

GLOBAL FINANCIAL CRISIS : STRENGTH OF INDIAN BANKING VIS-A-VIS US BANKING

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The financial crisis in the US and European countries has posed a serious threat to global financial stability and has badly affected the growth of several economies in the globe. It has exerted tremendous pressure on the various financial markets across the globe. The turmoil is not only hammered the US and European financial institutions but has caused tremors in the Indian financial markets affecting the growth of Indian economy. This crisis has affected various sectors of the Indian economy particularly information technology, textiles, and real estates. The Indian banking is not an exception to this. Hence, it is imperative to ensure stability and soundness of the Indian banking system which accounts for around 60% of the total assets held by the Indian financial sector. In this backdrop, this paper examines the strength of Indian banks vs US banks in withstanding the global crisis.

The meltdown in US spread like a wild fire to the financial sector as a whole in the US and to Europe and then to the other economies of the world. It has shattered the confidence of the investors and has posed a threat to global financial stability. The crisis has sent shock waves to the Indian financial markets with far reaching consequences on the Indian banking system. In the words of **Subbarao, Governor of RBI**, "India's financial sector is stable and healthy. All indicators of financial strength such as capital adequacy, ratios of non-performing assets, and return of assets for our commercial banks, which accounts for 88 percent of banking assets, are robust. While many banks and quasi-banking financial institutions in advanced countries suffered large losses and needed substantial capital infusion and bailout packages, Indian banks have been affected only peripherally as they do not have direct financial exposure to the US sub-prime assets...." This statement proves that not much damage has been caused to the Indian banking. There are several factors that contribute to make the Indian banking strong, sound and resilient. The following are the factors that have strengthened the Indian banking as compared to their US counterparts.

1) No direct exposure to the sub-prime mortgage assets :

The Indian banking system has no direct exposure to the sub-prime mortgage assets or to the failed institutions. It has very limited off-balance-sheet activities or securitized assets. However, a few Indian banks like ICICI had exposure in entities like Lehman Brothers of nearly Rs. 400 crores and suffered some losses on account of sub-prime crisis. This loss is quite modest in relation to their huge investments assets which has only limited financial impact.

2) Purpose of lending :

The purpose of lending has assumed significance in deciding the stability of banks. The advances granted for productive purposes strengthen the recovery position of banks. In such cases there is no danger of converting loans into toxic assets. The Indian banks have in the practice of giving priority to productive loans rather than advances to consumer durables and home loans. The percentage of consumer durables and home loans to the total bank credit accounts for 11.76%. This speaks the prudent lending policy of the Indian banks that prevented

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the loan losses. On the other hand, the US banks are lending significant portion (nearly 39.25%) of their funds for unproductive purposes like purchase of car, consumer electronic goods and homes. None of these activities are productive investments and hence, no new wealth is created out of them. As a result, they hamper the recovery process and tend to convert such loan as NPAs.

3) Higher GDP growth :

GDP is one of the key components of the growth of banks. Higher GDP results into higher income and higher savings that enable banks to enhance their resources in the form of deposits and advances. Export is one of the factors that influences the growth of GDP. Though there is a slowdown in the Indian exports from 12.27% billion dollars (Nov 2007) to 11.5 % billion dollars (Nov 2008), this will not hurt the growth of GDP where the exports contributes less than 15 percent to GDP. Moreover the real strength of India lies in its domestic consumption and investments owing to its vast population. Estimation shows that there is a robust annual growth of GDP of 8.5% (2010) that is 2 ½ times faster than the rest of the world. Therefore, Indian banks as compared to their American counterparts are not badly affected. There is an ample scope to exploit the continued domestic demand for mobilisation of resources and expand lending activities.

4) Gap of responsibility between lending and recovery :

Bank lending is a risky business. The responsibility of lending and recovery should go hand in hand. Hence there should not be a gap of responsibility between the two set of people engaged in lending and recovery activities. The crisis in the US banking emanated from the neglect of the fundamental tenet of prudent lending and recovery policy. In US, there existed a wide gap of responsibility between the lending and recovery authorities. Advances are sanctioned by one authority who is not accountable for its recovery. By the time the loan is due for recovery, the sanctioned authority would have switched over to another organization due to flexibility of labour laws. As a result, no action shall be initiated against such authority for his negligence, if any, in sanctioning the loan proposals. On the other hand, there exists an equal amount of authority and responsibility for sanction and recovery of advance in Indian banks. The responsibility lies on the of public sector banks and other private sector banks to recover the advances., any laxity in assessing the loan proposals and advances to the dishonest and less credit worthy persons are severely punished. One more hurdle that exists in the recovery process of US banking is that, the debt is treated like a commodity and traded from one institution to another institution. In this system, any default in repayment of loans, the borrower who borrowed loan from one institution will receive reminders from several institutions resulting into the loss of personal touch between the borrower and the lender. This process hampers the recovery process due to absence of responsibility of borrowers to several agencies. But, in India, the banks could not sell loans like commodities. The loan accounts have remained in the books of the lending banks and the banks continue to maintain their relationship with their customers. Above all, the responsibility to recover these loans remained with the banks themselves resulting to prompt recovery.

5) Role of credit rating agencies :

One of the reasons for financial crisis in US is the heavy dependence of US banks on credit rating agencies who are responsible for assessing and rating the assets to be mortgaged as well as assessing the integrity of the borrowers. The rating agencies in US without proper verification of the antecedents of the borrowers awarded AAA to the dubious borrowers and has caused a lot of damage to the US banking system. But Indian banks are in the practice of assessing loan proposals emphasizing more on the documentation and considering the overall magnitude of risks involved in sanction of the loans. They focus more on preventing loans to the dishonest and sub-prime borrowers.

6) Neglect of liquidity considerations and sub-prime lending

Liquidity is an important factor on which the solvency of the bank depends. Crisis in US banking erupted with abundant liquidity and ended with liquidity crunch resulting to collapse of US banking system. The US banks have violated the very fundamental prudent liquidity principle of banking. The low interest rate regime prompted

by abundant liquidity in the beginning paved way for new avenues of lending and investments. As a result, commercial banks and investment banks lent vast sums for house purchase and consumer loans to such borrowers who were not really equipped to repay. Ultimately, the bubble bursts due to the default of the sub-prime borrowers causing massive losses in the mortgages. This default caused severe liquidity crunch in the banking system. The US banking did not pay attention to the risk and liquidity factors involved in lending. On the other hand, the Indian banks recognized the risk inherent in the liquidity mismatch and strictly adhered to the principle of liquidity by maintaining a certain percentage of their deposits in liquid forms. They survived because of their comfortable reserve position to meet their liability requirements both in domestic and foreign currencies. The Indian banks proved to be cautious and not greedy and reckless in managing their liquidity.

7) Structured fraud products :

The type of the financial products that the banks offer also decide the financial soundness of the banks. Banks in US, for instance, have involved in dealing with the structured products. They used their customer's mortgages and values of their homes to create two new products known as mortgages bond securities and credit default swaps. These products were sold in massive scale to hedge funds, mutual funds, private equity firms etc as packed loans. Further, such loan is bundled as an Asset Backed Security and traded them regularly. Such securities have been purchased by pension funds and insurance companies whose risk management practices did not allow them to buy such risky assets. Consequences of the burst of bubble of house market, the US banks exposed the vulnerability of investments made by them in such questionable instruments posing threat to their strength. Where as the Indian banks identified danger of structured products in maintaining the solvency position of the banks and avoided such toxic products that ensured safety and soundness of Indian banking.

8) Tradition of saving :

The tradition and culture of India rescued the Indian banks from present crisis. It is the traditional virtue of savings and thrift habits of the Indian people who are giving priority to savings. In fact the saving rate as a percentage of GDP is more than 34%. But in US, it is the greed driven and dubious standards that have encouraged lavish spending and luxury life. This has dampened the savings rate to 12% of GDP. The US Banking created the pitfalls in greedy products like credit cards and other consumer loans. On an average an American is holding 10 credit cards as compared to their Indian counterparts where hardly 2.7% of the population is holding the credit cards.

9) Role of regulatory authorities :

Role of the regulatory authorities is a crucial consideration on which the sound financial system depends. The crisis in the US banking showed many cracks in the administrative machinery while discharging the responsibilities of the regulatory authorities. One of the root causes of US financial mess is the failure of the regulatory authorities to take preventive measures against excessive risk taking by neglecting the importance of prudent regulations. They have failed in regulating the role of market players and credit rating agencies who played havoc in US financial system. On the other hand, the Reserve Bank of India has adopted the proactive measures to prevent the crisis and ensured the safety and stability of Indian financial system.

Conclusion :

The global financial crisis that emanated from the subprime crisis in the US has badly eroded the investors confidence and has posed a serious threat to the stability of banking over the globe. But the Indian banking has been negatively impacted by the globally interconnected crisis. Indian banks remained strong, sound, and resilient because they are not directly exposed to the US subprime mortgage or to the failed institutions. The Indian banks focused on the prudent lending policies with an emphasis on productivity and safety of loan. They have maintained perfect co-ordination between lending and recovery process and encouraged productive advances and discouraged unproductive advances. An effort has been made by the Indian banks to strengthen their resources contributed by the growth of GDP in the form of deposits and advances. The Indian banks faced the challenges of global crisis by strictly adhering to the principal of liquidity and ensured safety of banks by

maintaining a certain percentage of their deposits in liquid form. They have identified the structured products and maintained the solvency of the banks by avoiding toxic assets that enabled the banks to manage the crisis positively. The significant role of regulatory authorities who have taken preventive measures against excessive risk taking by the market players and giving prime consideration to the liquidity factor on which the solvency of the bank depends have come a long way in rescuing Indian banks and ensured the safety and soundness of Indian financial system. The regulatory authorities who have adopted the preventive measures such as discouraging aggressive bank lending to real estate by increasing risk weights of real estate loans, housing loans against mortgage of property. The crucial measure of limiting the borrowing of banks up 200% of net worth and reserve, injecting liquidity by reducing the statutory requirements of maintaining the CRR are the key components that have prevented the crisis of Indian banks. Hence, Indian banks have followed the tradition of cannons of liquidity, profitability and safety in their lending and investment that enabled them to meet the challenges of global financial crisis and withstand the crisis successfully. On the other hand, the US banks have lent significant portion of their funds for unproductive purpose that has not created any wealth but hampered the recovery process. They have also neglected the prudent lending and recovery policy where there is a gap between lending and recovery authorities. Credit rating authorities have played havoc in damaging the US banks by awarding AAA to dishonest and sub-prime borrowers and failed to identify the structured products that have posed a threat to the US banking. Role of regulatory authorities in preventing the excess risk taking by the banks, failure to regulate the role of market players and rating agencies are prime causes of the US financial crisis.

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