GLOBAL AND ECONOMIC RECESSION: IMPACT ON BANKING SECTOR IN INDIA

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Abstract

During 2008 the global financial crisis and economic downturn increased uncertainty and negatively affected the world wide economy. The sharp decrease in export volumes during the latter half of 2008 and the first quarters of 2009 has already had a major impact on industry. This is also evident from the financial forecast which, despite noting signs of stabilization in the economy, indicates that the indirect impact of the financial crisis may cause significant risks to the economy and inflation. When the financial crisis erupted in a comprehensive manner on Wall Street, there was some premature triumphalism among Indian policymakers and media persons. It was argued that India would be relatively immune to this crisis, because of the "strong fundamentals" of the economy and the supposedly well-regulated banking system.

One of the key features of the current financial turmoil has been the lack of perceived contagion being felt by banking systems, particularly in Asia. The Indian banking system also has not experienced any contagion, similar to its peers in the rest of Asia. A detailed study undertaken by the RBI in September 2007 on the impact of the subprime episode on the Indian banks had revealed that none of the Indian banks or the foreign banks, with whom the discussions had been held, had any direct exposure to the sub-prime markets in the USA or other markets. However, a few Indian banks had invested in the collateralised debt obligations (CDOs) / bonds which had a few underlying entities with sub-prime exposures. Thus, no direct impact on account of direct exposure to the sub-prime market was in evidence.

Keywords:
Global financial meltdown, Bankruptcy, Mortgage-backed securities, Basel II Framework, Subprime turmoil.

Introduction

Over the past decade, India has emerged as one of the fastest-growing economies on the globe. The rest of the world has been impressed to see that the reforms initiated in the early 1990s are bearing fruit. To sustain any country's growth, of course, a strong and dynamic financial sector is essential. In recent years, financial markets have undergone some of the most rapid and extensive changes perhaps foremost among recent changes in world financial markets have been their accelerating integration and globalisation. This development, which has been fostered by the liberalization of markets, rapid technological progress and major advances in telecommunications, has created new investment awareness and financing opportunities for business and people around the world. The banking system is, by far, the most dominant segment of the financial sector.

Adopting common financial reporting should be a major step towards improving the efficiency of international financial markets. It will reduce barriers to both trade and the flow of capital. Investors will have access to more reliable financial data to assess corporate performance in many jurisdictions. Audit firms will be better able to assure the quality of audits among national partner firms. Financial sector supervisors and regulators will benefit from the greater consistency and quality of information. Ultimately, the adoption of such common standards will lead to increased opportunities for global investment, and will boost employment and growth globally.

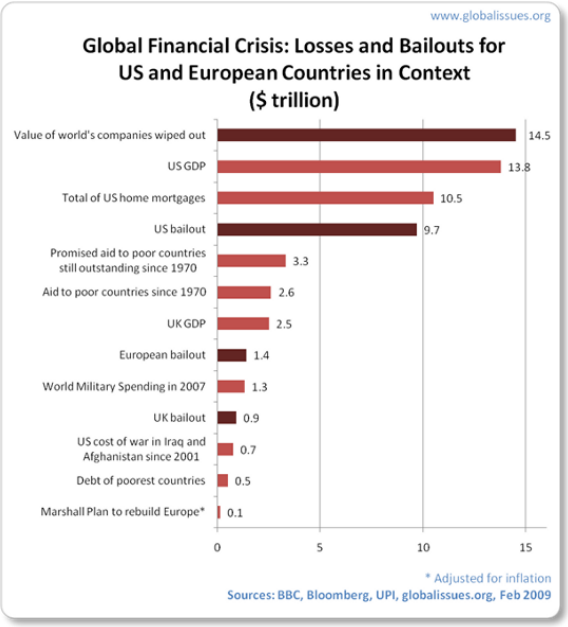
Banking Sector in India

In a country like India, where the sheer volume of people, the expanse of regions and the diversity of languages exists, this new medium of learning holds immense promise. The banking industry is a vertical segment, where timely adoption of technology plays a critical role in deciding the leader and the laggard. With an employee base from different streams of education and walks of life, it becomes imperative to enhance the awareness and transfer of technology in an easy and efficient manner. If we look at the traditional way of imparting education in this industry, the role of the staff training colleges and similar academic institutions has been vital and significant. While these have largely met our requirements, the changing face of technology being used in our operations necessitates the need to reflect these changes in our human capital on par. The need to transform into a learning organization is more apparent in today's dynamic environment.

Paradigm shift in the banking and financial environment of the country has created an emergent need for a new genre of management professionals to meet the emerging challenges in managing Banks, Financial Institutions (FIs), Non-banking Financial Companies (NBFCs) and Corporates. The intense competitive pressure on the financial system has generated a variety of products and services to meet the specialized needs of millions of customers. The impact of these changes in the international financial system was felt in India in the early nineties when she initiated the process of integrating her economy with the global economic order. This ushered in the phase of financial sector reform in our country. Reforms, which are primarily aimed at aligning the Indian banking system to the international best practices, are having lasting effects on the entire fabric of the Indian financial system, which is presently undergoing a major phase of metamorphosis.

Global Financial Crisis- A Special Story

The "Global Financial Crisis" of 2008, also called as global financial meltdown, global financial turmoil mainly resulted from the subprime mortgage crisis of 2007. Subprime lending crisis, which began in the United States has become a financial contagion and has led to a restriction on the availability of credit in world financial markets. Hundreds of thousands of borrowers have been forced to default and several major subprime lenders have filed for bankruptcy.



Initially the companies affected were those directly involved in home construction and mortgage lending such as Northern Rock and Countrywide Financial. Financial institutions which had engaged in the securitization of mortgages such as Bear Stearns then fell prey. On July 11, 2008, the largest mortgage lender in the US collapsed. IndyMac Bank's assets were seized by federal regulators after the mortgage lender succumbed.

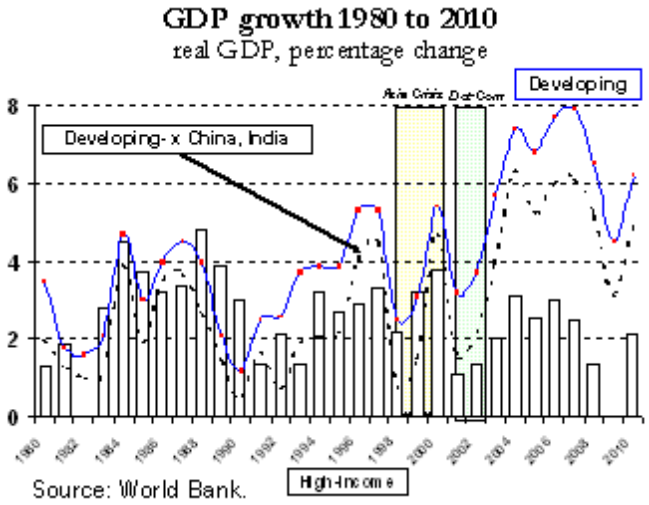
Thereafter, US government saved mortgage lenders Fannie Mae and Freddie Mac, by placing the two companies into federal conservatorship on September 7, 2008. It then began to affect the general availability of credit to non-housing related businesses and to larger financial institutions not directly connected with mortgage lending. Exposure to these mortgage-backed securities, or to the credit derivatives used to insure them against failure, threatened an increasing number of major FIs. Beginning with bankruptcy of Lehman Brothers on Sunday, September 14, 2008, the financial crisis entered an acute phase marked by failures of prominent American and European banks and efforts by the American and European governments to rescue distressed financial institutions.

Impact of the Global Financial Crisis on Developing Countries

(a) Revised Global Outlook

The world economic outlook has worsened dramatically. The intensification of the financial crisis in the United States and its rapid spread since the middle of September to both other high-income and developing countries has changed growth projections dramatically. Growth in developing-countries, whose economies had been expected to expand by 6.4 percent in 2009, has been marked down to 4.5 percent and the economies of high-income countries, many of which have already entered into recession, are now expected to contract by 0.1 percent in 2009. Growth rates are projected to recover in 2010, although there is considerable uncertainty and much will depend on the policy responses in developed and developing countries. Global trade, which grew by 9.8% in 2006, is projected to fall in 2009 for the first time since 1982.

Virtually no country, developing or developed, has escaped the impact of the widening crisis, although countries that entered the crisis with stronger fundamentals and less integration into the global economy have generally been less affected. The deterioration in financing conditions has been most severe for countries with large current account deficits, and for those that showed signs of overheating and unsustainably rapid credit growth prior to the intensification of the financial crisis. Of the 20 developing countries whose economies have reacted most sharply to the deterioration in conditions (as measured by exchange rate depreciation, increase in spreads, equity market declines and large current account deficits), seven come from Europe and Central Asia, and eight from Latin America.



The poorest countries, including many in Africa, will be significantly affected by the crisis even though the channels of transmission are likely quite different from those operating in emerging markets. Financial sectors in Low-Income Countries are less integrated into global financial markets. As a result, the direct impact of the crisis is likely to be more limited. Nevertheless, the poorest countries will be harmed through slower export growth, reduced remittances, and lower commodity prices (which will reduce incomes in commodity exporters). The crisis may also lead to a reduction in private investment flows, making weak economies

even less able to cope with internal vulnerabilities and development needs. In this environment, meeting global commitments to provide development assistance to the poorest countries becomes paramount.

(b) Policy Response in Developed Countries Business.

After some hesitation, the financial sector policy response has become increasingly robust. Governments and central banks are stepping in forcefully to guarantee debt, promote interbank liquidity and recapitalize stressed but healthy banks where necessary. Although these efforts have eased credit conditions somewhat, credit flows remain weak and commercial banks wary of lending to one another. At 200 basis points, the interbank interest rate spread, while down from recent highs, remains well above pre-crisis levels of around 30 basis points. Stock markets throughout the world remain highly volatile after experiencing large losses, and are recording massive day-to-day changes in valuations.

India and the Global Financial Crisis

When the financial crisis erupted in a comprehensive manner on Wall Street, there was some premature triumphalism among Indian policymakers and media persons. It was argued that India would be relatively immune to this crisis, because of the "strong fundamentals" of the economy and the supposedly well-regulated banking system. This argument was emphasized by the Finance Minister and others even when other developing countries in Asia clearly experienced significant negative impact, through transmission of stock market turbulence and domestic credit stringency.

These effects have been most marked among those developing countries where the foreign ownership of banks is already well advanced, and when US-style financial sectors with the merging of banking and investment functions have been created. If India is not in the same position, it is not to the credit of our policymakers, who had in fact wanted to go along the same route. Indeed, for some time now there have been complaints that these "necessary" reforms which would "modernise" the financial sector have been held up because of opposition from the Left parties.

But even though we are slightly better protected from financial meltdown, largely because of the still large role of the nationalised banks and other controls on domestic finance, there is certainly little room for complacency. The recent crash in the Sensex is not simply an indicator of the impact of international contagion. There have been warning signals and signs of fragility in Indian finance for some time now, and these are likely to be compounded by trends in the real economy.

Economic Downturn

After a long spell of growth, the Indian economy is experiencing a downturn. Industrial growth is faltering, inflation remains at double-digit levels, the current account deficit is widening, foreign exchange reserves are depleting and the rupee is depreciating. The last two features can also be directly related to the current international crisis. The most immediate effect of that crisis on India has been an outflow of foreign institutional investment from the equity market. Foreign institutional investors, who need to retrench assets in order to cover losses in their home

countries and are seeking havens of safety in an uncertain environment, have become major sellers in Indian markets.

In 2007-08, net FII inflows into India amounted to $20.3 billion. As compared with this, they pulled out $11.1 billion during the first nine-and-a-half months of calendar year 2008, of which $8.3 billion occurred over the first six-and-a-half months of financial year 2008-09 (April 1 to October 16). This has had two effects: in the stock market and in the currency market.

Exposure of Banks

So far the RBI has claimed that the exposure of Indian banks to assets impaired by the financial crisis is small. According to reports, the RBI had estimated that as a result of exposure to collateralised debt obligations and credit default swaps, the combined mark-to-market losses of Indian banks at the end of July was around $450 million. Given the aggressive strategies adopted by the private sector banks, the MTM losses incurred by public sector banks were estimated at $90 million, while that for private banks was around $360 million. As yet these losses are on paper, but the RBI believes that even if they are to be provided for, these banks are well capitalised and can easily take the hit.

Such assurances have neither reduced fears of those exposed to these banks or to investors holding shares in these banks. These fears are compounded by those of the minority in metropolitan areas dealing with foreign banks that have expanded their presence in India, whose global exposure to toxic assets must be substantial. What is disconcerting is the limited information available on the risks to which depositors and investors are subject. Only time will tell how significant this factor will be in making India vulnerable to the global crisis.

A third indirect fallout of the global crisis and its ripples in India is in the form of the losses sustained by non-bank financial institutions (especially mutual funds) and corporates, as a result of their exposure to domestic stock and currency markets. Such losses are expected to be large, as signalled by the decision of the RBI to allow banks to provide loans to mutual funds against certificates of deposit (CDs) or buyback their own CDs before maturity. These losses are bound to render some institutions fragile, with implications that would become clear only in the coming months.

Global Financial Crisis and Indian Banking Sector

Indian banking sector too is better placed to cope with the adverse consequences of the ongoing financial turmoil in the west. First of all, our banking industry is subject to stricter prudential regulations with respect to capital and liquidity.

For instance, while restricting the overnight unsecured market for funds to banks and primary dealers, the RBI has imposed limits on their borrowing and lending operations in the overnight inter-bank call money market. In order to encourage greater reliance on stable sources of funding, the RBI has imposed prudential limits on banks' purchased inter-bank liabilities and these limits are linked to their net worth. Also, the incremental credit-deposit ratio of the banking industry is continuously monitored by the RBI. The ALM guidelines in India take into account both on and off balance sheet items. In order to strengthen capital requirements, the credit conversions factors, risk weights and provisioning requirements for specific off-balance sheet items (including derivatives) have been reviewed in the last few years. Moreover, in India, complex structures like synthetic securitization have not been permitted so far.

The Indian banks with overseas presence and foreign banks operating in India have successfully migrated to Basel II Framework by March 2008 and all other scheduled commercial banks are encouraged to migrate to Basel II not later than March 2009. Indian banking industry is quite healthy. As much as 34.0% of its deposits are in government securities and cash with the RBI. Its "Consumer Loans to GDP" ratio is just 10.0%, whereas this ratio is as high as 100.0% for the U.S.

As per information with the RBI, Indian banks do not have any direct exposure to sub-prime mortgages. The banking sector, through its overseas branches, has some exposure to distressed financial instruments and troubled financial institutions. But this exposure is part of the normal course of their business and is quite small relative to the size of their overall business.

As stated earlier, what Indian markets have been witnessing today is an indirect, knock-on effect of the global financial situation. This is only a reflection of the uncertainty and anxiety in the global financial markets. However, Indian policymakers have responded to these untoward circumstances extremely swiftly. To re-establish orderly conditions in the money, equity and forex markets and to improve the overall liquidity in the system, the RBI has cut the CRR to 6.5% from the earlier 9.0% in less than two weeks this month. To help mutual funds, as a temporary measure, the RBI has allowed banks to avail of additional liquidity support of up to 0.5% of their net demand and time deposits. This is in addition to the ad hoc reduction in the statutory liquidity ratio to 24%. The central bank has also allowed banks to raise interest rates on NRI deposits so that more money would flow to India. The policymakers have come out with a plan to raise the capital adequacy ratio of Indian banks to 12.0% by a suitable date in future. Even at present, no Indian bank has a capital adequacy of less than 10.0%. The limit on FII investment in corporate bonds has also been doubled. In short, India's government as well its central bank has been promptly responding to global developments so as to ensure financial stability through active and flexible liquidity management.

Conclusions and Recommendations

The financial crash of 2007-2008 was the result of the interaction of several different factors, some of which had been building for many years. While market corrections and crashes are nothing new, indeed they are an inherent part of the capitalist system, it behoves governments, regulators and market participants to take the appropriate steps in response to ensure that the impact of the next correction is minimised. It is not universally agreed that one result of the financial crisis has been to generate a paradigm shift in the way the banking business model is structured. However there is no doubt that banks will need to modify their strategies and structures in response to the events of 2007-2008.

In the first instance, banks and regulators, recognising that a business cycle is an inherent part of the economic system, need to implement "counter-cyclical" capital and supervision regimes. In other words, capital should be built up during a bull market to, when it is easier to raise, to cover for the impact of a bear market. One approach here would be to raise "contingent capital", for example debt that can be converted to equity when required. A trigger could be when the equity value falls to a specified point. Regulators must also stress supervisory oversight even during a bull market, when it tends to be relaxed.

Banks must look to running a strategy that is sustainable over the business cycle. This will mean lower return on capital targets, which shareholders will need to accept. A long-run average of 10%-12% is more realistic than the recent 18%-22% that was targeted by the large banks.

India has by-and-large been spared of global financial contagion due to the sub prime turmoil for a variety of reasons. India's growth process has been largely domestic demand driven and its reliance on foreign savings has remained around 1.5 per cent in recent period. It also has a very comfortable level of forex reserves. The credit derivatives market is in an embryonic stage; the originate-to-distribute model in India is not comparable to the ones prevailing in advanced markets; there are restrictions on investments by residents in such products issued abroad; and regulatory guidelines on securitization do not permit immediate profit recognition. Financial stability in India has been achieved through perseverance of prudential policies which prevent institutions from excessive risk taking, and financial markets from becoming extremely volatile and turbulent.

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