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ROLES OF BANKS DURING FINANCIAL CRISIS

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ABSTRACT:
The financial turmoil has spread to a wide range of other markets and economies around the world, morphing into a global financial crisis. This study outlines the role of banks in financial crises as well as the relationship between market liquidity and banking sector liquidity during the crisis. The aim of this study is to identify the performance and role of bank in financial crisis through qualitative approach by analysing the graphical data of profitability and credit ratio. The data are obtained from balance sheet and income statement that retrieved from Bloomberg. The selected Saudi banks in this study namely NCB, Samba and BSFR. The obtained statistical data reflected that each individual bank purposes differently and varies from one another in the subject of any financial ratios is it credit ratio or profitability ratio. The finding of this study suggested that the banks confidently have a main role in stabilize the economy.

INTRODUCTION:

Banks are considered to be the financial intermediaries that help in ease of transaction between the borrower and the lender. Apart from this primary function, it has other functions that it performs nowadays like that of investment, paying bills, designing portfolios, and many other functions. "A financial institution licensed to receive deposits and make loans and may also provide financial services, such as wealth management, currency exchange and safe deposit boxes."[1]. This means that they are involved in helping in depositing of the money from the lenders and also aiding borrowers in accessing loans with an applied interest rate. They are involved in managing the wealth of the people by safekeeping and also facilitating the currency exchange of the different countries all around the world. They are also known to provide liquidity for various assets and are hence preferred highly in the market. They are usually classified into two types based on their nature: commercial and a new form that is investment. Both have different characteristics and functions to perform respectively. The position of banks usually determines the position of the economy and the finance in the market. This section will discuss commercial and investment banks separately and in depth to understand and analyse each of their features thoroughly in relation to their functions and importance in the economy.Due to increase demands of the commercial banks, numerous banks are now everywhere all around the world. According to Kashyap et al. [2], the definition of commercial banks as, "Commercial banks are institutions that engage in two distinct types of activities, one on each side of the balance sheet-deposit-taking and lending." These are two primary functions of any commercial bank. Putting money in them is usually regarded as an act that involves less or no risk and is seen as a valuable deed done by the customers. They can be trusted with due to their high level of commitment towards their users. The information is safe and secure with them and are used for regulating and strengthening the banking system. The not only help in lending borrowers as individuals but also small and medium scale industries to aid in the up liftmen of the economy.These are different types of banks that exist solely due to the purpose of the investment. The Economic Times [3] defines investment bank as, "The financial intermediaries between security issuers and investors that help new firms to go public." They decide as to when, how and why should a firm go public based on the assets and debt, nature of business, its period in the market and position in the economy. They do this by buying or selling shares and charging commission for every share in the market. They are into trading securities, leveraging finance and restructuring the company based on the requirements of it going public based on their evaluation and certain strategies that they follow to help the company and making it run smoothly and efficiently [4].

Financial Crises

Financial crises date back to very olden times. However, the history will remember two of them that were tumultuous and shook the financial world and taking it by storm. The consequences were disastrous. One is the Great Depression of 1929 and the other one is the current scenario that poses a threat due to its long – lasting effect. The definition of financial crisis is stated as “A financial crisis is a situation in which the value of financial institutions or assets drops rapidly due to fluctuations in the economy."[5].Other reasons stated are overpricing of the assets, people investing irrationally and excess selloffs in the market thereby lowering the price of the assets. This has caused severe problems that happens suddenly and affects the whole economy and financial institutions thereby disrupting the whole meaning of finance and its associated terms. There is a set mechanism that follows but people are usually unaware of the resulting consequences which lead to financial crisis. It causes a major change in the economy by impacting the supply and demand, fluctuating prices, devaluation of assets and certain financial products, unemployment, shutting down of big, small and medium industries, banks losing liquidity and difficulty in maintaining the standards of living as basic amenities become scarce as their price rises.Regarding the history of the high – risk housing loans (subprime loans), which were securitized and were transformed into credit derivatives, more concretely into composite structured bonds (such as the CDOs), the now known as “toxic wastes”. These bonds were issued by the American banks as very promising, attractive packages (they were issued while the bubble of real estate lasted) and were sold throughout the entire world, contaminating the global financial system. As estimated, 5 trillion dollars of housing loans belong to the category of high risk, a number showing the enormous scale of the problem. The European banks were also badly hit by the crisis in the market of US housing loans. For instance, the banking colossus UBS, the largest bank of Switzerland, with assets of 1.9 trillion dollars, is one of the European banks worst hit. The minister of economics of Switzerland hastened to assure people that a possible bankruptcy of UBS is out of question. The IMF [6] estimated that the losses of the banks around the world from the accumulation of precarious loans and “toxic” assets connected with them will surpass the sum of 1 trillion dollars. But these estimates are continuously being revised upwards. On January 2009, this estimate increased to 2.2 trillion dollars and in early April it again increased to 4 trillion dollars, which by the end of 2010 [6].

This has now impacted all the countries around the world thereby bringing about the rising levels of poverty and diminishing amount of money from the economy and the financial markets. Some financial analysts predict that the current crisis has led to bringing in a lot of risk in every sector of the market. The developed countries are having an economy that is falling every time while the developing and poorer countries are struggling to attain growth. Many people are into formulating new strategies to eradicate this issue and propose new solutions to aid everyone trapped in the loop of crisis. The rate of growth and development has decreased significantly and is going very sluggish at this point. This means that even if the development is taking place, the rate is at a very slow pace. The banks have now come in action as they have rebuilt their institutions by coming up with revised rules, regulations and policies that will help in dealing with the situation of financial crisis in the nearby future and aid in mitigating associated types of risks.

Role of Banks in Financial Crisis

Banks are involved in playing a positive and negative role at the time of financial crisis. They are present to reduce the effect of crises in the financial system, the introduction of a government financial stability fund (or crisis fund), financed through a financial stability tax (or bank tax) has been suggested [7]. Following the crisis, several governments argued that financial firms should finance their own bailouts in future, in advance. For example, in 2009, the Swedish government introduced a permanent stability fee for banks and other credit institutions, and Germany, France and the UK are planning to, or have already followed suit [8]. While it has been argued that government bailouts could result in moral hazard, the requirement that the industry fund future bailouts itself may create incentives for improved risk management and governance. Conditioning access to the stability fund on compliance with sound risk management standards as well as robust capitalization could create incentives towards a sustainable and stable financial system. Banks are helpful in mitigating risk from the banks through restructuring of the banks. It can also help in building new policies and regulations in the bank that go hand in hand with the dealing of financial crisis. It can develop credibility among the customers by making an action plan on how to ensure safety and avoid this problem at once. They should develop an insurance system in the banks itself that cover up the losses generated by the crisis. It can also help investors in taking appropriate decisions. Strict supervision and penalties should be applied to defaulters because of whom these crises can rise accordingly. Banks can also act negatively by channelling the risk from one place to another. Banks with loose regulations often fall due to the crises as their policies cannot withstand the major crises issues. Hence, a bank should be able to cover up and act as a shield to the economy and financial markets by levelling up its game and strengthening its position.

METHODOLOGY

There are three types of research methodologies namely qualitative, quantitative and mixed methods. Qualitative is an intensive, holistic description and analysis of a single entity, phenomenon or social unit. Quantitative method involves quantifiable data such as numerical and statistical explanations. They research should have more than one variable to quantify the research problem in order to generate numerical data that can be transformed into useable statistics. Mixed method of research contains both qualitative and quantitative methods of research. This study used qualitative approach to assess the income statement and balance sheet of different banks through graphical analysis.

Data collection tools

Primary data

It refers to the data which has been collected for the first time for specific data research [9]. This study holds no account to the primary data as most of the data collected is secondary data.

Secondary data

Secondary data refers to the data that has been gathered by the previous research. It could be classified as book, peer reviewed, journals and the articles published. The data in this study are the balance sheet and income statement retrieved from Bloomberg.

Sample size

Sampling is the subset of selecting a group of sample from the in order to observe and investigate for specific perspectives. The data is collected from 3 Saudi banks namely NCB, Samba and BSFR.

Ethical Consideration

The data collected for the research is ethical, reliable and considerable. It is enough to validate the data of the research. The data will present the clear idea and understanding of the research and avoid any vague content.

Data collection

The data was collected by first making a Bloomberg account and then finding the income statement and balance sheet from the bank's page on the Bloomberg. Then, calculate the profitability and credit ratio.

Profitability Ratios

Profitability ratios measure the return earned by the company during a period. The ability to generate profit on capital invested is a key determinant of a company's overall value and the value of the securities it issues. Profitability reflects a company's competitive position in the market, and by extension, the quality of its management. The income statement reveals the sources of earnings and the components of revenue and expenses. Earnings can be distributed to shareholders or reinvested in the company. Reinvested earnings enhance solvency and provide a cushion against short - term problems.

Credit Ratios

Credit risk is the risk of loss caused by a counterparty's or debtor's failure to make a promised payment. For example, credit risk with a bond is the risk that the obligor (the issuer of the bond) is not able to pay interest and principal according to the terms of the bond indenture (contract). Credit analysis is the evaluation of credit risk. Credit analysis may relate to the borrower's credit risk in a particular transaction or to its overall creditworthiness. Credit analysis for specific types of debt (e.g., acquisition financing and other highly leveraged financing) often involves projections of period - by – period cash flows similar to projections made by equity analysts.

Data assessment

The obtained numerical data which collected from Bloomberg were then assessing through graphical statistical analysis.

RESULT AND DISCUSSION

The results gathered are based on the data collected from the Bloomberg for the banks – NCB, Samba and BSFR. The data collected was put into studying the credit ratio and profitability ratio to study the banks and analyse whose performance is better and who is credible enough to be trusted. The data generated showed varying results for each bank as each of them performed differently in terms of credit and profitability ratio. The graphs represent profitability and credit ratio for each bank which is NCB, SAMBA and BSFR.

NCB

Figure 1 shows credit ratio the over a period of 8 years from 2007 – 2014. The graph suggests that the credit ratio decreased during the period of 2008 – 2009 due to the global economic crisis but has been increasing ever since and this bank is named as the best bank in terms of credit performance and generating profitability.

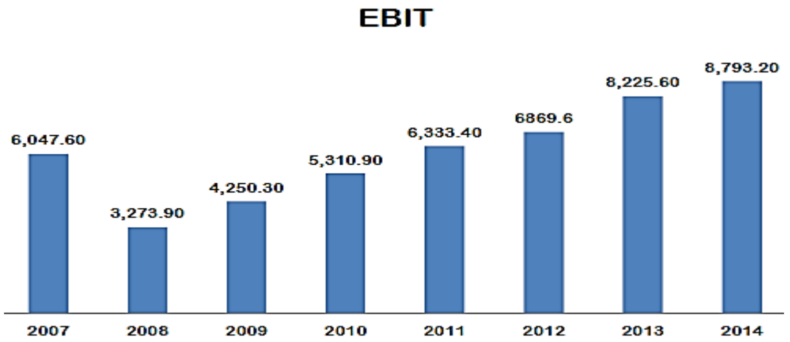

Figure 1: Graph of credit ratio for NCB

Figure 2 shows the profitability ratio for NCB bank. The return on assets they owned have been constant but have definitely increased since the period of 2008 and has achieved quite a huge amount of profitability in comparison to other banks.

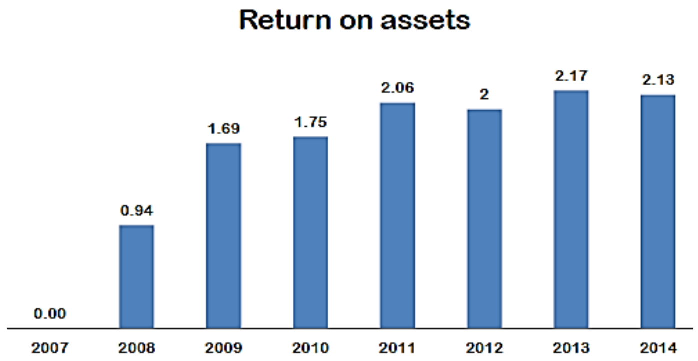

Figure 2: Graph of profitability ratio for NCB

SAMBA

Figure 3 shows the credit ratio for SAMBA depicts the varying results over the years and has gone up and down for a long time and then finally increased in the year 2014 where it performed exceptionally better in comparison to the other years.

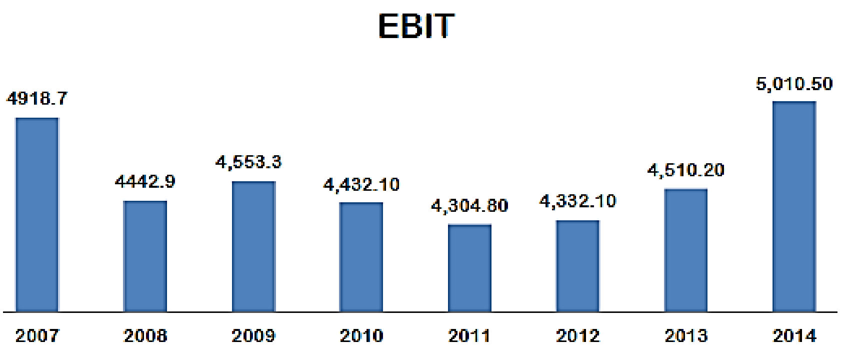

Figure 3: Graph of credit ratio for SAMBA

Figure 4: shows the profitability graph has witnessed decline due to the less return on assets and this is the reason why most of the customers and investors prefer NCB over SAMBA.

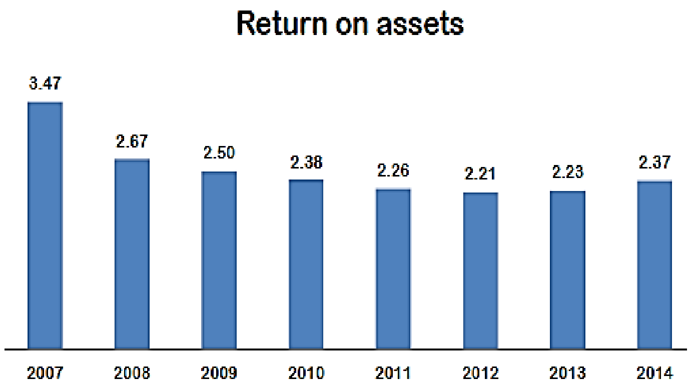

Figure 4. Graph of profitability ratio for SAMBA

BSFR

Figure 5 shows the graph of credit ratio for BSFR, it generated different results for different years but it did suddenly decline in 2013 and gained back its ratio in the year of 2014.

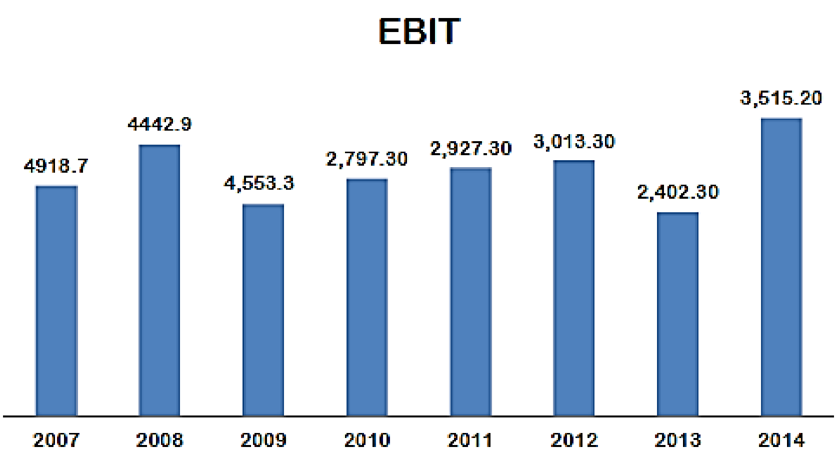

Figure 5: Graph of credit ratio for BSFR

BSFR has established a good place in the country but it also depicts different credit ratio over the years. The graph in Figure 6 shows the declining profitability. Over the years, it has declined in performance due to the tough competition; it has with the other banks that led to decrease in its profitability.

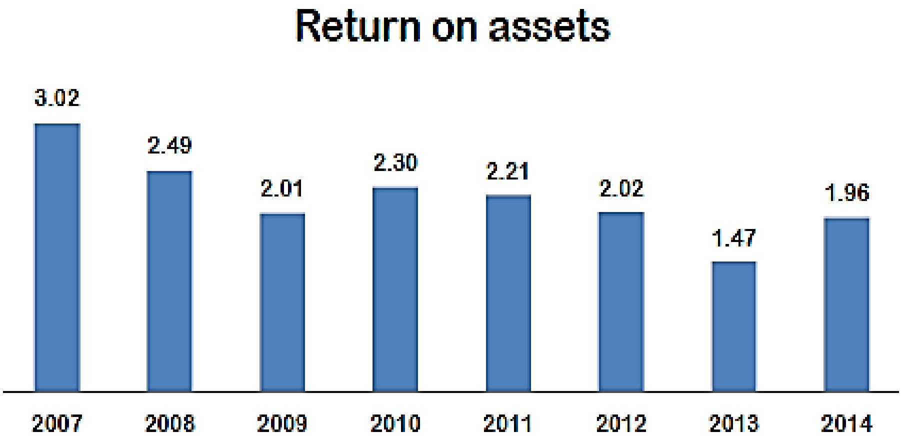

Figure 6: Graph of profitability ratio for BSFR

A financial crisis is a situation in which the value of financial institutions or assets drops rapidly. A financial crisis is often associated with a panic or a run on the banks, in which investors sell off assets or withdraw money from savings accounts with the expectation that the value of those assets will drop if they remain at a financial institution. A financial crisis can occur as a result of institutions or assets being overvalued, and it can be exacerbated by irrational investor behaviour. A rapid string of selloffs can further result in lower asset prices or more savings withdrawals. If left unchecked, the crisis can cause the economy to go into a recession or depression. There is because when the debts became unplayable Loan large sums of money into the ownership market pushes up the price of houses along with the level of personal debt. Interest has to be paid on all the loans that banks make, and with the debt rising quicker than incomes, finally some people become unable to keep up with repayments. At this point, they stop repaying their loans, and banks find themselves in danger of going bankrupt. After the crisis, banks limited their new loans to businesses and households. The slowdown in loans caused prices in these markets to drop, and this means those that have borrowed too much to consider on rising prices had to sell their assets in order to repay their loans. Banks lend when they're confident that they will be repaid. So when the economy is doing badly, banks prefer to limit their lending [10]. However, although they reduce the amount of new loans they make, the public still have to keep up repayments on the debts they already have. So when people repay loans faster than banks are making new loans, the economy slows down and prices decrease. As a result the economy risks slipping into a 'debt-deflation' spiral, where wages and prices fall but people's debts do not change in value.

CONCLUSION

The overall result showed that each bank functions differently and varies from one another in terms of any financial ratios is it credit ratio or profitability ratio. Out of all these banks, NCB performed the best followed by SAMBA and then BSFR which performed the least in comparison to the other banks. The comparative analysis gave us the idea of how each bank differs in their performance.

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