

**Central Bank of Sri Lanka** 

IN THIS ISSUE

Climate Change: Associated Financial Risks and Implications for Financial Institutions

Who bears responsibility for the Great Financial Crisis? With a special emphasis on the UK bank bailouts

Common Rating Errors in Employee Performance Evaluation

, June 2021

A OFI

Jumber

02

11

18

26

Breaking Barriers, Building Bridges: Navigating the Maze of Global Economic Fragmentation



The views expressed in the articles are those of the writers and are not necessarily those of the Central Bank of Sri Lanka. Climate Change: Associated Financial Risks and Implications <sup>RISK</sup> for Financial Institutions

> **S D Jayanetti** Senior Assistant Director Department of Supervision of Non-Bank Financial Institutions

#### 1. Introduction

Climate changes are identified as a key risk area that may adversely impact the performance of Financial Institutions (FIs)<sup>1</sup>. Long-term variation in global or regional weather patterns is known as climate change. Over the past few decades, notable changes in the global climate have been occurring, characterised by extreme weather events such as rises in temperature, frequent cold snaps and heat waves, severe droughts and floods, as well as an increasing number of other natural disasters. While creating varying impacts across several industries, global and regional changes in climate can have serious consequences for financial institutions and thereby the stability of the financial systems across advanced, emerging, and developing economies.

Nowadays, FIs have become more prone to climate risks due to two key reasons. Firstly, FIs have become more complicated and widened their international presence, thus exposing themselves to countries that are more vulnerable to climate change consequences. Secondly, as the branch networks of FIs expand to geographical areas with severe weather conditions, there is a growing exposure to risks associated with climate change. Therefore, climate change is emerging as a new source of risk for the FIs, requiring special attention to the impact of such changes.

Climate change affects FIs through two main risk drivers, namely, physical and transition risks, which manifest in the form of traditional financial risks, i.e., credit, liquidity, market, and operational risks. Physical risks refer to damages to people and properties arising from severe weather events and lasting environmental changes, while transition risks refer to the stresses linked to the transition into a low-carbon economy as a response to climate change. The safety and soundness of the FIs as well as the health of the whole financial system might be negatively affected if the FIs fail to identify, assess, monitor, and control such climate related financial risks.

Given this backdrop, FIs should take steps to integrate climate related financial risks into their existing risk management frameworks in order to ensure safe and sound management of such risks.

With the given importance of climate change

<sup>1</sup> Financial institutions referred to in this article are banks and deposit taking Non-Bank Financial Institutions.

associated financial risk, this article is structured as follows: In section 2, types of climate risks are discussed, and transmission of climate risk into financial risk is discussed in section 3. Section 4 is devoted to the implications for banks and Non-Bank Financial Institutions (NBFIs). The case for Sri Lankan banks and NBFIs, together with the possible ways to integrate climate risk into the existing risk management framework and the best practices that could be followed by the Sri Lankan FIs in doing so, will be discussed in section 5, and finally, a conclusion is drawn in section 6.

#### 2. Climate risk drivers

Climate change related factors that could give rise to financial risks are known as climate risk drivers. At high a level, such factors are classified into two broad categories, namely, physical risk and transition risk. Both those categories translate the climate related changes into financial risks affecting the safety and soundness of the financial system.

#### 2.1 Physical risks

Physical risks are changes in both weather and climate that affect the financial system as well as the economy as a whole. Physical risks that arise from sudden manifestations of extreme weather events (hurricanes, torrential rains, floods, and other natural catastrophes) are known as acute physical risks, while more gradual changes in climate (sustained increases in temperature causing sea level to rise, chronic heatwaves, or desertification) are categorised as chronic physical risks. The emergence of those risks could take a long time, and it is very difficult to predict the frequency and severity of each type of risk. Nevertheless, such events may entail physical damages to financial assets,

disrupt supply chains, and increase liabilities, impacting a range of economies, even though the significance of the impact on financial systems is disproportionate among advanced, emerging, and developing economies.

Physical risks to FIs can manifest either directly through their exposure to corporate, individual, and international customers who are subject to climate shocks or indirectly through the impact of climate change on the economy as a whole and its implications for the financial system. These include increased default risks on loan books and/or declines in asset values.

#### 2.2 Transition risks

Transition risks arise in the process of transitioning to a low-carbon economy and include changes in policies, regulations, technologies, and consumer preferences. Such changes may prompt a reassessment of a wide range of financial assets, accompanied by a fall in their value. However, the size of the transition risk depends on the time span of the transition, where the risk will be lower if the shift is made gradually and at a good time. In contrast, the risk will be higher if the changeover is sudden.

Transition risks affect FIs mainly due to exposures and concentrations in firms that are vulnerable to losses stemming from decarbonization, especially those that operate in the energy, transportation, and manufacturing sectors.

The magnitude of physical and transition risks and their interdependence are likely to be determined not just by the course of climate change but also by the course of actions taken to prevent such risks. For instance, sudden and unexpected policy responses to climate change might curtail physical risk but result in a disorderly transition to a lowcarbon economy, which could trigger the materialization of certain transition risks in the short term. Avoiding or postponing such adjustments, on the other hand, may prevent those materializations in the short term, but continuous increases in emissions may lead to increased manifestations of physical risks. Further, in some instances, physical and transition risks may interact and crystallize simultaneously.

## 3. Transmission of climate risk into financial risk

Both physical and transition risk drivers are translated into climate-related financial risks through a variety of direct and indirect links known as transmission channels and manifest in traditional risk categories, namely, credit, market, liquidity, and operational risks.

Direct transmission channels are also referred to as microeconomic transmission channels. Those comprise the causal links by which the individual customers or counterparties of FIs are impacted by climate risk drivers, potentially exposing the FIs and the financial system as a whole to financial risks associated with climate change. In addition, those include any direct consequences for FIs themselves arising from impacts on their daily operations or their ability to raise funds (BCBS, 2021) as a result of climate related factors.

The mechanisms through which the climate related risk drivers influence macroeconomic factors such as labor productivity and economic growth and thereby have an impact on the FIs are known as indirect or macroeconomic transmission channels (BCBS, 2021). Further, the effects on

#### Figure 1: Transmission of climate risk into financial risks



Source: Climate-related risk drivers and their transmission channels, Basel Committee on Banking Supervision

macroeconomic market variables, including riskfree interest rates, inflation, commodities, and foreign exchange rates, are also captured through macroeconomic transmission channels. The details of the channels that transmit the climate risk into financial risk can be given in the below figure.

Figure 1 illustrates the transition channels and physical risk drivers are transmitted into financial risks (BCBS, 2021). Both physical (acute and chronic) and transition risk drivers (column 1 in figure 1) impact the FIs through various microeconomic and macroeconomic transmission channels (column 2 in figure 1). Further, a variety of other variables or sources (column 2 in figure 1) can influence the likelihood and magnitude of such an impact on FIs. Ultimately, the implications of climate risk drivers on FIs are depicted through the typical types of risks faced by them, i.e., credit, market, liquidity, and operational risks (column 3 in figure 1).

#### 4. Implications for banks and NBFIs

This section summarises how climate risk drivers affect FIs through credit risk, market risk, liquidity risk, and operational and reputational risk.

#### 4.1 Credit risk

Extreme climatic events could result in considerable losses to businesses and individuals affecting their ability to service loans (income effect) as well as impairing the value of the assets pledged as securities (wealth effect). This leads to an increase in credit risk for FIs in terms of a higher possibility of credit defaults and a drop in the recoverable value of the collaterals. Similarly, the gradual climatic changes could also weaken creditworthiness and collateral values by weakening economic performance. Further, credit risk may rise if a FI has exposure to businesses whose business models do not correspond with the transition to a low-carbon economy since those businesses are more likely to experience declines in profits and business interruptions, which in turn could increase their likelihood of loan defaults. Moreover, the occurrence of physical hazards due to climate change might also result in credit losses given that such physical hazards can damage or destroy the physical capital (housing, inventory, property, equipment, or infrastructure) of households, corporates, and sovereigns, impairing their repayment capacities. Ultimately, both physical and transition climate risk drivers could have a variety of negative repercussions on the financial system, diminishing the value of investments and raising credit risks for lenders and other financial market participants.

#### 4.2 Market risk

Climate risk factors could significantly affect the value of financial assets. Financial markets may become more volatile due to uncertainty associated with the timing, intensity, and location of future severe weather events and other natural disasters. Physical and transition risks, in particular, can alter or reveal new information about future economic conditions or the value of real or financial assets, resulting in adverse price shocks and increased market volatility for traded assets. In addition, climate risks may potentially interrupt asset correlations, lowering the effectiveness of hedges and challenging the ability of FIs to actively manage their risks. However, the likelihood

of unanticipated price movements may be low when climate risk has already been factored into the value of financial assets.

On the other hand, transitioning to a low carbon economy may lead to substantial and sudden repricing of assets (bonds, shares, etc.) due to significant changes in policies, variations in the preferences of economic agents, and technological advancements. Substantial changes in the value of assets may also take place due to changes in consumer, business, and investor expectations for upcoming regulations or technological advancements. Hence, FIs and asset owners might suffer losses as a result of the risk of declines in the value of financial assets. Market risk may also arise as a result of sudden spikes in risk premiums brought on by uncertainty over the future returns on financial assets. Furthermore, the increased frequency of extreme weather events may adversely affect the actual and potential rate of economic growth of climate-vulnerable economies, thus affecting the value of their sovereign debt by raising the cost of borrowing and limiting access to markets.

#### 4.3 Liquidity risk

Climate risk factors may have an immediate influence on the liquidity risk of FIs, either directly through their inability to access contingent funding or liquidate assets or indirectly through increased drawdowns of deposits by customers. Moreover, such factors may affect the capacity of FIs to fund asset growth or fulfill immediate obligations without incurring losses. Further, physical climate risks to the customers may create liquidity pressures on the FIs and crystallize liquidity risks given that customers may withdraw deposits or apply for credit lines to finance the cash flow needed for recovery.

#### 4.4 Operational and reputational risks

Climate risk could affect FIs directly as an operational risk given that business continuity, including branch networks, offices, infrastructure, processes, and people, may be impacted by severe weather conditions. For example, the operations of the FIs may be disturbed if physical hazards affect transportation and telecommunications infrastructure. As a result of climate-sensitive investments and lending, FIs may also face rising legal and regulatory compliance risks. Further, if customers and investors believe that FIs are not sufficiently aligned with the goals of the transition to a low-carbon economy, transition risk may also manifest as a reputational risk.

#### 5. The case for Sri Lankan banks and NBFIs

Sri Lanka is confronting growing environmental and climate challenges as evidenced by frequent natural catastrophes, deforestation and forest degradation, deterioration of coastal and marine ecosystems, climate change and extreme weather, air and water pollution, and loss of biodiversity (CBSL, 2019). Therefore, considering the importance of transitioning into a low carbon, climate resilient, and environmentally sustainable economy, the Central Bank of Sri Lanka (CBSL) launched the Sri Lanka Green Finance Taxonomy on May 06, 2022, fulfilling a key action item outlined in the Roadmap for Sustainable Finance of Sri Lanka introduced by the CBSL in 2019.

Moving a further step ahead, the Monetary Board of the CBSL issued Banking Act Direction No. 05 of 2022 on Sustainable Finance Activities of Licensed Banks, aiming to ensure a sustainable economy and promoting the sustainable finance practices of licensed banks in line with the Sustainable Finance Road Map of the CBSL.

Similarly, in order to establish a governance and risk management framework for sustainable finance activities of License Finance Companies (LFCs), the guidelines on sustainable finance activities for LFCs were issued on November 29, 2022, by the Director of the Department of Supervision of Non-Bank Financial Institutions.

Nevertheless, rather than merely complying with the regulatory requirements, banks and LFCs have a vital role to play in developing green finance policies, Environmental, Social, and Governance (ESG) risk management strategies and methods to increase the resilience of the financial system to climate risks while fostering the transition into a low carbon or net zero economy. At the same time, it is paramount to ensure that climate related financial risks to banks and NBFIs are assessed, tracked, and controlled within the existing standard risk management frameworks.

# 5.1 Integrating climate risk into the existing risk management framework

Sri Lankan's FIs could focus on establishing a strategic approach to managing financial risk from climate change by embedding such risks in the business strategy, overall risk management framework, board-approved risk appetite, committee structures, and all three lines of defense using both quantitative and qualitative measures. Thus, they may identify, assess, monitor, manage, and report on their exposure to such risks in a manner proportionate to their business and include those outcomes in management information and risk reports to the Board of Directors (BOD). Effective climate risk management practices may include:

- Identification of material climate risk drivers together with their transmission channels
- Development of a well-defined quantitative risk appetite statement for climate related financial risks in line with the overall risk management framework and aligning it to the business strategy, business model, and balance sheet of the FI.
- Map and measure climate risks by factoring such risks into stress testing and any other modeling exercises by establishing prudent assumptions and proxies.

# 5.1.1 Enhancing approaches to manage climate risk

Following best practices (PRA, 2019) could guide the Sri Lankan FIs in developing and enhancing approaches to integrate climate risk into a broader risk management regime and associated governance and control structures.

#### a) Governance

Implementing an effective level of climate governance is key to managing climate related financial risks. Thus, a strong BOD and executive oversight on diverse elements of financial risks associated with climate change, including a sufficient long-term perspective on the risks that may occur in time to come, is vital in developing a climate risk management framework. Further, they

7

should address and oversee such risks within the overall business strategy and risk appetite of the financial institution while adopting appropriate policies, procedures, and processes to understand and manage the risk. In addition, appropriate key management personnel should be delegated the responsibility for addressing climate-related financial risks and trained to both understand and manage such risks to ensure the availability of adequate climate capabilities and expertise over time.

#### b) Risk identification and measurement

A comprehensive understanding of the financial risks associated with climate change and how such risks affect the business models of the FIs is of paramount importance in managing such risks. Thus, in order to identify and assess the short-term and longterm financial risks of climate change to their business models, FIs may employ techniques such as scenario analysis and stress testing. For instance, scenario analysis is one of the most sought-after methods to assess the impact of climate related financial risks on the overall risk profile and the business strategy, as well as to understand the vulnerabilities and resilience of the FI's business model to a range of climate related outcomes. At the same time, attention should be drawn to possible ambiguities associated with scenario analysis and addressed through prudent assumptions, sensitivity analysis, or manual adjustment. Moreover, FIs could move a further step ahead by

considering possible future trends in catastrophe modeling in addition to relying on historical data in conducting risk assessments and learning about such possible scenarios from one another.

#### c) Risk monitoring

FIs could adopt a variety of quantitative and qualitative tools and metrics to monitor their exposure to financial risks from climate change. For instance, those could be used to monitor exposures to climate related risk factors, which could arise from changes in the concentration of lending or investment portfolios of FIs or the possible impact of physical risk factors. Further, such metrics and tools should continuously evolve and mature with experience.

#### d) Risk management and mitigation

FIs should possess credible strategies or policies in place for managing potential financial risks from climate change when such risks are deemed material through scenario analysis and divulge how such financial risks will be mitigated. This may include efforts that the FIs are taking to reduce the concentration and impact of such risks. Further, the plans should include the distinctive elements of financial risks posed by climate change, which may differ from other risks.

# e) Risk reporting and management information

The BOD and other subcommittees should be provided with management information on the FI's exposure to climate related financial risks based on the results of scenario analysis or any other assessments, along with the proposed mitigation actions and the time lines for such actions. Further, such management information should be comprehensive enough for the BOD to discuss, assess, and take decisions on the adequacy of FI's management of climate related financial risk.

# 5.1.2 Principles for effective management of climate related financial risks

On June 15, 2022, the Basel Committee on Banking Supervision published 12 principles to guide banks in the effective management of climate related financial risk. Such principles, as best practices, could provide some insights to Sri Lankan FIs in establishing approaches to manage climate-related financial risks. A summary of those principles is stated below.

**Principle 1:** Banks should develop and implement a sound process for understanding and assessing the potential impacts of climate-related risk drivers on their businesses and on the environments in which they operate.

**Principle 2:** The board and senior management should clearly assign climate-related responsibilities to members and/or committees and exercise effective oversight of climate-related financial risks.

**Principle 3:** Banks should adopt appropriate policies, procedures, and controls that are implemented across the entire organization to ensure effective management of climate-related financial risks.

Principle 4: Banks should incorporate climate-

related financial risks into their internal control frameworks across the three lines of defense to ensure sound, comprehensive, and effective identification, measurement, and mitigation of material climate-related financial risks.

**Principle 5:** Banks should identify and quantify climate-related financial risks and incorporate the ones assessed as material over relevant time horizons into their internal capital and liquidity adequacy assessment processes, including their stress testing programs where appropriate.

**Principle 6:** Banks should identify, monitor, and manage all climate-related financial risks that could materially impair their financial condition, including their capital resources and liquidity positions. Banks should ensure that their risk appetite and risk management frameworks consider all material climate-related financial risks to which they are exposed and establish a reliable approach to identifying, measuring, monitoring, and managing those risks.

**Principle 7:** Risk data aggregation capabilities and internal risk reporting practices should account for climate-related financial risks.

**Principle 8:** Banks should understand the impact of climate-related risk drivers on their credit risk profiles and ensure that credit risk management systems and processes consider material climate-related financial risks.

**Principle 9:** Banks should understand the impact of climate-related risk drivers on their market risk positions and ensure that market risk management systems and processes consider material climate-related financial risks.

**Principle 10:** Banks should understand the impact of climate-related risk drivers on their liquidity risk profiles and ensure that liquidity risk management

systems and processes consider material climaterelated financial risks.

**Principle 11**: Banks should understand the impact of climate-related risk drivers on their operational risk and ensure that risk management systems and processes consider material climate-related risks.

**Principle 12:** Where appropriate, banks should make use of scenario analysis to assess the resilience of their business models and strategies to a range of plausible climate-related pathways and determine the impact of climate-related risk drivers on their overall risk profile.

#### 6. Conclusion

In conclusion, climate change imposes material financial risks on FIs and the financial system as a whole. A number of microeconomic and macroeconomic transmission channels translate both physical (acute and chronic) and transition risk drivers into financial risks associated with climate change, which typically manifest as credit, market, liquidity, and operational risks. In other words, FIs are often exposed to financial risks associated with climate change through conventional risk categories, namely credit, liquidity, market, and operational risks.

Even though, physical and transition risks are assessed separately, they are interconnected given that a strong and immediate response to climate change would increase transition risks while reducing physical risks. In contrast, gradual actions to mitigate climate change would increase physical risks without necessarily eliminating transition risks. Therefore, FIs should establish a strategic approach to manage the financial risk from climate change by incorporating such risks into their business strategies, overall risk management frameworks, Board of Directors (BOD) approved risk appetites, committee structures, and all three lines of defense by using both quantitative and qualitative measures. In doing so, the FIs may benchmark the leading best practices while adhering to the regulatory requirements applicable to them.

#### References

Bank of England Prudential Regulatory Authority (PRA), (2019) *Enhancing banks' and insurers' approaches to managing the inancial risks from climate change, Supervisory Statement* | *SS3/19.* London EC2R 6DA: Bank of England.

Basel Committee on Banking Supervision, (2020). *Climaterelated financial fisks: a survey on current initiatives.* Bank for International Settlements.

Basel Committee on Banking Supervision (2021). *Climate related risk drivers and their transmission channels*. Bank for International Settlemet.

Capasso, G., Gianfrate, G., & Spinell, M. (2020). Climate change and credit risk. *Journal of Cleaner Production, Volume 266*.

Central Bank of Sri Lanka (CBSL) (2019). Roadmap for sustainable finance in Sri Lanka.

Central Bank of Sri Lanka (2022). Sri Lanka Green Finance Taxomony.

Ozili, P. K. (2020). Effect of climate change on financial institutions and the financial system. *Finance, Insurance and Risk Management Theory and Practices*.

Roncoroni, A., Battiston, S., & Escob, L. O. (2021). Climate risk and financial stability in the network of banks and investment funds. *Journal of Financial Stability, Volume 54*.

# Who bears responsibility for the Great Financial Crisis? With a special emphasis on the UK bank bailouts

B R M N Mendis Deputy Director Bank Supervision Department

#### Introduction

Great Financial Crisis (GFC), which The overwhelmed the world, was one of the most critical economic downturns reported after the First World War. The crisis was triggered in the subprime mortgage market in the United States (US) in 2007 and subsequently spread across other countries. In September 2007, the United Kingdom (UK) experienced its first bank run resulting queues of depositors outside the branches long of Northern Rock (NR) (Davis, 2010) in which almost one fourth of total subprime mortgages in the UK were held. Securitisation was the prime funding source of NR, hence, the bank struggled to secure its liquidity position once the securitisation market of the UK dried out as a consequence of US subprime market failure.

The UK Government had to intervene in the matter by calling for the first bank bail-out of the UK due to GFC by nationalising NR. Further, the UK Government bailed out several other banks including Royal Bank of Scotland (RBS) and Halifax Bank of Scotland (HBOS), and introduced several liquidity support schemes. According to the statistics provided in the Parliament Committee on Banking Standards (PCBS) Report (2013, pp 82), 'total cash outlay for bank bail-outs during GFC was £133Bn, which equivalents to £2,000

*per person in the UK'*. This sounds how critical the banks bailouts were, since it resulted in the UK taxpayers bearing the losses occurred due to the crisis.

### 2. Causes of GFC

GFC was also called Minsky crisis, since Hyman Minsky, one of the greatest economists, predicted this situation in his idea known as 'Minsky Moment'. He discussed the vulnerability of the financial system due to curse of speculation. According to him, a robust economy can be transformed into a fragile economy as a result of undue speculation and excessive risk taking. The main reason behind GFC was the encouragement of high risk taking on speculative transactions due to ineffective and lenient approach by financial regulators. Then Queen, during a visit to the London School of Economics in November 2008, asked 'why did not anyone see this coming'? The view of most financial advocates was that the crisis was foreseeable, hence could have been avoided but disregarded.

Along with the deregulation of financial markets in 1980, the attention of banks shifted towards the wealth maximisation of shareholders from safeguarding the depositors' interest (Mullineux, 2011). As explained by Mullineux, banks' strategies, therefore, focused on closing down of loss making or low profitable branches and taking excessive risks. Banks started to rely on wholesale deposits than retail, which led to a drastic increase in bank's leverage and low level of liquid assets. This exposed banks to significant risk, since banks did not have any self-insurance to meet unexpected liquidity requirements. Hence, GFC was a result of significant failures in risk management mechanisms and corporate governance frameworks of banks, speculative trading, rapid but imprudent growth, etc. While some attributed the crisis to a liquidity problem, the true issue was the inaccurate assessment of banks' insolvency.

# **3.** Parties to bear responsibility of bank bailouts during GFC

The following can be identified as the parties to bear the responsibility for bank bailouts during GFC

## **3.1 Banks and other Financial Institutions** (FI)

- a) Complex financial products and poor decision making
  - The mortgages funded by one bank had then been sold as packages to investment banks, which created a huge market for mortgage securitisation. The investment banks reconverted such portfolios into other forms of financial instruments to hedge the risk. This resulted in the financial products used by banks and other FIs to get more complex.
- This practice created a considerable link amongst FIs, which resulted in a negative impact of one party's activities to bring a

subsequent effect on another (a contagion effect). This led to the consequences of the collapse of subprime market to cause a series of financial problems in other FIs.

• Further, as a result of banks' decisions to speculate with securitisation due to the greediness, banks lacked liquid assets. Thus, they suffered a liquidity problem, as there was no adequate liquidity to fund their business.

Therefore, these complex products and imprudent decisions of banks led the entire economy to suffer, requiring the support of the Governments to rescue them by way of bailouts.

b) Lapses in risk management, corporate governance and remuneration structure

Significant lapses in the bank's risk management systems and controls, governance structures, policies and procedures, management oversight, remuneration structures, etc. were identified during GFC. Therefore, the Board of Directors (BOD) of failed banks cannot escape from the allegation of negligence. The role of non-executive directors (NED) was highly criticised due to their inadequate oversight over bank's executives in taking excessive risks. The most of executives and NED was wrong selection due to their incompetency and inadequate skills and knowledge. Few evidence from the literature on GFC are as follows:

- Lehman Brother's Board included individuals with limited financial expertise and experience in the banking sector. Some members were criticized for not fully understanding the complex financial products and risks that led to Lehman's downfall (Financial Crisis Inquiry Commission, 2011).
- Fred Goodwin, the CEO of RBS at the time, faced criticism for his aggressive expansion

12

strategy and risk-taking. **The Board, including NED**, was accused of failing to challenge Goodwin's decisions and lacked the necessary expertise to assess the risks accurately (Martin, 2013).

• The Board of NR was criticized for not understanding the risks associated with their business model, which heavily relied on shortterm funding and securitization of mortgages. The NEDs were accused of not having the necessary expertise to oversee the risks effectively (Bruni & Llewellyn, 2009).

Though some banks had separate risk management committees, such committees failed to provide appropriate recommendations and guidance to the senior management in managing risks. According to Davis (2010), the *'inability and unwillingness of BOD'* to develop, measure, and mitigate banks risks have been identified as a key factor that led banks to a severe financial crisis.

The other main criticism on banks was their compensation structures. Chief executives and traders of banks were compensated based on short-term performance. This led them to focus more on high risky transactions, which generate high returns within a short period. This resulted in banks increasing their leverage and risk exposures. As a result, when the crisis hit, all such profits were converted into losses. By this time, all chief executives and traders had already drawn down their financial rewards, leaving shareholders and taxpayers of the economy to battle with the consequences. No such rewards were recalled or asked to payback after the crisis.

#### c) Moral Hazard

Moral hazard of banks regarding 'the lender of last resort' made the crisis worsened. Banks conducted their business based on poor decision making and taking high risks endangering banks into a disaster. Banks knew that they would be safeguarded from any failure, because of the consequences that it can create in the economy. A study carriedout by Kim (2013, pp 1) on bank bailouts and moral hazard, also has identified that 'a bank with a higher bailout belief takes more risks, especially when it is very close to bankruptcy'.

d) Interconnectedness and complex structures

The other reason for making banks responsible for bailouts is their complex structures and interconnectedness with other FIs in different countries. Hence, a failure of a bank in one country would have brought a negative impact on a bank in another country due to the contagion effect. Thus, although the banking activities were fraudulent, undue and imprudent, Governments had to bail-out such banks to avoid impact on their own economy as well as other economies.

#### 3.2 Regulatory authorities

There was poor coordination between three regulators of the UK namely the Treasury, the Bank of England (BOE) and the Financial Service Authority (the former regulatory structure of the UK is given at Annex B). This was mainly due to the fundamental differences between the roles of these parties. This exposed the entire financial system to greater risk because of the different views taken by three authorities during the crisis (Davis, 2010).

According to the report on 'The Run of the Rock', there were considerable lapses and failures of this tripartite system. The Report also criticises the duty of the Treasury, which failed to demonstrate appropriate authority over the other two parties. Such Report also shows the ineffectiveness of BOE oversight over the financial system subsequent to the reforms in 1997. In another report on bank supervision, it was identified that BOE lacked *'institutional specific information'* and the *'closer*  *understanding*' of the day-to-day activities of financial markets.

Further, the Report on 'The Run of The Rock' recognises the failure of regulatory bodies to require banks to hold adequate liquidity to safeguard themselves in a midst of a financial problem (Hauser, 2010). The Figure 1 below illustrates the change in the level of liquidity assets holding by British banks during last few decades.

Figure 1

have adequate supervision and proper assessment of the solvency of banks. This was attributed to disastrous policies and procedures in bank lending and other related activities and widened the space for banks to carry out more unethical and fraudulent activities.

#### **3.3 Auditors**

The auditing firms, who conducted audits of failed banks were identified as another main party



As shown above, it was an alarming situation for banks to equip themselves with adequate buffer against liquidity shocks. This clearly proves the lack of importance given by both regulators and banks to maintain adequate liquidity within banks.

Moreover, the main aim of the regulators pre-crisis was to encourage banks to rely on self-supervision and self-regulation. The key reason behind this was the provision of *'aid andabet'* by Government regulators (Davis, 2010), through deregulation and de-supervision. The undue influence from lobby groups and politicians had also resulted in them being lenient. As such, regulatory bodies failed to responsible for GFC. This was mainly due to their clear audit opinions on the soundness of the financial condition just before the collapsed of banks, e.g., auditors of Lehman Brothers issued an unqualified opinion about the bank's quarterly accounts in July 2008 and the bank filed for bankruptcy within two months (Davis, 2010). This raised fundamental concerns over the auditors' role, since their failure in alarming before the storm.

Most of the riskiest activities of banks had been recorded as off-balance sheet exposure to avoid reporting losses and hide real risks. The auditors also failed to raise their voice in this regard as well as on the high leverage position of banks. This resulted in raising concern over the independence and effectiveness of auditors. Further, another UK authority through a memorandum to the UK's Treasury Select Committee, had blamed auditors due to their failure in showing appropriate professional judgement (Davis, 2010). It further challenged that auditors should have made their due attention towards the default risk of borrowers and the imprudent processes and procedures followed by banks. These failures were attributed to restricting the ability in early recognition of risks and providing remedial measures to control the situation.

#### 3.4 Credit rating agencies (CRA)

The principal activity of CRAs is to provide organisations with ratings for debt obligations, which reflects creditworthiness of such organisations. The ratings bring considerable effect on the price of debts. The main business of CRA was related to corporate bonds for many years. However, with the rise of securitisation market. it created a huge profitable business for CRAs to issue ratings for asset-backed securities. The CRAs benefited largely from this business compared with its business for corporate bonds. Securitisation portfolios, which coupled with monoline insurance, were highly rated (Davis, 2010). As a consequence, banks started to provide monoline insurances for all asset-backed portfolios irrespective of the default risk of underline securities. This resulted in an increase in 'AAA' rated securities in the market.

Furthermore, CRAs also provided advisory service for banks on how to structure asset-backed securities to obtain a high rating. They provided this service at a very high fee. This also raised the fundamental concern over the independence of credit rating agencies in providing ratings. Along with the house price bubble, the value of securitisation portfolio started to plunge increasing the default rate of underline securities. This led the CRAs' activities to be greatly criticised.

#### 3.5 Accountants and accounting standards

Bank regulations and accounting standards are developed under two different perspectives. Bank regulations are to safeguard depositors' interest and financial system from a systemic failure, encourage prudential risk management practices and good governance frameworks, etc. However, accounting standards have been set to reflect true and fair view of financial position of organisations and ensure provision of timely, reliable and adequate information to stakeholders on the performance of an organisation. Therefore, there is a considerable difference between the objectives of these two parties.

The fundamental distinction between these two parties exploited during GFC, especially when the subprime mortgage market collapsed. According to the accounting standards, banks were required to record securitisation portfolio at the market value. This happened during an era when banks were experiencing huge liquidity problems. This led to significant objections in the financial market against accounting standards, with critics arguing that they caused banks to waste excessive capital (Davis, 2010). One of the former senior officials of Federal Deposit Insurance Corporation claimed that the fair value rules 'have destroyed hundred billions of dollars of capital in the financial system'. Hence, huge losses arose from the fair valuing of assets deteriorated banks capital. The experts in the financial market challenged fair value rules, blaming that it converted the liquidity problem into a solvency problem. This dragged banks to face severe solvency problems.

#### 3.6 Media

The UK media was also highly criticized for not raising the alarm about the emerging financial distress. Unlike regulators, the media has no restrictions on voicing concerns. However, they failed to alert the authorities at the right time to wake the authorities. Politicians mainly pointed their fingers at the media saying that they avoided the duty as the regulators did. The justification provided by the media was that they failed to understand the structures and complex financial products of banks. Though journalists tried to convince their helplessness, they could have kept eyes and ears opened on the activities of banks, as those started to grow dramatically by taking high risks and leverage. They knew the conflict between the regulatory bodies, saw unethical and undue practices conducted by banks, were aware of banks' unethical compensation structures, etc.

#### 3.7 Subprime Borrowers

Although the borrowers were misled by the mortgage brokers, they exposed themselves and banks to a huge risk through their undue borrowings. Borrowers, who had been granted subprime mortgage loans, were regarded not creditworthy (Davis, 2010). Most of such loans (Ninja loans), were distributed to people with 'no income, no assets and no jobs'. There was no income stream for such borrowers to repay their loans. They borrowed more and more by re-mortgaging the same property to pay defaulted payments. This resulted in obtaining loans exceeding the value of their properties. This was mainly due to the failure in demonstrating financial discipline in borrowing. Such behaviour led to banks giving them more loans and having the same property in several securitised portfolios.

### 4. Conclusion

Financial deregulation smoothed the path for banks to grow rapidly to become larger and larger. Such

rapid growth coupled with moral hazard problem led banks to have relaxed liquidity positions along with high leverage, speculation, and complex products, etc. The understanding of these concerns by banks and regulators was limited, hence banks deviated significantly from policies and procedures, provided poor oversight, failed remarkably in risk management practices, etc. These made banks highly vulnerable to financial distress and with weaker financial conditions. These were resultant in bringing new rules like Volcker Rule by the US, to safeguard banks by being a pray of investment banking and other speculative transactions.

It is also accepted the fact that regulators did not influence enough not only in conducting their supervisory and regulatory role but also in strengthening the liquidity requirements, capital adequacy, etc. However, this is not only because of the regulatory failure but also the support received by banks from the Government and lobby groups, who insisted self-regulating and self-supervising. In addition to this auditors, CRAs, media, accountants andborrowers were also responsible for GFC, hence for the bank bailouts.

Accordingly, GFCended up leaving a big lesson for all these parties. However, such lesson was learnt at the cost of taxpayers', who had to bear the cost of bank bailouts. Therefore, it should be borne in mind that activities of financial markets, especially banks, can create a huge risk to Governments and taxpayers than the risks that Governments can ever create to such markets.

#### 5. References

 Black, J., (2010), Managing the financial crisis

 the constitutional dimension: Law Society and Economy working papers, 12/2012, London School of Economics and Political Science.

- Bruni, F., & Llewellyn, D. T., (2009), The Failure of Northern Rock: A Multi-Dimensional Case Study. SUERF – The European Money and Finance Forum.
- Culpeper, P.D., & Runke, R., (2014), Structural power and bank bail-outs in the United Kingdom and the United States, Politics and Society, Volume 42(4): Sage Publications, pp 427-457.
- Davis, H., (2010), The Financial Crisis: Who is to Blame?: Polity Press
- Financial Crisis Inquiry Commission, (2011), The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States. Retrieved from https:// fcic-static.law.stanford.edu/cdn\_media/fcicreports/fcic\_final\_report\_full.pdf
- Hauser, A., (2010), Lender of last report operations during the financial crisis: seven practical lessons from the United Kingdom; BIS Paper No. 79, pp 81-92.
- House of Commons Treasury Committee, (2008), The run on the rock, Fifth report of session 2007-08, Volume I, report together with formal minutes.
- House of Commons Treasury Committee, (2008), The run on the rock, Fifth report of session 2007-08, Volume I, Oral and written evidence.
- House of Commons Treasury Committee, (2009), Banking crisis: dealing with the failure of the UK banks, Seventh report of the session 2008-09, Report together with formal minutes.
- Kim, Y., (2013), Bank bail-outs & Moral Hazard? Evidence from bank's investment

and Financing decisions: William E. Simon Graduate school of Business, University of Rochester.

- Martin, I., (2013), Making it Happen: Fred Goodwin, RBS and the Men Who Blew Up the British Economy. Simon & Schuster UK.
- Morrison, A.D., (2011), Systemic risks and the 'too big to fail' problem: Oxford Review of Economic Policy, Volume 27, 03.11.2011, pp 498-516.
- Mullineux, A., (2011), Briefing Paper: public duties and social responsibilities of British Banks: Centre on Household Assets and Savings Management.
- Nao.org.uk (2016), Available on https://www. nao.org.uk/highlights/taxpayer-support-foruk-banks-faqs/, [Accessed on 22.02.2016].
- Parliamentary Commission on Banking Standards (2013), Changing banking for good, first report of session 2013/14, Volume I, Summary, and conclusions, and recommendations.
- Parliamentary Commission on Banking Standards (2013), Changing banking for good, Volume II, Chapters 1 to 11 and Annexes together with formal minutes.
- Wray, L.R., (2012), Global Financial Crisis: A Minskyan Interpretation of the Causes, the Fed's Bail-out, and the Future: Working Paper No. 711, Levy Economics Institute of Bard College.
- Telegraph.co.uk (2016), Available on http:// www.telegraph.co.uk/finance/newsbysector/ banksandfinance/4285063/Bail- out-Britainsbanks-A-timeline.html, [Accessed on 22.02.2016].

# Common Rating Errors in Employee Performance Evaluation

H B S Deshapriya, Senior Assistant Director, Human Resources Department

#### 1. Introduction

The employee Performance Evaluation (PE) is a much broader and a complicated function related to Human Resources (HR) management, as it is a process to Plan, Manage, Appraise and Monitor the employee output. It needs continuous monitoring and proper feedback to make the PE objectively. PE integrates the management practices, including the review of employee performance and performance standards to meet the set organizational objectives & Key Results.

#### 2. Background

Sridevi et al (2010) stated that the employee PE is a crucial aspect of organizational management, providing a basis for rewards, promotions, and developmental feedback. However, the process is often plagued by various rating errors, which compromise its effectiveness and fairness. This paper aims to explore the common rating errors encountered in PE methods, examining their underlying causes and proposing strategies to mitigate their impact. By addressing these errors, organizations can enhance the accuracy and reliability of their performance appraisal systems, leading to improved employee satisfaction and organizational effectiveness.

# **3.** Objectives of Employee Performance Evaluation.

The primary objective of PE in organizations is to enhance employee performance. This objective can be accomplished through three key mechanisms:

- i. The information provided by the PE can be used for administrative decisions linking the evaluated performance to organizational rewards or punishments such as a salary increment, promotion, or discharge.
- ii. The PE process involves providing performance feedback (i.e., information regarding the level of performance) to the employees who were evaluated, allowing them to adjust their performance strategies to match the desired performance, and
- iii. The PE is a process that raises employee awareness to the fact that they are being measured.

Accordingly, employee PE serves as a fundamental tool for assessing individual contributions, providing feedback, and facilitating organizational decision-making. However, the accuracy and fairness of performance ratings are frequently compromised by various biases and errors inherent in the evaluation process. These rating errors not only distort the perception of employees' actual performance but also undermine the credibility and effectiveness of the entire appraisal system. This paper examines the common rating errors encountered in PE methods, elucidates their underlying mechanisms, and suggests practical strategies to mitigate their adverse effects.

### 4. Different types of Performance Evaluations

With the evolution of Human Resource Management subject, many procedures/methodologies/practices have been adopted and introduced for the PE Process over the past decades. These processes typically involve assessing employees' performance and furnishing them with feedback concerning the standard and caliber of their work.

#### 4.1 Ranking Method

This method involves ranking employees based on their performance relative to each other. While simple in theory, it becomes challenging in practice to directly compare individual traits across employees. Moreover, in group settings, accurately assigning individual rankings becomes even more complex.

#### 4.2 Forced Distribution Method

In this method raters allocate different percentage to different categories of employees. For example, 15%: Exceptional Performer, 20%: Very Good Performers, 30%: Average Performers, 20%: Satisfactory Performers, 15 %: Poor Performers. The positive thing with this method is that the rater's subjectivity has been removed. In recent times, it has been observed that the biasness is becoming a big issue and such issue is eliminated in this method to a great extent but grading creates the problem. The employees, who consider themselves more capable and productive against the grades assigned to them, feel demotivated and reluctant to work later.



#### **4.3 Critical Incident Techniques**

In this method, each employee is evaluated on the basis of some critical incidents, recorded in documents by the manager. The manager maintains a logbook detailing both positive and negative incidents for each employee. During performance appraisals, these records are reviewed and discussed. However, it's worth noting that the outcome is influenced by the rater's perception, which may introduce subjectivity into the evaluation process.

#### 4.4 Checklists

In this method, some statements are described. Each statement carries a value attached to it. Different weights are given against the statements. A checklist is made for each job and values attached with it. It is a widely used method to appraise the performance, but it is more expensive and also having a higher subjectivity issue.

#### 4.5 Management by Objectives

This method involves a collaborative effort between a superior and a subordinate to achieve shared goals. The manager and employee collaborate to establish goals aligned with their targets. They identify Key Result Areas (KRAs) and define performance standards in terms of quality, time, and productivity. Departmental heads and top management contribute to the formulation of departmental work plans within this framework. Head of Department then communicates the departmental goals with employees of concerned department. Head of Department see the gap between observed performance and desired performance. Department conduct appraisal interview and give feedback to overall performance. Management by objectives aligns and links organizational and

individual goals. It can easily be applied. It boosts high morale, confidence and measures the results other than personality factors. It is complex and time-consuming process as well. Not only this, it is expensive and lengthy process also.

#### 4.6 Assessment Centers

A crucial component of an assessment center is performance evaluations. Through various exercises, simulations, and observations, individuals are comprehensively assessed on their competencies, skills, and behaviors relevant to their roles and organizational objectives.

#### 4.7 Behaviorally Anchored Rating Scale

Performance is assessed using a rating scale that incorporates specific behaviors. Human resource professionals evaluate efficiency or inefficiency in these behaviors, rating critical incidents on a scale. Behav ioral Anchored Rating Scales (BARS) are employed for each dimension, aligning performance assessment with job standards. While BARS accurately measure performance, their preparation can be time-consuming, requiring different scales for various job roles.

#### 4.8 360 Degree Appraisal

360-degree appraisal is a multiple rating approach. Multiple ratings provide more reliable information. It is an approach where multiple feedback is taken, however, it is very time consuming and expensive. Various issues are involved in this approach and there is a risk of confidentiality as well. Earlier the organizations used to take reports from a single source which was not reliable as personal bias would arise while appraising an employee's performance. According to 360 degree, the employee's information is gathered by various sources which are presented given below:

- i. Manager
- ii. Peer
- iii. Self-Appraisal
- iv. Customers
- v. Team Appraisal

### 5. Common Rating Errors of Performance Evaluation

PE should ideally uphold complete accuracy and objectivity. However, in practice, the PE process often falls short of this standard, leading to potential rating errors. These errors, if not addressed, can markedly impact the fairness and precision of performance assessments. Several common rating errors may arise during the appraisal of an employee's performance. Below are some of the prevalent sources of these errors:

#### **5.1. Common Rating Errors**

#### 5.1.1. Halo Effect:

The halo effect is indeed one of the most common errors in performance appraisals. It occurs when a particular quality or trait of an employee influences the overall evaluation, overshadowing other aspects of their performance. For example, if an employee is soft-spoken, they may be rated higher on performance and productivity solely based on this trait, leading to potential injustice for other employees.

Another example is when an employee consistently meets or exceeds sales targets. Their manager may be inclined to rate them highly across the board, without thoroughly assessing their performance in other areas. This bias can cloud the judgment of the evaluator and result in inflated ratings that do not accurately reflect the employee's overall performance. Recognizing and mitigating the halo effect is essential for ensuring fair and objective performance evaluations.

#### 5.1.2. Horn Effect:

The horn effect is indeed a common error in performance appraisals. It occurs when one negative trait or aspect of an employee's behavior influences the overall evaluation, overshadowing their actual performance. For example, if an employee is hard-spoken, their performance and productivity may be rated low despite demonstrating superior performance in their tasks.

It's important that evaluations are based on objective performance metrics rather than behavioral aspects alone. Focusing solely on negative traits can unfairly penalize employees and lead to inaccurate assessments of their contributions to the organization. Therefore, it's crucial for evaluators to recognize and mitigate the horn effect by ensuring that ratings are based on a comprehensive and fair assessment of an employee's actual performance.

#### 5.1.3. Central Tendency:

The central tendency error occurs when evaluators consistently rate all employees as average, regardless of their actual performance. This reluctance to assign ratings at the extremes of the scale can result in unduly conservative evaluations that fail to recognize exceptional performance or address poor performance adequately.

For instance, if an employee demonstrates excellent performance, but the evaluator hesitates to assign the corresponding excellent rating and instead gives them an average rating, it reflects the central tendency error. Similarly, if an employee's performance is consistently poor, but they receive an average rating instead of a poor rating, it also indicates the central tendency error.

This error can undermine the effectiveness of performance evaluations by failing to differentiate between high and low performers, thus hindering opportunities for recognition, improvement, and appropriate feedback.

#### 5.1.4. Strict Rating:

The strict rating error occurs when evaluators consistently assign lower ratings than warranted by an employee's actual performance. Instead of recognizing and rewarding excellent performance, these raters tend to give average or even poor ratings, regardless of the employee's achievements.

For example, if an employee consistently demonstrates excellent performance, but the evaluator assigns them an average rating due to strictness or rigidity in their evaluation criteria, it reflects the strict rating error. Similarly, if an employee's performance meets the criteria for an average rating, but the evaluator assigns them a poor rating due to excessively high standards, it also indicates this error.

Strict rating can have detrimental effects on employee morale, motivation, and retention. Employees who consistently receive lower ratings than they deserve may become demotivated and disengaged, leading to decreased productivity and job satisfaction. Therefore, it's important for evaluators to remain objective and fair when assigning ratings, ensuring that they accurately reflect the employee's actual performance.

### 5.1.5. Lenient Rating:

Some Raters are naturally generous. This error is the opposite of a strict rating. Lenient rating error

### 5.1.6. Status Effect:

The "Status Effect" error in performance assessment refers to the tendency for a rater's perception of an individual's status or position within an organization to influence their evaluation of that individual's performance. This bias can lead to inflated ratings for individuals perceived to have higher status or authority, regardless of their actual performance. Conversely, individuals with lower status may receive lower ratings, even if their performance merits higher scores.

This error can undermine the fairness and accuracy of performance evaluations, as it introduces subjective judgments based on factors unrelated to job performance. It can also perpetuate inequalities within the organization by favoring individuals with higher status and disadvantaging those with lower status, regardless of their actual contributions or capabilities.

### 5.1.7. Spill Over Effect:

The spillover effect in performance appraisal occurs when past appraisal ratings influence or "spillover" into subsequent ratings, even when they should be evaluated independently. As example, the employee's past poor performance leads the rater to rate them as average despite their recent excellent performance. This effect can occur due to various reasons, such as the rater's reluctance to change their perception of the employee, biases towards consistency, or a belief that past performance is indicative of future performance.

22

#### 5.1.8. Attribution Errors:

Attribution is the process by which individuals make assumptions about the reasons or motives behind someone else's specific actions or behaviors. Attribution errors occur when these assumptions are based on subjective conclusions rather than objective evidence.

In a performance review, for example, an attribution error might occur if an employee provides a negative response to a question, and the appraiser immediately assumes that the employee has a negative attitude towards their work. This assumption is made without considering other possible factors that could have influenced the employee's response, such as external circumstances or misunderstandings.

#### 5.1.9. Initial Impression:

When an initial positive impression of a person influences the perception of their overall performance or character, leading to an overestimation of their qualities or abilities across the board. Conversely, if the initial impression is negative, it can lead to an underestimation of the individual's performance or abilities.

#### 5.1.10. Recency Effect:

The Recency Effect occurs when a rater's assessment of an individual's performance is heavily influenced by the most recent behaviors or events, rather than considering their performance over a more extended period. As an example, the employee is rated as excellent for the yearly assessment primarily because of their outstanding performance in the last month, overlooking their performance throughout the entire year.

#### 5.1.11. Contrast Error:

The "Contrast Error" in PE occurs when an individual's performance is assessed not based on absolute standards or criteria, but rather in comparison to the performance of others. This error can manifest in two primary ways.

- 1. Positive Contrast Error: This occurs when an individual's performance appears better than it actually is because it is compared to the performance of others who are performing poorly. For example, an employee might receive a higher performance rating simply because they outperform their underperforming colleagues, even if their performance objectively does not meet the required standards.
- 2. Negative Contrast Error: Conversely, negative contrast error happens when an individual's performance seems worse than it actually is because it is compared to the performance of others who are excelling. In this case, an employee might receive a lower rating because they are compared to high-performing colleagues, even if their performance is satisfactory or even above average

#### 5.1.12. Sympathy Effect:

The "Sympathy Effect" in PE occurs when a rater's judgment of an individual's performance is influenced by feelings of sympathy or empathy rather than objective assessment of their actual performance. This can lead to inflated ratings or evaluations for individuals who may be experiencing personal hardships or difficulties, regardless of their actual job performance.

#### 6. Causes of Rating Errors

#### **6.1. Rater Characteristics**

Individual differences in rater perceptions, attitudes, and cognitive biases significantly contribute to rating errors. Factors such as rater's personality traits, prior experiences, and personal biases can influence the evaluation process and lead to inconsistencies in ratings.

#### 6.2. Lack of Training

Insufficient training and guidance on PE techniques can exacerbate rating errors among raters. Without proper instruction on objective rating criteria, rater calibration, and bias reduction strategies, individuals may rely on subjective judgments and intuition, thereby increasing the likelihood of errors.

#### **6.3. Organizational Culture**

Organizational culture and climate play a pivotal role in shaping PE practices and influencing rating errors. Cultures that prioritize competition, favoritism, or fear of reprisal may inadvertently encourage biased evaluations and hinder the effectiveness of performance appraisal systems.

#### 7. Recommendations & Conclusion

### 7.1.Recommendations for minimizing the Common Rating Errors

#### 7.1.1. Rater Training and Development

Providing comprehensive training programs on PE techniques, rater calibration, and bias mitigation strategies can enhance rater competence and reduce rating errors. Ongoing development initiatives, including feedback sessions and peer discussions,

can further refine raters' assessment skills and promote consistency in evaluations.

#### 7.1.2. Standardized Rating Scales

Implementing standardized rating scales and clear performance criteria can minimize subjectivity and ensure consistency in evaluations. By establishing objective benchmarks for performance assessment, organizations can mitigate the impact of biases and enhance the reliability and validity of the appraisal process.

#### 7.1.3. Multiple Rater Evaluation

Incorporating multiple raters or perspectives in the evaluation process can mitigate individual biases and increase the reliability of performance ratings. Utilizing peer assessments, self-evaluations, and upward feedback mechanisms can provide a more comprehensive and balanced view of employees' performance.

#### 7.1.4. Regular Monitoring and Feedback

Regular monitoring of the PE process, coupled with timely feedback to raters, can identify and address rating errors promptly. By promoting transparency, accountability, and open communication, organizations can foster a culture of fairness and continuous improvement in PE practices.

#### 7.2. Conclusion

In conclusion, writer believes that the rating errors pose significant challenges to the accuracy and fairness of employee PE methods. By understanding the underlying causes of these errors and implementing appropriate mitigation strategies, organizations can enhance the reliability, validity, and effectiveness of their performance appraisal systems. Ongoing training, standardized rating scales, multiple rater evaluations, and regular monitoring, organizations can mitigate biases, promote fairness, can ensure that performance evaluations serve their intended purpose of facilitating employee development and organizational success.

#### **References:**

- i. Cassandra Williams, March 29, 2023
   Employee Performance Evaluation: Definition, Benefits and How To Prepare
- ii. Elaine D. Pulakos Performance Management

- iii. Performance Evaluation Definition, Method, Survey and Example (questionpro. com)
- iv. A Study of Performance Appraisal System in Indian Banking Sector (researchgate.net)
- v. Markos, S., & Sridevi, M. S. (2010). Employee engagement: The key to improving performance. International journal of business and management, 5(12), 89.
- vi. Fred C. Lunenburg Performance Appraisal: Methods and Rating Errors

Breaking Barriers, Building Bridges: Navigating the Maze of Global Economic Fragmentation



Dr. V. D. Wickramarachchi Deputy Director Economic Research Department

#### Introduction

Trade has played a pivotal role in shaping the wellbeing of the people ever since human civilisation started sprouting in different corners of the earth. Over the centuries, with the advancement of science and technology, great strides made in transport infrastructure, and enhanced productivity through competition led to extraordinary expansion of trade throughout the world, improving the living standards of the populace. On the other hand, global factor markets continued to flourish, especially cross border capital mobility which drastically improved over the post-World War II decades. All these suggest that the world was heading towards greater economic integration throughout recorded history, a process that has morphed into what we call globalisation today. However, the recent trend demonstrated by nations in introducing alarmingly high constraints on cross border trade, led by geopolitical concerns rather than economic intuition, is worrisome. Exacerbating the fragmentation of the global economy, the world is witnessing a rise of competing blocs, with each bloc trying to win the rest of the world based on strategic interests and shared values. In view of the widespread implications of this phenomenon on many facets of policymaking, this article aims to provide a brief account of the background of the issue and a perspective of how best the extreme repercussions of global economic fragmentation be managed.

#### **Global** gains

Globalisation refers to the building of linkages among the world's economies, cultures, and populations that lead to integration and interdependence through international trade, investment, technology transfers, migration, and flow of information. The last few decades have been a thriving era of globalisation in which many people across the world were able to escape poverty, hunger, and early death due to the transmission of a plethora of benefits of global economic integration that led to improved well-being. The debate on the pros and cons of global economic integration has also intensified over the years and continues to nourish the dialogue on globalisation in economic and policy circles. Generally, it is believed that Globalization uplifts the well-being of people by fostering economic interdependence among nations in a plethora of forms. The linkages created through globalisation cause increased efficiency in global resource allocation by promoting specialisation by nations in producing goods and services in which they enjoy a comparative advantage. Moreover, globalisation spurs technological advancements and innovation by way of cross border dissemination of knowledge and ideas, thereby driving growth and shared prosperity. However, Figure 1 shows the steady growth of trade during the latter half of the 20<sup>th</sup> Century which continued into the first decade of the next century, only to experience a deceleration subsequently.

#### **Faltering Cooperation**

Nevertheless, in the last few years, especially during the post pandemic era, the world economy has been demonstrating increased segregation into interconnected blocs, a phenomenon termed as the global economic fragmentation (GEF). GEF is characterised by increasing barriers to trade and investment driven by protectionism and selfinterest, which in its extreme form would cause countries to enter into a modern day economic cold war by breaking into rival economic blocs, risking a reversal in the transformative gains from globalisation over the decades. For example, the number of restrictions imposed worldwide annually on trade in goods and services and investment has increased exponentially over the last four years (Figure 2). Intriguingly, the cost of global economic fragmentation is alarmingly high. The IMF estimates the impact of fragmentation on global economic output to be as much as 7 per cent over the long term or about \$7.4 trillion in current US dollars, similar to the size of German and French economies combined and three times sub-Saharan Africa's annual output. To sum up, the



#### Figure 1: Trade Openness (Sum of exports and imports, percent of GDP) 1870-2021

Source: IMF (2023)

decades of rewards of globalisation are under the threat of reversal.

Recent evidence suggests that policymakers are increasingly wary of preserving economic sovereignty amidst concerns over contemporary global geopolitical developments. The economic impacts of the war in Ukraine, the situation in be cautious of sharing technology across borders, even with their overseas subsidiaries. Accordingly, the governments will increasingly be concerned about looming threats that would undermine economic sovereignty.

Also, the impending anti-integration bias has given rise to a new wave of pro-protectionist and anti-





Source: IMF (2023)

the Red Sea, and the Palestine-Israel conflict and their global spillover effects have reiterated that peacetime economic dividends cannot be taken for granted and for too long. Also, GEF could take different forms ranging from 'nearshoring' at the firm level and regional trade affiliations at the national level to the formation of geopolitical blocs with discriminatory access to friendly economies. For example, at the national level, concerns over national security would urge the policymakers to be more cautious about labour migration and supply chain connectivity through the provision of access to ports for cross border trade. In addition, corporates will be wary of possible infringements of intellectual property rights and copyrights and

globalisation lobbying. Despite the broad-based improvement in well-being and productivity improvements across the world, economic globalisation is blamed for increased inequality, acceleration in climate change, and exploitation of resources. The job losses and shutting down of domestic firms in the wake of increased competition from foreign firms, causing increased international inequality, have been attributed to increased foreign ownership in domestic firms. In case the looming anti-globalisation sentiments foster protectionism in economic policies, countries will tend to be cautious of national interests over the benefits of globalisation. Interestingly, the risks of anti-globalisation sentiments dominating policy thinking might be worryingly high, as national elections are to be held in around 70 countries in the world in 2024.

Moreover, the impact of GEF extends to other forms of cross border linkages, characterised by disrupted capital flows, technological decoupling, and restrictions on migration. It is pertinent to note that even though the global flows of goods and capital have levelled off since the global financial crisis, the new trends in globlisation suggest a reversal of this phenomenon. Also, the disruption to capital flows, especially to foreign direct investments, will be detrimental, not only due to lower capital flows but also owing to the hindrance to the diffusion of other spillover benefits such as financial deepening and technological diffusion. geopolitical alignments increasingly Also, influence both foreign direct investment and portfolio flows. The impact of changing dynamics in global Foreign Direct Investment (FDI) flows could be disproportionate, with Emerging Market and Developing Economies (EMDEs) identified to have been more vulnerable to FDI relocation as the FDI inflows to such economies originate predominantly from economies which are distant from their geopolitical alignment. It has also been highlighted that relocation risks are widespread across the EMDEs irrespective of the size or how advanced the economy is while EMDEs with reduced access to Advanced Economies are particularly affected, through reduced productivity gains and lower capital formation (Ahn 2023). Accordingly, the host economies would experience a plethora of negative effects such as lower capital accumulation, slower technology deepening, lower productivity improvements due to reduced competition from foreign firms, and lower demand in downstream sectors.

#### **Neighbourly Nexus**

GEF may affect the global economy on many fronts but despite how costly the phenomenon is to the global economy, it is not without its benefits in some contexts. The rise of deindustrialisation, that is falling share of manufacturing in the advanced economies in the past few decades, is often blamed on offshoring, which however fostered greater integration. However, a more recent trend in offshoring is nearshoring, that is, a domestic firm opts to work with a supplier that's located in a nearby country. Unlike offshoring, which involves working with distant and often overseas suppliers, nearshoring allows companies to leverage on geographical proximity to gain economic advantages. In addition to improved communication and collaboration and enhanced efficiency, there are many supply chain advantages of nearshoring, such as flexibility and agility in operations, improved risk mitigation, sustainability and lower environmental impact due to shorter transport distance, and faster lead times. Economic incentives of such supply chain advantages will drive the deindustrialisation and regionalisation further leading to greater disintegration of regions from the global economy (Lábaj and Majzlíková 2023). Another phenomenon that has emerged recently is 'friendshoring', that is, locating businesses among the members of a bloc, due to ongoing international political and trade tensions. Accordingly, despite short term benefits it might bring in in some contexts, in the long run the overall loss of welfare to the world economy from GEF will be inevitable.

#### **Central Banking in Geopolitical Uncertainty**

Prevalence of a favourable geopolitical environment since the end of the Cold War fostered

29

greater global integration witnessed by improved flows of trade through ever-expanding global value chains and a resurgence in global labour markets. Accordingly, despite the increased risk of transmission of global shocks to the domestic economy, global supply became more elastic to changes in domestic demand through improved trade, leading to a long period of relatively low and stable inflation (Forroni and Mojon, 2017). As a result, the central bankers could focus more on inflation driven by domestic aggregate demand conditions rather than global supply side developments. However, the rise of fragmentation would have far-reaching implications on the global supply side conditions and thereby on Central Banking. A recent study has revealed that the increase in the global level of consumer prices due to the fragmentation of global value chains along geopolitical concerns could range between around 5% in the short run and roughly 1% in the long run (Attinasi et al 2023). In addition, as repeated supply shocks could be expected going forward, compared to longer periods of more elastic global supply that prevailed, there is a risk of de-anchoring inflation expectations.

On the international reserve currency front, the changing trade patterns may reflect in the composition of international reserves where nontraditional reserve currencies such as the Indian rupee or Chinese renminbi may gain prominence. Also, the rise in efforts by Central Banks of countries with considerable regional trade footprints to promote the use of their currencies in cross border transactions could drive this trend further. In addition, these new arrangements would provide countries, which were restricted from trade due to geopolitical concerns or sanctions, with opportunities to reduce their dependency on Westled currency frameworks and payment systems. On the financial stability front, GEF may intensify cross border risks, due to uneven capital flows and possible contagion effects while opening doors to regulatory arbitrage. This would call for the central bankers to collaborate with international regulatory bodies to ensure oversight while remaining increasingly vigilant on the spillover of systemic risks.

Moreover, Fiscal and structural policies also have a role in mitigating risks to stability emanating from GEF. Supply-side pressures originating from the changing geopolitical landscape could be addressed, for example, through policies aimed at energy diversification, investment in new supply chains, and by encouraging firms to secure resilient supply chains, leading to lower volatility and thereby lower inflation. However, any attempt on the fiscal front to replenish increased costs through income support, over and above a targeted response to unexpected, transitory and large shocks, would not only lead to inflationary pressures but will hamper fiscal space to take more effective measures (Lagarde 2023). Accordingly, policymakers would have to be wary of these interlinkages and be aware of far-reaching policy implications when they formulate complementary policy action.

#### The Need for Building New Bridges

The world is becoming more shock-prone due to challenges posed on a multitude of fronts, including climate change, and geopolitical uncertainties. The COVID-19 pandemic has taught the world how unprecedented economic shocks can cripple economic activity while intensifying the deeprooted vulnerabilities. On the other hand, despite the strong initial promise for shaping future growth, emerging disruptive technologies such as artificial intelligence could also carry significant risks unless employed for economically beneficial purposes. Meanwhile, from the point of view of emerging market economies, including Sri Lanka, the GEF could hamper the efforts aimed at a complete recovery from the implications of COVID-19 while posing further challenges on the stability front. Currently, most of the emerging market economies are in the process of building buffers, such as foreign reserves, while the pressures from debt distress are yet to dissipate. If GEF is to continue, the reserve build-up of such countries would be affected due to the resulting decelerated progress in recovery in global trade, while the weakening debt sustainability would exacerbate the vulnerabilities.

The economic repercussions of GEF would soon become quite visible across the world, necessitating immediate corrective action. The inaction as well as delayed action could both be equally detrimental, given the slower than expected recovery in the world economy since the COVID-19 pandemic and the widely prevalent vulnerabilities. In this regard, multilateral organisations such as the IMF, the World Bank, and the World Trade Organization will have a pivotal role to play while the involvement of the United Nations will be crucial for securing the political commitment of world leaders for collaborative action to avoid the implications of GEF. They need to further strengthen the global integration that has been in place since World War II while nurturing the bonds of trust among nations. Moreover, it is an opportune time for multilateral agencies to work out a collective plan to revamp the global financial safety nets which support countries with heightened vulnerabilities driven by GEF. Also, despite intensified lobbying during a politically vulnerable era, policymakers need to withstand the pressure from protectionist groups which advocate returning to inward looking policy regimes as a solution, while keeping up with the

momentum of outward oriented reforms. From a broader global policy perspective, GEF invariably necessitates greater policy cohesion among nations, by recognising the interdependence between policies without compromising independence.

#### **Implications for Sri Lanka**

While GEF presents both challenges and opportunities, Sri Lanka would have to harness its strengths, especially of being located in a strategic location and a global growth hotspot, to tap the benefits and mitigate the risks, The strategic location of Sri Lanka in the Indian Ocean makes it a geopolitical focal point in the tussles of global superpowers, especially the two regional powers, China and India. Sri Lanka has been part of various initiatives of regional and global powers to expand their strategic sphere of geopolitical influence, such as the Belt and Road Initiative of China. Accordingly, despite the global trend towards further fragmentation, Sri Lanka would have to carefully navigate its foreign and international economic policies to avoid the unwarranted repercussions of being aligned towards any global superpower. Going forward, the policies would have to be geared towards building capacity to mitigate the impact of global economic shocks, diversifying exports in terms of both products and destinations, and improving trade related infrastructure and logistics, while forming strategic relationships with global superpowers and major reading partners. Strengthening regional cooperation further through frameworks such as South Asian Association for Regional Cooperation (SAARC) and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) would be beneficial. Notably, having entered into Free Trade Agreements (FTA) with some of the important trading partners, Sri Lanka has a few more FTAs

31

under discussion, including an Economic and Technology Cooperation Agreement (ETCA) with India. By proactively taking measures, Sri Lanka would be able to mitigate potential negative repercussions, while leveraging new opportunities emerging from a fragmented global economic landscape.

#### Conclusion

The decades-long rapid globalization and cross border integration are decelerating and the forces of protectionism are on the rise. The onus of multilateralism, that is attaining global shared prosperity by leveraging the advantages of cross border economic integration needs to be upheld. The early signs of fragmentation are already proving detrimental to the welfare of the global economy. More than any of its predecessors, this generation of humans has gone through enough hardships to be convinced that global issues necessitate global solutions. Accordingly, rather than disintegration, there needs to be an international approach to restore dissipating interlinkages with a view to accelerate economic recovery through collective efforts that lead to greater resilience and equality. With many new risks emerging from GEF on the stability front, their monetary policy implications need to be addressed with a complementary fiscal approach. Greater multilateralism is an absolute necessity in navigating the new challenges that are emanating from GEF. A collective rather than individual approach to take on the challenges in a more shock-prone global economy is the current exigency.

#### References

Ahn, J., Carton, B., Habib, A., Malacrino, D., Muir, D., & Presbitero, A. (2023). Geoeconomic fragmentation and foreign direct investment. *IMF World Economic Outlook: A Rocky Recovery*.

Attinasi, M.-G., Boeckelmann, L. and Meunier, B. (2023), "Friend-shoring global value chains: a model-based assessment", *Economic Bulletin*, ECB, Issue 2.

Bolhuis, M. A., Chen, J., & Kett, B. (2023). The costs of geoeconomic fragmentation. *FINANCE & DEVELOPMENT. International Monetary Fund, Washington DC.* 

Ferroni, F., & Mojon, B. (2017). Domestic and global drivers of inflation in the euro area. *ECB Economic Bulletin*, (4), 72-96.

Garcia-Saltos, T. G., Ilyina, A., Kangur, A., Kunaratskul, T., Rodriguez, S., Ruta, M., & Trevino, J. P. (2023). Geoeconomic Fragmentation and the Future of Multilateralism. Staff Discussion Note, International Monetary Fund, Washington DC.

Goldberg, P. K., & Reed, T. (2023). Growing Threats to Global Trade. *FINANCE & DEVELOPMENT*. International Monetary Fund, Washington DC.

Lagarde, C. (2023). Central banks in a fragmenting world. Speech at the Council on Foreign Relations' C. Peter McColough Series on International Economics. New York, 17 April 2023.

Lábaj, M., & Majzlíková, E. (2023). How nearshoring reshapes global deindustrialization, Economics Letters, Volume 230, 111239

The International Monetary Fund (2023): IMF Blog: The High Cost of Global Economic Fragmentation, Washington DC