- African economy USD469 billion 2007
- Lower government revenues, budget deficit, GDP contraction
- Pressure on business expansion & credit availability
- Less availability of funds for aids & sponsorship programmes

# IMPACT ON MALAYSIA

- Malaysia is a trading nation & now top 30 exporters
- Demands worldwide shrink and natural resources prices (oil, palm oil, rubber) decrease - reduction in trading income & revenue
- Reduced economic activities result in retrenchment, increase unemployment & squeeze on cost of living
- Prices of goods & consumer items increased due to earlier increase of oil & other prices – pressure in corporate & individual spending capabilities
- FIs uncertain of outlook, may be in liquidity problems, lost capital, therefore conserve cash, stop/hold on lending

# IMPACT ON ECONOMY

- Economic depression – meltdown, recession, retrenchment, personal spending
- Country cannot produce, do not achieve GDP required, individuals squeezed due to lesser money, money value deteriorates, credit facilities unavailable
- Entire economic expansion halted & pressure on liquidity affect spending & growth
- The world needs to address the depression, recession with combination of fiscal & monetary policies
- Next problem areas – credit cards? derivatives?

# SOME TERMINOLOGIES

## FINANCIAL CRISIS

- FI's or assets suddenly lose large part of their value
- Can be due to banking panics, recessions, stock market crashes, currency crisis, sovereign default, financial bust, speculative bubbles

## BRETTON WOODS

- System of monetary management for commercial & financial relations among world's major industrial states post World War II agreed at Bretton Woods, USA
- Formation of IMF and later World Bank
- Obligation for each country to adopt monetary policy that maintain exchange rate within fixed value by reference to gold
- System collapse in 1971 when USA suspended convertibility from USD to gold

# SOME TERMINOLOGIES

## GREAT DEPRESSION

- Worldwide economic downturn starting in most places in 1929 and ending at different times in the 1930s or early 1940s
- Originated in the USA with the stock market crash on 20 Oct 1929 known as “Black Tuesday”
- Devastated country and population around the globe with international trade plunged by  $\frac{1}{2}$  to  $\frac{2}{3}$ <sup>rd</sup> affecting personal income, industries, farming, mining, employment etc

## RECESSION

- When there is significant reduction of a country’s GDP for at least two consecutive quarters
- Reduces economic activity reflected in reduction/erosion in personal income, employment, industrial production, whole-retail sale

# SOME TERMINOLOGIES

## MONETARY POLICY

- The process which the government, central bank or monetary authority of a country controls the supply, availability and cost of money (interest rate)
- To achieve certain target of growth & stability of the economy
- Expansionary policy – increase supply of money to combat unemployment by lowering interest rate
- Contraction policy – decrease supply of money to combat inflation by increasing interest rate

## FISCAL POLICY

- Government attempts to influence direction of economy through changes in taxes and fiscal allowances i.e. the use of government revenue & spending
- Policy can be neutral (fully funded), expansionary (rise in spending) or contractionary (government spending reduced)

# GLOBAL OUTLOOK

- Global financial system suffered heavily and leads to economic depression
- IMF estimates world GDP growth for 2009 only 0.5% (2008:4.8%)
- Banking institutions need USD1.7 trillion to re-capitalise
- World economy needs USD4 trillion to get back on track of growth target
- *Malaysian GDP growth for 2009 is estimated below 3% (2008:5.9% USD397b)*
- *Malaysia need RM40b to achieve GDP growth target, has RM23b o/s on credit cards (population 25m)*

# MICRO ECONOMIC OUTLOOK

- Generally immediate term outlook is still bleak & uncertain
- Next 6 to 9 months does not seem exciting & perhaps some improvement towards end of 2009 or early 2010
- Much depends on market confidence, stimulus packages, monetary & fiscal policy
- Stock market may slide further in the absence of new leads - may offer opportunity to accumulate some valuable selected counters
- Property market softening but offers investment opportunity with right asset that has upside potential
- Business environment play wait & see – effect of stimulus packages & availability of financing facilities
- Need adjustment in lifestyle, conserve liquid asset, selective new commitment that can bring value

# GOING FOWARD

- Global stimulus package announced by various governments to date almost USD2 trillion (USA USD825b, China USD586b, Japan USD250b)
- SMI & micro-financing to generate economic activities & job creation
- Strategic M&A exercise
- Selective assets & stocks accumulations with upside potential
- Next downturn cycle - 10years?

[ thank you ]

q & a

*contact :*

abdul khudus naaim

ks & associates

chartered accountants

16-1-1a, jalan medan pb2a, seksyen 9, pusat bandar bangi

43650 bandar baru bangi, selangor, malaysia

t : +6 03 8925 8454 \* f : +6 03 8926 8454

email : [aknaaim@streamyx.com](mailto:aknaaim@streamyx.com)

## **ABDUL KHUDUS MOHD NAAIM**

*FCCA (UK), CA (M), ATII (M)*

Partner

KS & Associates, Chartered Accountants



- Abdul Khudus Mohd Naaim is a fellow of the Association of Chartered Certified Accountants United Kingdom, a chartered accountant with the Malaysian Institute of Accountants, an associate of Malaysian Institute of Taxation and an associate of Institute of Co-operative & Management Accountants. Khudus is also a graduate of Diploma in Accountancy, Universiti Teknologi Mara.
- On completing the accounting diploma in 1975, Khudus articulated with an international audit firm Messrs Arthur Young & Co, Public Accountants, Kuala Lumpur and continued with Messrs Ramoss Jassen & Partners, a medium-sized chartered accountancy firm in London for four and a half years. He then spent one year with the London office of Luxembourg based Islamic financial group, Islamic Finance House PLC, London as their Accountant.
- Khudus served for about seven years, the last position being senior finance manager with Syarikat Takaful Malaysia Berhad, a company listed on the Malaysian Securities Exchange before taking up the Director of Corporate Affairs, Emile Woolf Group of Colleges of Malaysia. He came back into public accountancy practice in 1997.
- In a professional capacity, he currently sits on the board of directors and member of the audit committee of some companies listed on the Malaysian Securities Exchange and also that of the London Stock Exchange. He is a member of the Technical Committee of the Malaysian Accounting Standards Board (MASB) and also the Deputy President of the Malay Accountancy Firms Association of Malaysia. He was appointed a board member of the Muslim Youth Cooperative Society in 1997 and retired as Vice Chairman in 2006.
- Khudus is an approved company and cooperative's auditor. He is also a licensed liquidator, a qualified company secretary and a tax agent. Apart from the auditing, taxation and company secretarial appointments, he has been acting in the corporate recovery engagements for Pengurusan Danaharta Nasional Berhad (national asset management company) and some financial institutions.
- In the takaful and Islamic finance related engagements, Khudus has been acting as consultant, trainer and technical adviser to the operation of takaful companies in Malaysia, Brunei, Indonesia, Middle Eastern countries, West Africa, Thailand and Mauritius. Khudus has also been undertaking speaking engagements and presenting papers on takaful subjects in and outside Malaysia over the last fifteen years.