

## IMPACT OF GLOBAL FINANCIAL CRISIS ON INDIAN BANKING SECTOR

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### ABSTRACT

The Sub prime Crisis which surfaced around August 2007 had affected Financial Institutions in the United States and Europe. The collapse of the Lehman Brothers in mid September 2008 had aggravated the situation. Being a part of the global financial system Indian Banking sector cannot remain isolated from the rest of the world, but India escaped direct impact of the global recession because the banks in India were not exposed to toxic agents, that affected the disease elsewhere in the world. The Indian Banks were well placed to weather the impact of global financial crisis. The present study intends to put forth such optimism by studying the impact of global financial crisis on Indian Banking Sector, and suggested to be more transparent, to implement proactive risk management strategy, best corporate governance practices and a shift from capital adequacy to efficient capital management and to adopt process innovative to review their performances on on-going basis to be more resilient to future crises.

### Introduction

The 2008 year has created chaos particularly in the world of financial markets because of the present global financial crisis. Financial crisis refers to the occurrence of series of calamitous events that result in sudden loss of value in an asset class leading to the incurrence of monetary loss to individuals, firms, corporate and the government. It creates a panic kind of a situation, by leaving a trail of destruction of investors' wealth, and may lead to prolonged economic recession. If the financial crisis has international implications it is called 'global financial crisis'. The origin of the current global financial crisis was traced back in mid 2007.

Sub prime crisis that surfaced around August 2007 had affected financial Institutions in the United States(US) and Europe. Sub prime crisis refers to the credit status of the borrower, which is being less than ideal. Sub prime lending refers to the practice of making loans to borrowers who do not qualify for the best market interest rate because of their deficient credit history that includes payment delinquencies and possibly more severe problems such as charge-offs, judgments and bankruptcies, borrower with incomplete credit histories. It is also called B-Paper, near prime or second chance lending. A subprime loan may be offered at a rate higher than A-paper loan due to high risk involved in it.

The collapse of the Lehmann Brothers in mid September 2008 had aggravated the situation, leading to a crisis of confidence in the financial markets. It became prominent to the entire world with the failure of large financial institutions in US mainly due indiscriminate lending, flawed credit rating mechanism, complex innovative products, liquidity risk, securitization and appalling corporate governance.

In US and Europe the housing market collapsed first and then dragged down banking system.

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They together have dragged down the real economy. But in India, it is the real economy that got impacted first on account of exports, discouraging inflow of funds Foreign Institutions Institutions (FIIs) ( FIIs pulled out \$11 billions from Indian equity market), drying up of overseas finance from many firms. Hence the Indian Banks were affected indirectly by the slowing down of the economy.

The direct impact of the crisis on the Indian Banking system was insignificant because Indian banks do not have big exposure to the sub prime market, our unique approach to the issue of banking ownership and regulation, our reliance on home grown solutions, and sticking to the prudential banking norms, regular flow of information sharing arrangement among the strong regulators, unflawed credit rating agencies, role played by the RBI governors in implementing right policies at right rimes have made our banking system more resilience to the present global financial crisis.

The meltdown in US has not created any credit crunch in India, but the credit crunch in the US led to panic in India (V.V.L.N.Sastry). Mr.C.Rangarajan, (Chairman of Economic Advisory Council to the Prime Minister) said that India escaped from direct impact of recession because its banks were not exposed to "toxic assets" that affected the disease elsewhere in the world. In fact, the country did not have recession. It only had slowdown in growth due to decline in production.

A study by Brand Finance PLC in association with the Bankers Magazine published from Britain, revealed that the twelve Public sector namely Punjab national Bank, Bank of India, Canara Bank, Bank of Baroda, Union Bank of India, Indian overseas Bank, Indian Bank, Oriental Bank of Commerce, Syndicate Bank, and State Bank of Hyderabad, State Bank of Patiyala, State Bank of Bikaner & Jaipur found place out of 19 Indian banks found place in the top 500 global financial brands of 2009 year. This number is tripled against the six Indian banks which found place in the list in the year 2007. Indian banks do not have any direct exposure to sub-prime mortgages. Though its overseas branches has some exposure to distressed financial instruments and trapped financial institutions. (Dr.Subba Rao, RBI Governor, Times of India, October 12, 2008).

Hence it can be noted clearly that the Indian Banks are well placed to weather the impact of global financial crisis. There are good reasons for such optimism. The present study intends to study such reasons.

The Major objectives of the present study are:

- To study the impact of financial crisis on Indian banking sector.
- To identify the lessons for resilient banking system on crisis prevention management and recommendations in the light of the present crisis.

### **Methodology :**

The data have been collected from secondary source comprising RBI Bulletin, IBA Bulletin, Statistical tables, Annual reports of RBI, for the period from 2004-05 to 2008-09. The collected data has been classified and analysed in a systematic manner. For analysis various statistical tools like percentages and comparative analysis were employed. The parameters like Spread, Capital Adequacy Ratio, Non-performing Assets, Housing Loans, and Off-Balance Sheet Items were taken to study the objectives of the present study. Indian Commercial Banks comprising Scheduled Commercial Banks, Public sector Banks, Private Sector Banks, Private Sector Banks, and Foreign Banks were taken to study the impact of global financial crisis on Indian Banking Sector.

The year 2008 has been of turbulence in the world of finance. The collapse of the Lehman

Brothers in mid September 2008 had aggravated the situation leading to a crisis of confidence in the financial markets. The situation slowly spreaded among the countries of the world like a contagion, because of the consequence of greater integration of nations.

The effect of the financial crisis on the Indian economy was not significant in the beginning. Slowly and slowly India also felt the heat of the financial meltdown by discouraging inflow from FII to India in 2008, by softening of the earnings of software companies and with double digit inflation, crashing down of stock markets to a record low level and overall high rate of interest in our economy. But the effect seems to be not affected the Indian Banking sector. The Indian Banking sector is well placed to weather the impact of global financial crisis. There are good reasons for such optimism.

Spread is the difference between Interest Income and Interest Expanded. Table- I shows the spread as a percentage of assets during the study period from 2004-05 to 2008-09. The spread as a percentage of total assets which was around 2.58%, 2.35%, and 2.40% in 2006-07, 2007-08, and 2008-09 was lower than the spread around 2.83%, and 2.81% in the year 2004-05, 2005-06, In Scheduled Commercial Banks. The same trend more or less can be seen in Public and Private sector banks, where as we can see a continuous increase of spread as percentage of assets in foreign banks. The percentage of around 2.4% in the present situation is quite appreciable more over the volume growth in credit today may offset any decline in spread during this period. Besides, banks have learnt to boost revenue though non-interest income also.

Table-1

#### SCHEDULED COMMERCIAL BANKS SPREAD AS PERCENTAGE OF ASSETS

Name of the Bank	2004-05	2005-06	2006-07	2007-08	2008-09
Scheduled Commercial Banks	2.83	2.81	2.58	2.35	2.4
Public Sector Banks	2.91	2.85	2.55	2.15	2.1
Private Sector Banks	2.34	2.40	2.24	2.41	2.7
Foreign Banks	3.34	3.58	3.76	3.79	3.9

Source: Report on Trend and Progress of Banking in India 2004-05 to 2008-09.

#### Capital adequacy ratio

Basel II adopted a broad bush approach of requiring banks to maintain 8 % of loan as capital requirement because of the tough stance taken by the RBI. In India the Central Bank kept Capital Adequacy norms well above the levels prescribed by Basel II. As per this requirements banks in India have to maintain a capital adequacy ratio of 9 % as against 8% Basel II norms. From the above table it is crystal clear that the CRAR of all the banks though decreased from 2004-05 to 2005-06 thereafter increased from 2005-06 to 2008-09 except in Public Sector Banks. It is indeed gratifying to see from the Table-2 that the CRAR of scheduled commercial has gone up by 0.73% points over the previous year from 12.28%. By and large CRAR of all the banks are more than 3% than required norm of 9%. Private sector banks and foreign banks are better than their Public Sector banks in terms of CRAR. From the above it clearly indicates that Indian Banks have enough internal strength to weather out the

crisis. Now It is the time for the Indian banks to shift from Capital adequacy to efficient capital Management and Balance Sheet Management for proper utilization of the capital. The banks in India, are not involved in risky business as was prevalent elsewhere in the world. This may be because of sticking to the basic banking business which has safeguarded Indian banks from falling prey to the credit crisis.

Table-2

**CAPITAL ADEQUACY OF SCHEDULED COMMERCIAL BANKS**

Name of the Bank	2004-05	2005-06	2006-07	2007-08	2008-09
Scheduled Commercial Banks	12.80	12.32	12.28	13.01	13.2
Public Sector Banks	12.90	12.17	12.36	12.51	12.3
Private Sector Banks	12.50	11.69	12.08	14.08	14.3
Foreign Banks	14.00	13.02	12.39	13.08	15.1

Source: Report on Trend and Progress of Banking in India 2004-05 to 2008-09.

**Non-performing Assets**

Gross NPAs and NET NPAs of Commercial banks were consistently came down by 1.22% in Scheduled Commercial banks from 2004-05 to 2008-09, decreased by 1.53% in Public Sector Banks from 2.73% to 1.2% decreased by 0.75% in Private Sector Banks from 2.05% to 1.3% during 2004-05 to 2008-09 but where as in the Foreign Banks Gross NPAs to Total Advances decreased by 0.61% during 2004-05 to 2007-08 and there after increased by 0.72% over the year from 2007-08 to 2008-09, and an increase by 0.07% from 2004-05 to 2008-09. But the overall position of Indian Banks except public sector banks in reducing NPAs is appreciable even during these times of global recession.

Table-3

**GROSS NONPERFORMING ASSETS TO TOTAL ADVANCES**

Name of the Bank	2004-05	2005-06	2006-07	2007-08	2008-09
Scheduled Commercial Banks	2.52	1.83	1.46	1.30	1.3
Public Sector Banks	2.73	2.05	1.60	1.34	1.2
Private Sector Banks	2.05	1.37	1.24	1.38	1.3
Foreign Banks	1.43	0.97	0.82	0.78	1.5

Source: Report on Trend and Progress of Banking in India 2004-05 to 2008-09.

The position of Net NPAs to Total advances were also decreased by 0.32%, 0.35%, 0.28% from the years 2004-05 to 2008-09, in Scheduled Commercial Banks, Public sector Banks and Private Sector Banks. Whereas in Foreign Banks the Net NPAs to Total Advances increased by 0.28% during the above period it may be due to increase in gross NPAs in this sector.

Table-4

**NET NONPERFORMING ASSETS TO TOTAL ADVANCES**

Name of the Bank	2004-05	2005-06	2006-07	2007-08	2008-09
Scheduled Commercial Banks	0.92	0.67	0.58	0.57	0.6
Public Sector Banks	0.95	0.72	0.62	0.59	0.6
Private Sector Banks	0.98	0.55	0.54	0.60	0.7
Foreign Banks	0.42	0.41	0.34	0.34	0.7

Source: Report on Trend and Progress of Banking in India 2004-05 to 2008-09.

Table-5

**DEPLOYMENT OF CREDIT BY SCHEDULED COMMERCIAL BANKS TO HOUSING LOANS.**

(Rs. In Crores)

Year	2004-05	2005-06	2006-07	2007-08	2008-09
House Loans in	85346,45 (9.70%)	12679763 (11.00%)	18216718 (12.03%)	22892335 (11.78%)	2484397 (10.28%)
Total Credit	88031203 (100%)	115246793 (100%)	151384213 (100%)	194709962 (100%)	241700152 (100%)

Source: Report on Trend and Progress of Banking in India 2004-05 to 2008-09.

Table-5 shows the deployment of credit by the scheduled commercial banks to housing loans for the period from 2004-05 to 2008-09. The housing loans are around 9.70%, 11.00%, 12.3%, 10.28% of the total Gross Credit during the years from 2004-09. It can be noticed that though the Housing loans percentage to Total credit increased by 2.33% from 2004-05 to 2006-07, thereafter decreased by 1.75% from 2006-07 to 2008-09. Even if 20% of the housing loans go bad as in case of US Sub prime Market, the maximum impact would be a rise in NPAs ratio to total Assets. The Indian Commercial banks with an average capital adequacy ratio of 14%, banks are well placed to withstand an increase of NPAs of this order.

**Off Balance sheet Assets(OBS)**

These are the obligations that are contingent liabilities of a bank which do not appear on its

balance sheets. In general these items include direct credit substitutes in which a bank substitutes its own credit for a third party including stand by letters of credit, irrecoverable letters of credit that guarantees repayment of commercial papers of tax exempt securities, risk participations in bankers acceptance, sale and repurchase agreements and assets also with recourse against the seller, interest rate swaps, interest rate options and currency options and so on.

Table-6 shows the Off-balancesheet items in Indian Banking system and figures in brackets indicate their percentage to total liabilities. The Ratio of OBS exposure to Total Liabilities increased from 120.25% to 333.47% during the year from 2004-05 to 2007-08 and thereafter decreased drastically by 129.87% from 2007-08 to 2008-09 in Scheduled Commercial Banks.

Table-6

**OFF BALANCE SHEET ITEMS**

Name of the Bank	2004-05	2005-06	2006-07	2007-08	2008-09
Scheduled Commercial Banks	2832508.03 (120.25)	4249541.72 (152.43)	7431714.10 (214.58)	14427369.59 (333.47)	10671961 (203.6)
Public Sector Banks	683896.89 (38.55)	842206.98 (41.09)	1051277.50 (43.09)	1857172.53 (61.45)	1909422 (50.7)
Private Sector Banks	498007.85 (169.15)	790142.13 (187.39)	1258139.07 (215.12)	2250147.68 (301.79)	1625037 (204.3)
Private Sector Banks OLD	59967.26 (44.93)	63024.24 (42.09)	71953.69 (44.81)	111137 (57.12)	116834 (50.4)
Foreign Banks	1590636.03 (1035.33)	2554164.92 (1267.04)	5050343.85 (1816.56)	10208912.24 (2803.88)	7020667 (1570.1)

Source : Report on Trend and Progress of Banking in India 2004-05 to 2008-09.  
Figures in parentheses are % of Off-Balance sheet to Total Liabilities.

But where as in Public sector banks they increased by 12.15% from 38.55% to 50.7%, by 35.15% from 169.15% to 204.3%, by 5.47% from 44.93% to 50.4% and by 534.77% from 1035.33% to 1570.1% in Public, private and foreign banks respectively. But we can notice a great decline of OBS percentage to total liabilities from 2007-08 to 2008-09 by 129.87%, 10.75%, 97.49%, 6.72% and 1233.78 % in Scheduled commercial banks, public sector banks private sector and foreign banks respectively. The Biggest exposures of Off-balance sheet items are among Foreign Banks (1570.1%) New Private sector Banks (204.3%) at the end of March 2009.

Being a part of the global financial system Indian Banking Sector cannot remain isolated from the rest of the financial world. Indian Banks should have a broad based strategy to face the new range of challenges and to convert every challenge into an opportunity by taking into consideration a few following points.

The following suggestions are made with ostensible intention of strengthening the banking

system and making the government policies acumen for facing such crisis more boldly in future.

Though the Indian banks are well equipped with the capital Adequacy Ratios, now its the time to shift from Capital adequacy to Efficient Capital Management and Balance Sheet Management for proper utilization of the capital. It is not only necessary fir the Indian Banks to try to achieve global benchmarks in diverse areas, but also must review their performance in an on-going basis in attaining the highest ratios.

### **Proactive risk management strategy**

It is necessary for the Indian banks to implement proactive risk measurement strategy to avoid high risk and ensures that risks are taken consciously and with full knowledge of all facts and all aspects of the risk. Banks should understand the nature of risk involved in every area of activity and in all lending and investments. Besides the ratios like Return on Assets, and Return on Equity, Banks should measure shareholders value and shareholders wealth created from-time-to-time by using Risk Adjusted Return on Capital (RAROC) Ratios also.

### **Best Corporate Governance Practices**

Indian banks have to ensure highest ethical standards in the process of conducting business to increase the value of all its stake-holders. Basel committee recommendations like prescribing and enforcing clear lines of responsibility and accountability, qualified directors on the board, effectively using the finding of audit and ensuring the compensation policies should be in consistent with banks ethical values and conducting of operations in a transparent manner should be strictly adhered

### **Transparency**

To evaluate the position and performance of the banks different users are intended to know the liquidity, solvency, risk position and profitability of the banks. Hence Indian banks should strictly follow the Generally Accepted Accounting Principles and Standards in preparation of their balance sheets. The banks should not only provide the adequate details in their financial statements but also should provide commentary and notes on the financial statement for clarity and understanding. Further more, Accounting Standards should also clearly specify how to account for losses and profits arising out of derivative transactions which is a great concern in recent days.

### **Best practices**

For developing and strengthening domestic financial architecture and for facilitating smooth integration with global financial markets, and to become stronger, sounder and enduring performances of our banking system, implementation of internationally accepted best banking practices, standards, codes and other global bench marks are very essential.

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