

CURRENT MULTI NATIONAL FINANCIAL CRISES – AN ATTEMPT TO TRACE ITS DEVELOPMENT

By S. Chidambaram, Consulting Actuary

E-mail: sankhyam@sancharnet.in

Key words: Bank Money, Global Credit creation, Derivatives, Credit Default Swaps, Collateralized Debt Obligations

SUMMARY

The paper briefly outlines the current economic situation and then traces the development of modern economy through the instrument of money. The uses and functions of money are touched upon followed by a discussion as to how capital needs of an enterprise are addressed. The sources of capital, domestic savings and governmental policy routes and also credit money produced by financial institutions are brought into focus. The paper brings forth some arguments for tight regulation of international credit creation and flow on a generally acceptable basis.

- 1. Current Economic Scenario:** The question of solvency of financial institutions has now come to the fore following the serious financial crisis that have afflicted some of the major financial behemoths like the Lehman Brothers, AIG, Washington Mutual etc. Like the 20th century Titanic designated as unsinkable that went down tragically on its maiden voyage, the belief of the investing public about the robustness of these institutions has been shattered. The cascading effect of the malady has led to a depression like situation. One after the other industries in non-financial sector is also facing the music. Policymakers desperately try to save the situation but the financial storm that is raging seems to be in no mood to abate. The serious situations have forced economists to look again at the fundamentals of the modern economic system so that similar disasters do not recur in future. One of the key fundamental questions is Market versus Regulation. There are quite a lot of specialists now in operation under modern economic system like Bank Managers, Treasury Controllers, Stock Market experts, Accountants, Auditors, Credit Innovators, Economic Analysts, Asset Managers, Product Designers, Product Dissemblers and Product re-packagers, Side betters, Monetary Control Agencies, Rating Agencies and many other bodies invested with the responsibility to supervise and control operations, brokers of several kinds and the list can go on. In this long list actuaries also figure. The profession of actuaries is quite bemused by the surge of this financial metamorphosis of a super scale unable to apply their time tested skills to play their roles as the tool kits with which they are familiar is no match to the mind boggling stupendous 'innovations' that occupy the centre stage of modern economy today. The profession is doing its best to hone the skills but we do not appear to have come to grip with the epic scenes now at play. Now everybody agrees

that things like this should not happen and not be allowed to happen at all but at the same time certain generally accepted economic policy consensus should not be disturbed. Is it possible? What is at the bottom of this muddle? Actuarial profession also has to understand why this came about. True, the problem is not one of actuarial but it is palpably a problem of political economy. Since we have to handle huge funds gathered from the public, actuaries also have to explore what best has to be done to ensure the confidence of public with whom the profession is connected.

2. **Money and Market:** It cannot be gainsaid that the advent of modern civil society would not have been possible but for the invention of money and the system of producing goods and services for the market rather than for self. It promotes not only individual good but also common welfare if we permit ourselves to apply our skills in vocations for which one is more suited and allow the special skills that some people possess becoming serviceable for all. As a result goods and services once mere wishes got produced in great quantity at cheap prices and made available for more and more people to consume and relish. Thus people produced for the market and in the market they exchanged their wares however sophisticated through the mechanism of money. The role played by money and market is no small to take society forward.
3. **Money and its functions:** Classical economists have studied what we call money, how it operates and serves the purposes of individual and society. It is primarily the generally accepted medium of exchange. With money our command over the wares in the market and services offered for sale has become a matter of simple everyday practice. The apparently incomparable goods and services put out for sale became weighable in terms of money. So people have a means to budget their life style against what they can offer to society at large in the shape of their service, expertise and legitimate possessions. They can now prioritize in the matter of what to buy and what not to buy, how much of their economic command they earned through their efforts and by applying their possessions for the good of the society that they should postpone for later days of greater need. This important measure of propensity to consume and save would not have been possible without money. When certain goods under favourable economic circumstances got manufactured in quantities far exceeding what reasonably a society can consume, the mechanism of money helps to motivate some to store them for later use. For instance, a bumper harvest can turn out to be a disaster for the farmers unless someone is willing to absorb the excess for storage. That someone could be government or some resourceful private persons. But to facilitate such motivation and make this practicable money plays its part. True these are basics. But what ensures the equity of transactions through such exchanges where money plays the role of arbiter? One could say the equilibrium is brought about by common but silent consent and knowledge of what happens. Sadly, we all know that there are well informed and the clever, somewhat knowledgeable and not so clever and the hapless many that have little knowledge as to how to weigh transactions fairly and these last lot is unfortunately

not an insignificant part of every society. Money is helpless to decide the fairness for everyone and to that extent it remains an inefficient mechanism of modern commerce.

4. **Market and its functions:** A most general definition of market would be any system in which buyers and sellers of goods and services can participate without restraint so that the exchange of commodities is ensured as freely as practicable. The classical perfect market in which by the sheer predominance of their numbers and therefore inability to form coalitions or cartels either on the side of sellers or buyers, a fair equilibrium of exchange of values is expected to be achieved through a system of automatic rationing of available supply of goods to the available demander for such goods. This like the single dimension entity called a line in mathematics exists only in thoughts and never seen in practice. But concepts of the kind are useful as it gives some idea about the degree of market imperfections. In the absence of markets individual monopolies would be the order of the day and the existence of the market certainly reduces quite significantly the influence of monopoly practices though all shades of its cannot be eliminated by the market. One could say that an active market is the best choice for a large measure of equity and fair play. This is achieved by freedom of operation of the players in the market. Market senses what things and services would be in need and what will become obsolete. So the supply side readjustment is facilitated. In order to be efficient market information has to be accurate as well as abundant and more importantly freely accessible. The advent of modern communication facilities and knowledge explosion has brought about a near ideal situation. Even so imperfections continue to exist and these market imperfections are sought to be mitigated by a continuous process of interference, adjustment and readjustment. So long as players exist to exploit an imperfection such adjustments will go on. So it may not be inappropriate to say that money and market together made modern commerce possible and modern commerce largely operate to the advantage of the public wherever they are.
5. **Money – its production and distribution:** Common man understands that money is created by governments. This is quite true because unless governments get on with the creation of currency, there will never be money at all. The process of manufacture of money does not end with government. Money exists and operates and controls transactions not in the guise of the physical money supplied by governments. Other kinds of money also operate with equally good force and power. By far such money in its supply and sway far exceeds the physical money printed by governments. Such monies are though physically invisible, are quite manifest and facilitate modern commerce and occupy the central stage of the economy. A bank is an institution that accepts deposits of money from public. Depositors are in a never ending process of depositing and withdrawal of their money from the Bank. When the deposits total quite a large sum and the number of depositors are also quite large, the effect of individual deposits and withdrawals from the bank on any day remains more or less in balance and the banks can be sure that there will always be a substantial large sum of money at

their disposal which they can sell to others who need it. One of the sources of revenue for the bank is the result of such sale of money. This is why commercial banks always try to enhance the number of their deposit accounts so that residual reservoir of deposits that lie with them always in spite of the withdrawal and deposit operations by such account holders will grow. The banks are thus in a position to sell more and more money. In other words commercial banks buy money from depositors for a price (rate of interest on deposits) and sell this money to others at a higher lending rate of interest. Banks thus converted money into something that can be bought and sold just like any other goods. They made money tradable, a very useful purpose. As in any trading of goods, banks canalize money to where it is needed from where it was not immediately needed. Economic resources could thus be put to greater use and not wasted away in private lockers to be idled.

But deposit and borrowing route alone does not equip a bank to be a massive provider of finance. Banks are in a position to create money in the form of bank credits. The bank credits, the invisible money, can easily exceed several times the deposits it actually holds. So long as the commercial world and the public believe that a bank creating such credits is capable of honouring its financial commitments, there is no danger. But there is a limit dictated by the size of the cash resources and the actual credit needs sought from a bank beyond which any stretching of this ability of the bank to create money is bound to wreck it sooner or later. A bank failure is not just an isolated economic event. One failure can even jeopardize the credibility of the banking industry as a whole and when this happens it is simply an economic disaster.

Precisely to prevent such disasters, regulators exist. In India the Reserve Bank is the regulator of all types of banking services within the country. The regulator mandates commercial banks to maintain a minimum cash reserve with respect to its deposits and a minimum of liquid assets in relation to the liabilities they contract. Certain other stipulations with regard to assets held also are mandated. When banks function within these tight regulations there is an automatic check on lending operations and running the risk of bank failures.

Bank money supports the credit needs of commercial and industrial establishments for their working finance and short to medium term financial requirements. Projects with very long gestation periods could be highly capital intensive and can be organized only with long term capital. Since banks' resources in the shape of their deposits and also the average duration taken by the credit money they create to come back to them for honouring is short term or best medium term, the banks are not suited to provide a long term capital and if they are allowed to do so, they are bound to run into an asset-liability mismatch risk.

To return to the subject of money we see that an economy operates on government manufactured physical money and bank money. When the supply of money is just adequate to fulfill all the emerging commercial transactions and activities the economy is in a stable equilibrium. The ideal situation seems to be that this supply should be a shade more than actually needed by the transactions because this excess will act as a motivator for innovations and improvements and as a cushion against temporary constraints of shortage of money supply.

This much was said only to emphasize that proper regulation is a sine qua non for the smooth operation of an economy in which banking system plays a very big role. If such supervision is lax or certain sectors of the financial scene are able to ignore with impunity such supervision, economic troubles are bound to crop up.

- 6. Capital and Capital Market:** Capital is long term finance and is needed for new projects and ventures. It is needed for renewal of existing assets that wear away. It is also needed to beat back obsolescence of once productive assets. Commercial banks are generally not in a position to supply this because the requirement is quite massive and usually for a very long time. Domestic savings is the major source through which such long term capital can be mobilized through specialized instruments and institutions. A government can also meet the requirement to an extent by running a fiscal deficit. But the fiscal deficit will have to be not too out of tune from Gross Domestic Product of the economy. If that is the case instead of doing good the deficit could cause an inflationary spiral and drive up the cost of capital and thus de-motivate expansion and new projects. Another source of capital is import of the same from external economies.

Instead of participating in ventures of big companies through bank deposits, public are facilitated for direct participation with the prospects of better rewards, however small may be the spare money available at their disposal. Capital markets come to their aid. Enterprises requiring massive investments cannot exist even with the combining pooling of the capital available with the promoters. Necessarily they have to borrow from public. Broadly two categories of units of capital are marketed to the public to contribute – equities and bonds. While bonds carry a guaranteed return and a promise of redemption at a future date, equities do not have any such guarantees. But the surpluses accruing to the enterprises over the years are available to the equity. Periodically part of such accumulating surplus is distributed in cash as dividends. Thus equities have the right on the residual assets of a company when it is closed down.

But the life span of the investing people would be significantly smaller than that of the enterprise in which they invest in equities. To facilitate transfer of values back to the investors markets exist through which a willing buyer of the stock can always be found for a person who wants to relinquish his equity. The market worth of such equity is not only based on the undistributed surpluses but also on the demand for equity

participation by other prospective investors. Thus liquidity assured through markets, higher gains of course with greater risk motivates private savings to flow to enterprises. Long term bonds are also similarly marketed to ensure liquidity for the investor. One of the major participants in the capital markets is the investors either individuals or other institutions who have a surplus to spare to promote newer enterprises or any other enterprise already operating.

All markets operate not merely on the money put by investors in the real sense. The bonds and stocks appreciate or depreciate in value depending both on the past records as well as the present and future prospects of the enterprise and also more importantly on the expectations of growth or slump by the participants in the market. Stocks are bought and sold to take advantage of low prices at buy times and high prices at the time of sales. An active market is thus characterized by the volume of trading in stocks and bonds. The market remains vibrant largely through the activities of such participants who come to the market for purely trade and not investments. Just as operations of banks needed regulations markets also need regulation without which a group of stock traders can push down or push up the stock prices to achieve their narrow speculative gains.

Like any other market a stock market will remain ideally perfect if the number of sellers and buyers of stocks are enormous with no single person or group of persons in a position to dictate the market trend. If trading operations gain primacy rather than markets serving the need of enterprises for more capital for expansion and growth then a situation of over speculation can develop. No regulator is in a position to keep the market in an ideal degree of volatility suited for and acceptable to investors and traders. If too much of regulation is attempted, traders can withdraw and move to other markets more suitable for their purpose. If not regulated, then also others, largely traders, can crowd in with their speculative motives increasing the volatility of the market at a level that would be thought undesirable. If the operations of such speculating traders do provide a ready means of liquidity options for the real investors, too much of it will money to float in speculative activities rather than real capital formation the *raison d'être* for markets.

- 7. Innovations and derivatives:** There is an inherent contradiction as well as conflict of interest in these markets which is very important. Domestic savings are attracted to the market through bond or equity investments. When speculative activities on such instruments go on transfer of economic resources change hand from speculator to other with gains unimaginable for the original investors. Sooner or later even these original investors are tempted by the short term but quite substantial gains and join the band wagon. When speculation takes the riding seat enterprises in whose name such activities flourish take the back seat. Rather than through enterprise if a means is available to make gains through speculation and wagering, there is little point in engage

oneself in the onerous business of enterprise with its long gestation periods and risks. It is but natural that institutional speculation will emerge, in fact these have emerged in no small number. The net result of these trading activities is to drag the domestic savings to be transferred into the hands of the financial players.

Individuals who are powerless to match the financial strength of stock market speculation organize themselves into institutions – unit funds – and attempt to compete with the big finances. In an economy where the domestic productive resources are applied optimally, there may be no more scope for enterprise finance. They thrive through this kind of speculation and create innumerable innovations in financial products. Unregulated money get created and has to find some investment space to reside in.

With scope of enterprise stocks and bonds stagnating new instruments based on such stocks were invented – the derivatives. Derivatives in the ultimately means a trade on mere promises. Put and Call Options, Futures of higher sophistication have to emerge and have emerged. These are mere traded promises to supply or purchase or sell a bond or a stock at a stated price at a time or within a stated duration with no obligation to invoke the promise. Who wants these promises? Naturally, those who want to speculate on the price movement on the stocks will be one major target. Others who have contracted liabilities and desirous of matching such liabilities by acquiring stocks and share also want these derivatives as a protection against downside movement of the stocks in their possession at times they believe they will have to unload them. They manage such stock price risk by using these derivatives to ensure the solvency of their own business. These derivatives – promises – are shown in their books as supplemental assets. Bond derivatives, currency derivatives on similar lines are now an integral part of the financial markets.

8. **On sophistication of derivatives:** If promises can be sold at will there is good reason to manufacture them in devious ways. Mortgages are securities held by banks to cover the housing or construction loans they advance. The property under construction is developed by the loanee and the income derived from such property or other sources is used to liquidate these liabilities in predetermined instalments. When money can be created plentifully, especially in the absence or lack of regulations, institutions are apt to produce as much as possible and deliver them up to seekers even unmindful of the risk of default on the part of the mortgagor. From experience one may gain a sort of confidence that if at all there is a default, there is always the security of the property to fall back upon. Such failures from the side of loanees may not be thought quite significant, a bearable risk. If the appetite for risk taking assumes greedy proportions, not only prime eligible candidates are given the loan but sub-prime seekers of credit are also taken in. These sub-prime risks became transferable through what is called

Collateralized Debt Obligations (CDO) – another derivative. The transfer mechanism is however very complex.

CDOs are essentially corporate entities. A corporate entity acquires a portfolio of credits, say, a block of mortgage backed securities or high yielding corporate loans. The entity acquires such a portfolio by applying the proceeds of such bonds and equities. The bonds and equities so issued are entitled to the cash flows from that credit portfolio based on some seniority criteria set forth in the transaction documents. The senior notes issued gets precedence in payment over junior notes, while equity notes issued will have to wait until the dues to the bond notes are met. The pricing of such instruments is based on the expected reward and the contracted risks. This means that senior notes will attract a larger price than the junior notes and equity notes will be the cheapest. When the goings are good the return for all such notes will be quite attractive and much larger than would be possible from other well known instruments like a triple A commercial bond.

CDOs can hold as assets other CDOs enhancing the complexity of the nature of the instrument and very often as a result of packaging the CDOs on CDOs such convolutions of the nth degree (where n can be 2,3,4, or even larger order) can and do bring about the recurrence of the same CDO more than once albeit in some less proportion. The packaging in a CDO can comprise of a host of other instruments in varied proportions. Such a complex arrangement poses the daunting problem of their risk evaluation and therefore fair pricing. A market for CDOs exists mainly because the return offered to the investor is 2 to 3 percent more than a traditional investment vehicle carrying the same credit rating. Recourse to statistical mathematics lend a lot of credibility for its risk evaluation and pricing. When the complexity of the transactions are accommodated in statistical framework and fed into an IT system with suitable number crunching tools, the complex calculations get done quickly enough in the computer output. Clearly the trust one can repose on it depends also upon the reliability of the mathematical model applied. Eventually, it is simply a promise and the degree of credibility the issuer of such instruments can impose on the taker.

Bewildering arrays of CDOs now exist and have grown in size to astronomical proportions. Primarily, CDOs can be classified into Cash-Flow CDOs – hopes to pay interest and principle to holders using cash flow generated by CDO assets, Market Value CDOs – hopes to ensure greater investor returns through frequent trading of CDO assets, Hybrid CDOs – this is some way in between the two classes cited above.

The referral asset for the CDO can be anything from a Bank Loan, Corporate Bond, Mortgage Debts almost any sort of marketable acknowledgement of debts. The investor in a CDO has however no right over the referral assets. The interesting thing about it is that they are promising high returns with less volatility and a high credit rating. How is it possible, unless one is able to manufacture money to foot the surging claims.

We have another sophisticated derivative known as Credit Default Swaps (CDS). CDS is a contract like arrangement about the state of a referral asset on which neither party may have any real interest. The party called buyer of CDS makes a series of payments to the seller until the end of the term or on the happening of a specified event connected with the referral asset before the term ends. If the specified event associated with the referral asset is to happen within the term of the contract seller party pays the buyer a sum which is equivalent to the value deterioration of the referral asset as acknowledged in the market between the commencement of the contract and the occurrence of the event.

The arrangement is sometimes referred to as protection provision for the buyer on the deterioration of the value of the asset. Clearly it is a wagering contract and in many countries wagering contracts are ab initio void. The total absence of insurable interest and the question of any indemnity upon an asset deteriorating in value with which neither party may have any connection makes it clear that the arrangement is not insurance. Nevertheless for a person in possession of the referral asset and who is risk averse such an arrangement might be a real protection provided the price he pays for the protection is tolerable. The seller of CDS can pocket the premiums he receives if the event referred is not to happen and when he is pretty sure of that he is in a position to offer very attractive price for protection for the risk-averse owner of the asset. But the CDS seller does not make just one such contract, but several of them on different referral assets and hope to set one loss against another and eventually balance his books with a handsome profit. A person hoping to become eventual owner of the referral asset can also enter into a CDS deal. He can opt for physical settlement if the event specified is to happen, deliver to the protection seeker the promised worth of the asset. Under a cash settlement option only money equivalent to the value deterioration is paid by the seller of CDS. Numerous CDS contracts are written on major companies like Lehman Brothers and Washington Mutual etc. When the credit event associated with the Swap happens, settlements can be made by auction. The participants of the CDS then make bids for settlement. Based on the bids a final settlement price is fixed which is then accepted for full satisfaction of the contractual obligation.

Credibility to these transactions is achieved by applying a probability model for the risk event. Thus pricing is not arbitrary and subjective but based on some scientific approach. The probability of the series of cash payments and the probability of credit event happening pre-designed, pricing is a matter of calculation, annuity like.

When Lehman Brothers went broke, it was argued that the large prices put up by sellers of CDS on Lehman led to the confidence loss and downfall of the company. But it can also be argued that the CDS sellers were alerting stakeholders in Lehman about the condition of that company through their CDS spreads. How legal and ethical would it be for anyone to bet on anybody else with no demonstrable pecuniary interest on the subject of bet.

CDS sellers are not totally risk savvy. They too buy CDS on the subject matter on which they sold CDS and thus hedge their risk. In fact this seems to have happened in the case of Lehman Brothers. Even though the total amount of CDS pay out on Lehman bankruptcy is reported to be over \$350 billion, the net cash flows after the settlements is estimated to be in the region of \$7 billion only.

But the failing entities like the Lehman Brothers and AIG themselves were counter party to several other CDS deals, for those who sought protection from them through CDS ceased to have that protection while losing the premiums they paid gone for nothing. CDS can thus produce real risk to an economy.

Since CDS chains can exist any failure of a link in the chain can create problems down the line in a domino effect. If a CDS holder is paying a premium of say 1.5% if the referral entity's solvency position worsens the price for a CDS based on that referral will increase to say 5%, then 1.5% CDS holder can sell it to someone and gain from the difference in premium. Similar chains can develop from the secondary CDS holder to another party and so on dictated by the widening of the CDS spread from time to time. A network of CDS can thus exist. The ability to fulfill the contractual obligation depends upon financial status of any one in the chain. If for some reason one fails, a whole lot of CDS can fail below him. This is a systemic risk that remains uncovered.

But swaps are sought as investment channels by many entities like commercial banks, mutual funds, investment trusts, insurers, particularly re-insurers, pension Fund Trusts etc. to protect their assets against deterioration in value.

Swaps and CDOs are not regulated for their solvencies and so float in the market by virtue of the reputation of the manufacturer of swaps. This means in effect that they are creating credits on an unregulated scale and have the potential to expand it indefinitely. So the counterpart failure risk always exists and the problem is that the risk will grow in size density of derivatives created by any given entity.

Bank money in the above sense is a derivative from the bank's credibility, the numerous financial instruments with which money is created are also used to produce derivatives and super derivatives. Practically there is no one who stands guarantee for such instruments and the only guarantee is continuous growth of an economy through which any compulsion to honour the commitments can be ensured by a transfer or further borrowing possibility resulting from growth.

9. **Alarm Bells from Basel:** But the serious possible (now visible) consequences of allowing such instruments to flood the markets were not unnoticed. Banks the starting point of credit money led to the development of new institutions and they can practice the business of manufacture and sale of money now on an international scale, unmindful of the risks involved. Perhaps the Basel Conventions sounded the first serious alarms about these happenings. European financial institutions were beginning to feel

the stress and strain from such unregulated system. But there is no way they could compel every body to conform to the best practice norms and adequate risk evaluation of the transactions these institutions enter into. Since globalization facilitated the migration of institutions from place to place and transfer of credit became a matter of mille-seconds thanks to the IT revolution, the governmental arms that could control such matters ceased to be long enough. So the next best thing is to force them into some sort of desirable self-regulation. This gave birth to the Basel Norms for the banking industry. Every country party to the Basel was asked to impose the norms so that through the multi governmental controls these institutions could be forced to conform and take risks only to the extent they have the capacity to bear. Solvency Norms for insurers are also evolved and being put into practice. Perhaps norms that apply to non-banking and non-insurance entities are being evolved. Sadly, the crunch came all too suddenly before these remedial actions could take root firmly. Now the situation is different. Every economy is concerned with its own problems and cannot be expected to put in place a global norm because the norm could hurt them more than it could hurt others. The possibility of consensus is evaporating though its need today is paramount at any time before.

10. **Domestic savings Vs international Credit flow:** An economy's capital requirement is first met through domestic savings and only when that is not sufficient one has to seek off shore funding. True when the components of projected development have necessarily to be sought from abroad, be it technology or plant and machinery not available from within, some funds have to come from abroad. The economy being in a state of sufficiently advanced with means available from technology and resources available from within, capital requirement through domestic savings is the best source. As domestic capital can be controlled from volatile outward flows the planned developments are free from such risk. On the contrary dependence rather over dependence of foreign capital can expose the projects to the contingencies of flight of capital just when it is needed for the economy. True it may be possible to arrest such flows, but then the terms demanded could be unattractive as well as uncomfortable. It seems sound logic that the developmental finance is best funded through domestic savings. The authorities in the economy are also in a position to make it less costly and can even leverage propensity to save through monetary and/or fiscal policies. That convenience is not available in the case of foreign capital.

But domestic capital availability is in short supply, recourse to foreign capital is a *sine qua non*.

But capital floats about in the global context practically liberated from control by any state or authority. What is more institutions have developed capability to create finance capital based on their global exposure and reputation. The financial strengths of some of the large institutions are well known to be far in excess of many governments. The problem however is that free floating capital has necessarily to seek residence in assets

without which they become utterly meaningless. So, international finance capital naturally competes with domestic capital. Since domestic capital springs from need or compulsion for postponement of consumption and are dictated by the price requirements for its growth and ready supply, it is at a disadvantage with international capital which can turn the table against it through cheaper terms of cost and more convenient servicing schedule.

The effect of influx of foreign capital into Indian economy following the partial opening of the economy can be gauged from the dramatic change in the cost involved for public borrowing. The supply of capital in the economy suddenly rose and government could dictate terms for public borrowings and as a result the rate of interest in the economy came down sharply. Savers had a severe day and were forced to turn to the equity markets to achieve the desired level of return. The instance is cited only to emphasize the fact that the influx of capital can create problems as much as the flight of capital. This only underscores the inevitability for foreign fund flow management – again a matter of regulation. Such regulations can be anathema for those who advocate absolute freedom for markets and trust the markets fully to decide what is best and what is not.

11. What could be the root cause for this kind of a situation – a near system failure?

Basically money and capital are behind the state of an economy. A bundle of economic policy strategies cannot be pursued in isolation of the sanction of its people. When the strategies are seen to hit hard the people the authorities no longer have the comfort to pursue them.

A domestic economy is largely controllable through internal means, fiscal or monetary. But who will control the ebb and flow, not to speak of its multiplication, of international credit. International credit creators do not relish any sort of regulation, legal or ethical. When one sort of regulation comes in their way, they have guile and wizardry to outwit it. Commonsense is more sensible than wisdom of financial wizardry. It is commonsense for the Queen of England to ask the economic pundits, “Why everybody did not see the hole?” Growth is a product of our inherent strength. Motivation can play a bit to stretch it a little. But it is sheer commonsense that one cannot grow beyond one’s capacity. To grow further one must first develop the capacity and this economic capacity cannot be substituted by an over abundance of money, domestic or international that an economy can sustain. Credit and value creation will necessarily have to be watched. There will have to be a general agreement for such a regulation. The ultimate effect of this kind system failure is borne by the man in the street and he has every reason to question and agitate, for, the problem has been shifted on him.

Ideally the credit requirements of an economy should be based on the economic values created for consumption. Any over supply is as dangerous. Because, such oversupply will encourage unsound investments, led by greed as has happened in the sub-prime crisis occasioned in the US economy and the spiral it has started.

(end)

Bio-data of S. Chidambaram, Consulting Actuary

Academic & Professional Qualifications

B.Sc.(Physics); Associate Member of Institute of Actuaries London, Associate Member of Insurance Institute of India, Mumbai, Fellow of Institute of Actuaries of India, Diploma in Journalism & Mass Communications

Others:

1. Running an independent Actuarial Consulting service tendering advice on matters relating to Life insurance, Pension and Employee Benefit Risks
2. Actuary to Government of Kerala for the Valuation of the Life Policies portfolio
3. Valuation of Gratuity Funds, estimation of Leave Encashment Benefit costs, designing Pension Schemes and other Employee Benefits Scheme by applying statistical theory and methods
4. Published several articles on subjects on actuarial/insurance and other matters of common interest
5. Presented papers in global conference of actuaries and local insurance institutes
6. Acted as Paper setter and examiner for actuarial examinations conducted by Institute of Actuaries of India
7. Statistical Analysis for various research data and reporting on results – Eg. Regional Cancer Centre, Tropical Botanical Gardens etc
9. Appointed Actuary for Agriculture Insurance Co. of India, New Delhi