CHAPTER 1
INTRODUCTION

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Banking is the lifeline of any modern economy. An efficient and sound banking system plays a vital role in promoting economic growth, intermediating financial flows, supporting the payment system and in the conduct of monetary policy. In emerging market economies like India, banks take a lead role in the development of other financial intermediaries and financial markets. Individuals prefer banks to ensure liquidity and safety of their savings and corporates also depend on the banking sector for their financial requirements.

This chapter gives a detailed history of Indian banking and its evolution from banking in ancient times to its structure at present. It throws light on the importance of banks in the modern Indian economy and how they contribute to the betterment of lives of common people and corporates alike. The chapter also discusses at length the meaning of financial crisis, types of financial crises and the causes of financial crises. It gives a detailed account of the Global Financial Crisis of 2007-08, its causes and its global impact. After stating the topic, it enumerates the objectives of the current study. A brief summary of the chapter plan of the current study is also provided.

1.1 EVOLUTION OF BANKING IN INDIA AND ITS HISTORY

This section gives a detailed history of Indian banking, and how it evolved into its present day structure from the informal banking in ancient times.

1.1.1 Banking in ancient times
Banking has been in India since ancient times. The form of banking, however, evolved over time. The details are given below.
1.1.1 (1) Indigenous bankers

Banking, in India, is said to have its origin in Vedic times, in the form of money lending operations. According to the Indian Central Banking Enquiry Committee (1931), money lending activity in India could be traced back to the Vedic period i.e. 2000 to 1400 BC. The existence of professional banking could be traced back to 500 BC. References to creditors, lenders and lending rates in Kautilya’s Arthashastra could be traced back to 400 BC. The system of banking at that time was suitable to the requirements of trade, commerce, agriculture and individuals then.

1.1.1 (2) Modern commercial banking

The beginning of modern commercial banking in India could be traced back to the early 18th century, when European agency houses erected a structure of European controlled banks with limited liability. In 1683, the first bank was set up in Madras by the officers of East India Company. The first joint stock bank, Bank of Bombay, was established in 1720 in Bombay and then Bank of Hindustan was established in 1770 in Calcutta (Pathak, 2011).

1.1.1 (3) Presidency banks

The East India Company had divided India into three Presidencies as the units of administrative jurisdiction. Three banks, governed by the Royal Charters, were established in these Presidencies – the Bank of Bengal (1806) in Calcutta, the Bank of Bombay (1840) and the Bank of Madras (1843) – to cater to the requirement for modern banking services, uniform currency to finance foreign trade and remittances by British army personnel and civil servants. The enactment of the Companies Act in 1850 led to the first formal regulation for banks. The concept of limited liability was brought in 1860. With the enactment of the Paper Currency Act in 1861, the right to issue currency notes was transferred from the Presidency banks to the Government. The Presidency Bank Act enacted in 1876 brought these three banks under a common statute and imposed some restrictions too. These three banks were amalgamated into a single bank, the Imperial Bank of India, in 1921. Prior to the establishment of the Reserve Bank of India in 1935, the Imperial Bank of India functioned as a commercial
bank, a banker’s bank and a banker to the government. After independence, this bank was converted into the State Bank of India (Pathak, 2011).

1.1.1 (4) Indian banks
The Swadeshi Movement in the pre-independence period provided a great thrust to set up joint stock banks of Indian ownership. The first such bank was the Allahabad Bank set up in 1865 in Allahabad, followed by the Punjab National Bank in 1895 in Lahore. Between 1906 and 1913, other banks viz. Bank of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank and Bank of Mysore were set up. These banks financed foreign trade, while domestic trade was largely handled by shroffs and moneylenders (Pathak, 2011).

1.1.1 (5) Co-operative banks
With the co-operative banking movement in India in the last decade of the nineteenth century, the first urban co-operative bank was established in the then princely state of Baroda in 1889 and the second in 1905 in Bangalore in the then princely state of Mysore. These banks catered to the requirements of urban lower income group population (Pathak, 2011). In March 1923, 68 co-operative banks existed, which more than doubled to 158 by March 1929, which included 18 Class A banks and 140 Class B banks. However, the size of their deposits was much smaller (RBI, 2009).

1.1.1 (6) Banking institutions under the Companies Act 1913
By December 1913, there were 56 commercial banks in the country which included 3 Presidency banks, 18 Class A banks (joint stock banks with capital of greater than ₹ 5 lakh), 23 Class B banks (joint stock banks with capital of ₹ 1 lakh to ₹ 5 lakh) and 12 exchange banks (foreign owned banks engaged mainly in foreign exchange business) (RBI, 1954). There were many other entities (loan companies, indigenous bankers and nidhis) too registered under the Companies Act 1913 as banks. However, as many as 94 banks failed during the World War years 1913 to 1918, mainly due to individual imprudence and mismanagement, fraudulent manipulation by directors and managers, and incompetence and inexperience (RBI, 2009).
By 1930, the number of commercial banks increased to 107, which included 31 Class A banks, 57 Class B banks and 18 exchange banks (RBI, 1954). However, the Imperial Bank of India dominated the Indian banking sector. There were totally 1258 banking institutions registered under the Indian Companies Act 1913, 134 of which failed during the Great Depression (1928-1934), mainly due to loans going bad (RBI, 2009).

1.1.1 Reserve Bank of India

The Reserve Bank of India was set up in 1935 as the central bank of the country under the Reserve Bank of India Act 1934. Its main functions were to act as a banker to the Government, to act as a banker to other banks, to issue notes and to maintain the exchange rate. At that time (1935), there were 124 commercial banks which included 106 joint stock banks and 17 exchange banks apart from the Imperial Bank of India. The banks were reclassified as A1, A2, B, C and D banks according to their size. The enactment of Indian Companies (Amendment) Act 1936 incorporated a separate chapter on provisions relating to banking companies. The RBI, however, did not have adequate powers of control or regulation. The number of non-scheduled small banks was very large, more such banks came into existence and they remained outside the purview of the Reserve Bank. They suffered from limitations such as inadequate capital structure and unsound methods of operations and management. 708 small banks failed between 1936 and 1945, of which 455 failed during the World War II years from 1939 to 1944 (RBI, 2009).

1.1.2 Banking in independent India – 1947 to 1967

Development in Indian banking in the first 20 years after independence is explained below.

1.1.2 (1) All private banks

When the country attained independence, all Indian banks were in the private sector and most of them had a regional focus. Imperial Bank, the largest bank, had deposits of ₹287 crores, and there were other five big banks each having deposits of ₹100 crores or more, viz. Central Bank of India, Punjab National Bank, Bank of India, Bank of Baroda and United Commercial Bank. 97 scheduled commercial banks had 86% of
the total deposits aggregating to ₹ 1090 crores. A large number of other small banks co-existed, 557 non-scheduled banks and 395 co-operative banks with total deposits of ₹ 89 crores and ₹ 82 crores respectively. The Reserve Bank was also not completely state owned until it was nationalized in terms of the Reserve Bank of India (transfer to Public Ownership) Act, 1948. However, 38 banks failed in 1947 and 45 in 1948 causing great hardships to savers (RBI, 2009).

1.1.2 (2) Banking Regulation Act

The breakthrough came in 1949, when the Government of independent India in consultation with the RBI enacted the Banking Companies Act 1949 (renamed as Banking Regulation Act 1949 in 1966). This was the first regulatory step which gave extensive powers to the Reserve Bank for banking supervision as the central banking authority of the country. However, bank failures continued. In order to protect public savings, efforts were made to strengthen the banking sector (Pathak, 2011).

1.1.2 (3) State Bank of India

The Indian Government nationalized the Imperial Bank of India by converting it into the State Bank of India in 1955 with the enactment of the State Bank of India Act, 1955. This was done in order to enlarge the reach of banking services, especially in rural and semi-urban areas, and for diverse other public purposes. RBI started the task of consolidation after it was formally given the powers in 1960. The number of banks was reduced through elimination, amalgamation, mergers and liquidation. 8 banks that then formed subsidiaries of SBI were nationalized in 1960, and thus brought one-third of the banking segment under the direct control of the Government (RBI, 2009).

The banking scenario from 1947 to 1967 had three distinct disquieting features.

- Bank failures which raised concerns regarding the soundness and stability of the banking system.
- Nexus between the banks and industry due to concentration of resources in the hands of a few business families or groups.
- Neglect of agriculture in bank credit
1.1.3 Social control over banks – 1967 to 1991

After two decades of private sector control on majority Indian banks, the Indian government used nationalization as the tool to bring banking under social control. The developments that took place are explained below.

1.1.3 (1) Nationalization of banks

In order to serve better the needs of development of the economy in conformity with national policy objectives, the Indian Government nationalized 14 banks with deposits of over ₹ 50 crores in 1969. Further, 6 other banks with deposits of over ₹ 200 crores were nationalized in 1980. The names of these banks are given as Annexure 1.1. The objective was to promote economic growth, better regional balance of economic activities and diffusion of economic power, and to extend the reach of organized banking services to rural areas and other neglected sections/sectors of the society (RBI, 2009).

1.1.3 (2) Regional Rural Banks

However, when commercial banks failed to cater to the needs of the rural people, a separate banking structure known as the Regional Rural Banks (RRBs) was set up in 1976, with the enactment of the Regional Rural Banks Act 1976. The objective was to develop the rural economy by providing credit for the purpose of development of agriculture, trade, commerce, industry and other facilities, particularly to the small and marginal farmers, agricultural labourers, artisans and small entrepreneurs (RBI, 2009).

1.1.3 (3) Other controls

During this phase, various controls were introduced e.g. allocating credit according to plan priorities, increase in lending to weaker sections, priority sector lending, differential rate of interest, minimum lending rate, maximum rate for bank loans, classification of bank loans into eight categories according to their performance, increase in Cash Reserve Ratio (CRR) from 5% in June 1973 to 15% in July 1989, increase in Statutory Liquidity Ratio (SLR) from 26% in February 1970 to 38.5% in September 1990, etc. These controls combined with the absence of adequate
competition resulted in decline in productivity and efficiency of the banking system and eroded its profitability (RBI, 2009).

1.1.4 Phase of financial sector reforms – 1991-92 onwards

Government control and nationalization killed competition and stifled innovations in banking. Banks functioned in a regulated environment with no incentive to make profits. The government realised the need to upgrade the operating standards, health and financial soundness of banks to internationally accepted levels, and so financial sector reforms were undertaken, the details of which are given below.


The first phase of comprehensive reforms in the banking sector were undertaken in 1992 by implementing the recommendations of the Committee on the Financial System (CFS) (Narasimham Committee I - 1991) on the financial system, which emphasized on creating a viable and efficient banking system, deregulation, liberalization, and greater disclosure and transparency in accounting (RBI, 2009).

With a view to improving the health of the banking sector, internationally accepted prudential norms relating to income recognition, asset classification and provisioning, and capital adequacy were introduced in a phased manner.

Government ownership in nationalized banks was diluted for the first time with the State Bank of India and the Oriental Bank of Commerce coming out with their maiden initial public offerings (IPOs), followed by most other banks.

External constraints on banks were removed. CRR was brought down to 9.5% and SLR to 25%. Interest rates were deregulated and banks could fix the interest rates on deposits and loans depending on the overall liquidity conditions and risk perceptions. This had a positive impact on the profitability of the banking sector. Freedom was provided to banks to open new branches and install automated teller machines (ATMs).
Competition was infused in the banking system in 1993, when the RBI allowed entry of new banks in the private sector, and foreign banks were allowed to open branches.

Total operations and performance of domestic commercial banks were evaluated under the CAMELS system (Capital adequacy, Asset quality, Management, Earnings, Liquidity, and System and controls) and of foreign banks under the CALCS system (Capital adequacy, Asset quality, Liquidity, Compliance and Systems).

The Banking Ombudsman Scheme was introduced in 1995 for quick and inexpensive resolution of customer complaints. Efforts were made to restructure RRBs and to improve rural credit delivery system.

1.1.4 (2) Second Phase of Reforms –1998-99 onwards

The second phase of comprehensive reforms in the banking sector were undertaken in 1998 by implementing the recommendations of the Committee on Banking Sector Reforms (CBSR) (Narasimham Committee II - 1998). The focus was on further strengthening of the prudential norms in line with the international best practices, improving credit delivery, strengthening corporate governance practices, promoting financial inclusion, strengthening the urban co-operative banking sector and improving the customer service (RBI, 2009).

Banks were able to bring down their non-performing assets, improve asset quality, improve their profitability and also increase the flow of credit to agriculture and SME sectors. Increased use of technology combined with other initiatives helped banks improve the customer service.

1.1.5 Banking in the 21st century

The reforms in the financial sector and in the banking sector gradually transformed the Indian banking in tandem with the global developments. The RBI had adopted a phased approach to implementation of Basel norms. Accordingly, as stipulated by RBI, all banks have been maintaining a minimum Capital to Risk-weighted Asset Ratio
(CRAR) or Capital Adequacy Ratio (CAR) of 9% on an on-going basis. It is expected that the Basel III norms will be implemented by Indian banks by 31st March 2019.

The Central Government enacted the IT Act in 2000 to provide legal recognition to electronic transactions and other means of electronic commerce. With the increasing importance of IT based banking services, the RBI facilitated the development of e-banking in India by consolidating the payment and settlement system and by upgrading the technology to establish an efficient, integrated and secure system functioning in real-time environment (Bhasin, 2009).

Tackling the high level of non-performing assets (NPAs) remained a challenge. The Credit Information Bureau of India Ltd (CIBIL) was set up in 2000 in order to facilitate sharing of comprehensive credit information related to borrowers, their payment track records and their defaults among banks and financial institutions. RBI and the Central Government initiated several other institutional measures to contain the levels of NPAs, and in order to put in place a mechanism for timely and transparent restructuring of corporate debts of viable entities facing problems. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act was passed in 2002, which enabled the setting up of asset management companies to provide a significant impetus to banks to ensure sustained recovery without intervention of courts. The 90-day delinquency norm was adopted for the classification of NPAs from March 2004. Guidelines for sale/purchase of NPAs were issued in 2005 in order to increase the options available to banks for dealing with NPAs (Bhasin, 2009).

The guidelines on “Know Your Customer” (KYC) principles were revised by RBI in November 2004 in line with the recommendations made by the Financial Action Task Force (FATF) on anti-money laundering standards and for combating terror financing. Giving more importance to the customer services, RBI initiated several measures to enhance the quality of customer service, to protect customers’ rights and to strengthen grievance redressal mechanism in commercial banks (Bhasin, 2009).
The ongoing banking sector reforms have supported the transition of the Indian economy to a higher growth path, while improving the stability of the financial system and the performance of commercial banks in terms of both stability and efficiency.

1.2 INDIAN BANKING AND STRUCTURE

Banks included in the second schedule of the Reserve Bank of India Act 1934 are known as scheduled commercial banks. The structure of scheduled banks in India and the number of banks as on 31st March 2016 is represented in Chart 1.1. The list of the names of scheduled commercial banks functioning in India (except Regional Rural Banks) is given as Annexure 1.2.

Chart 1.1: Structure of Scheduled Banks in India

Data Source: www.rbi.org.in

1.3 IMPORTANCE OF BANKS

Banks are the most important financial intermediaries in the financial system of an economy. A sound, solvent, well-developed banking system is indispensable for the growth and development of a country. Thus, banks are the lifeline of a modern society. They are as important to the economy as heart is to a human body.
• Banks mobilise savings by accepting deposits from the people in the form of term deposits or demand deposits. Thus, banks inculcate the habit of savings and financial planning among the people.

• Banks create credit by lending money to their customers and to other banks too. Priority sector advances to agriculture and allied activities help rural development. Loans to businessmen are helpful to start new business units and expand and diversify existing ones, and thus help in the industrial development, employment generation, increase in output, and overall growth and development.

• Banks purchase government securities, and thus help to fund various government programmes and activities.

• Banks are inevitable in foreign trade, for foreign exchange and for transfer of money.

• Banks also provide merchant banking services to businessmen.

• Banks provide customers with safe deposit vaults and thus provide security to their valued possessions.

• Banks have become a ‘one stop shop’ and provide customers with various investment opportunities under the same roof, viz. capital markets, government securities, insurance, etc.

1.4 FINANCIAL CRISIS

1.4.1 Meaning of Financial Crisis
Financial panics or crises are as old as capitalism itself and can be traced at least to the Dutch tulip mania of 1636-37 and the South Sea Bubble of 1719-20. The literature on financial crisis can be split into two schools of thought.

Monetarists like Friedman and Schwartz (1963) have linked financial crisis with banking panics and concluded that banking panics result in monetary contractions which, in turn, lead to severe contractions in economic activity. Financial crisis events which did not result in banking panics were not classified as a financial crisis by the monetarists and they termed these events “pseudo – financial crises”.

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However, according to Minsky (1972) and Kindleberger (1978), financial crisis is a broad term and either involves sharp declines in asset prices, failures of large financial and non-financial firms, deflations or disinflations, disruptions of foreign exchange markets, or some combination of all these.

Thus, financial crisis indicates stress on the financial system, on banks and other financial intermediaries, usually resulting in failures of systemically important institutions and sharp contractions in the national economy. It can be called as an episode of financial market volatility marked by significant problems of illiquidity and insolvency among financial market participants that requires an official intervention to contain such consequences. Liquidity evaporates quickly because available money is withdrawn from banks, forcing them either to sell other investments to make up for the shortfall or collapse. Thus, a financial crisis may eliminate or impair a significant portion of the banking system’s capital (RBI, 2010).

1.4.2 Types of Financial Crises

Financial crises can be generally categorized into four types as shown in Chart 1.2, viz. debt crisis, banking crisis, currency crisis and crisis due to a financial contagion. An economy may be affected by any of these crises or may experience the occurrence of more than one variant simultaneously or in rapid succession. The distinction between different types of financial crises has therefore become blurred (RBI, 2010).

**Chart 1.2: Types of Financial Crises**

![Diagram showing Types of Financial Crises]

Source: Report on Currency and Finance 2008-09, RBI
1.4.2 (1) Debt Crisis

A debt crisis occurs either when the borrower defaults or lenders perceive this as significant risk and therefore withhold new loans and try to liquidate existing loans. This can apply to commercial (private) debt and or sovereign (public) debt. Debt crisis often leads to a sudden decline in capital inflows and a spike in capital outflows (RBI, 2010).

1.4.2 (2) Banking Crisis

A banking crisis is triggered by a sudden withdrawal of bank deposits by several clients, a situation known as a ‘bank run’. A banking crisis occurs when actual/potential bank runs induce banks to suspend the payments to depositors due to lack of sufficient funds or compel the government to intervene to prevent the collapse of the bank by extending assistance on a large scale. A banking crisis generally results in the erosion of most or all of aggregate banking system capital (Kaminsky and Reinhart, 1999).

1.4.2 (3) Currency Crisis

A currency crisis occurs when a speculative attack on the exchange rate results in a devaluation or sharp depreciation of a currency, or forces the country authorities to defend the currency by expending large volumes of reserves or by significantly raising interest rates. Investors flee a currency because they fear that it might be devalued, and in which much of the pressure for such a devaluation comes precisely from capital flight (RBI, 2010).

1.4.2 (4) Contagion

A financial contagion is a process by which a shock in one part of the financial system spreads to other parts through a series of linkages, in trade and capital, across nations. The channels of contagion generally include flow of information and interbank claims. The shock/crisis could be a fall in stock market prices or depreciation in currency, or a banking crisis. It gets stronger as it passes from region to region and becomes a contagion (Kodres and Pritsker, 2002). The East Asian crisis is an example of how contagion can affect several economies in the region.
1.4.3 Incidence of Financial Crisis

The nature of financial crises has changed over the years with changes in the economic landscape. Various researchers in the West have studied financial crises in detail. Reinhart and Rogoff (2008), Bordo et al (2001) and Laeven and Valencia (2008) have compiled databases on financial crisis. Accordingly, a list of major financial crises during 1873-2007 has been compiled and is given below.

<table>
<thead>
<tr>
<th>Year</th>
<th>Name/Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1873</td>
<td>German and Austrian Market Collapse</td>
</tr>
<tr>
<td>1890</td>
<td>Barings Crisis</td>
</tr>
<tr>
<td>1907</td>
<td>USA</td>
</tr>
<tr>
<td>1929</td>
<td>USA</td>
</tr>
<tr>
<td>1980s</td>
<td>Latin American Debt Crisis</td>
</tr>
<tr>
<td>1980</td>
<td>Savings and Loan Crisis, USA</td>
</tr>
<tr>
<td>1987</td>
<td>World</td>
</tr>
<tr>
<td>1991</td>
<td>UK</td>
</tr>
<tr>
<td>1991</td>
<td>Nordic countries (Finland, Norway, Sweden)</td>
</tr>
<tr>
<td>1994</td>
<td>Mexican Crisis</td>
</tr>
<tr>
<td>1997</td>
<td>East Asian Crisis</td>
</tr>
<tr>
<td>1998</td>
<td>Russia</td>
</tr>
<tr>
<td>2000</td>
<td>Dot.com bubble</td>
</tr>
<tr>
<td>2001</td>
<td>Argentina</td>
</tr>
<tr>
<td>2007</td>
<td>Sub-prime Crisis, USA</td>
</tr>
</tbody>
</table>

Source: Report on Currency and Finance, RBI, 2008-09

Financial crises have impacted both advanced as well as emerging market economies. The analysis of the incidence of financial crisis over the past 150 years reveals that though crisis occurs without warning, the incidence can largely be explained in terms of the prevailing macro-economic conditions, the financial regulatory regime, currency regime, fiscal discipline and global capital and trade flows.
### 1.4.4 Causes of Financial Crisis

Any imbalances in the domestic economy related to the real economy, the financial sector, the macro economy, international money and capital flows, or asset pricing result into a financial crisis. Increase in interest rates, stock market declines, increase in uncertainty, declines in aggregate price levels, bank panics, and loss of depositor and investor confidence cause a financial crisis. With free international capital mobility, high external debt, currency depreciation and swing in the current account have emerged as major causes of financial crisis. A crisis may arise after major financial or technical innovations too. Most recent crises were a result of serious banking and financial sector weaknesses, overly inflationary monetary policies, large fiscal deficits, large current account deficits, national balance sheet weaknesses (RBI, 2010).

A financial crisis, thus, can be caused by many factors as summarised in Chart 1.3.

**Chart 1.3: Causes of Financial Crisis**

- Financial reasons and panic
- Common elements in crisis
- Imbalances in domestic economy
- Monetarist dimension
- Free capital mobility & banking crisis
- Adverse selection & moral hazards
- Financial & technical innovation

Source: Report on Currency and Finance 2008-09, RBI
1.5 GLOBAL FINANCIAL CRISIS OF 2007-08

1.5.1 The Global Financial Crisis (GFC)

The global financial crisis (GFC) of 2007-08 that turned into an economic crisis is the first major financial crisis of the 21st century, and is the first truly global crisis. The crisis which originated in the US in August 2007 as the sub-prime mortgage crisis, reached its peak during September 2008 when some of the prime financial institutions collapsed, leading to a worldwide failure of confidence and affected the whole world, advanced as well as developing countries. The United States and Europe, which had become dependent on the financial sector as their engine of growth, were at the epicentre of the crisis. Asia was affected due to a sharp decline in demand for their exports from the developed countries. Eastern Europe was hit by reversal of capital flows. African and South American countries suffered through the huge drop in commodity prices and deterioration in their terms of trade. Thus, the turmoil in the financial sector of the advanced countries traversed to the financial sector of the emerging market economies through financial, trade and confidence channels, despite their relatively sound fundamentals. The sub-prime crisis in the US housing market turned successively into a global banking crisis, a global financial crisis and then a global economic crisis (RBI, 2010).

The nearest precedent to the global financial crisis of 2007-08 is the Great Depression of the 1930s in terms of its depth, geographical spread, intensity and duration. Almost all countries were affected, although the impact varied across nations. However, a unique feature of this crisis is that the emerging economies have been creditor countries financing the deficit in advanced countries.

Cross crisis comparisons are usually based on the duration and depth of the crises (Bordo et al, 2001; Ceccheetti et al, 2009). Estimates suggest that the duration of the global crisis of 2007-08 (2.5 years) may be comparable to previous crises, but the cost of the crisis in terms of cumulative GDP loss (20%) has been more severe than any other crises, despite unprecedented monetary and fiscal measures and international coordination.
1.5.2 Causes of the Global Financial Crisis

The global financial crisis of 2007-08 was not triggered by a single or an isolated cause. There were many intertwined causes that contributed to it. As a consequence of the large global imbalances in various systemically important economies, savings from emerging market economies got invested in advanced countries. This gave rise to excess liquidity in these countries and drove down their short term and long term real interest rates. This led to massive expansion in credit quantity with erosion of quality (sub-prime loans) because of the search for higher yield. This, in turn, led to the generation of new toxic financial products through slicing, hedging and originating and distribution. Weaknesses in the regulatory structure for financial institutions and problems in risk measurement, accounting and incentive structure also contributed to the crisis. All of this brew the crisis to an explosive dimension (Subbarao, 2009).

RBI Report on Currency and Finance (2008-09) mentions various causes of the global financial crisis of 2007-08, as shown in Chart 1.4.

**Chart 1.4: Causes of the Global Financial Crisis of 2007-08**

Source: Report on Currency and Finance 2008-09, RBI
1.5.3 Impact of the Global Financial Crisis

In an integrated world, the impact of the financial crisis in the advanced economies was transmitted to the emerging market economies. RBI (2010) spells out the impact of the global financial crisis as shown in Chart 1.5 and as explained later.

**Chart 1.5: Impact of the Global Financial Crisis of 2007-08**

Source: Report on Currency and Finance 2008-09, RBI
1.5.3 (1) Impact on Financial Markets

The crisis had started spreading across financial institutions, markets and countries from August 2007. However, the closing of the large US investment bank Lehman Brothers in September 2008 aggravated panic in the financial markets. The crisis affected various segments of the financial markets in advanced economies and in Emerging Market Economies (EMEs) as mentioned below.

- Concerned about counterparty risk due to uncertainty, banks became reluctant to lend to one another. This resulted into severe tightening of funding conditions in the interbank credit markets and significant increase in short term interbank interest rates.
- In advanced economies, there was a sharp decline in household credit growth due to tightened lending standards of banks and a slowdown in demand, though business credit expanded by increased use of existing credit lines. In EMEs, credit growth to the corporate sector weakened and remained lower than the household sector.
- The stock markets all over the world had to bear much of the heat of the crisis. Equity markets witnessed high volatility and sharp decline in prices. Not only the global stock market turnover, but the market capitalisation of major stock exchanges also declined significantly. There were significant sell-offs by foreign institutional investors (FIIs) in most Asian EMEs.
- In advanced economies, corporate bond issuance was not much affected. But lower-rated firms did face difficulties in raising funds in bond markets during the crisis. However, international corporate bond issuance from EMEs fell sharply due to both demand and supply factors.
- Government bond markets all over the world saw large swings in yields. Giving preference to highly liquid and safe securities, investors shifted from stocks and other risky assets to sovereign bonds. Thereby, the long-term government bond yields declined in the US and the euro area. However, yields increased in most Asian EMEs.
• There was increased volatility in foreign exchange markets, which reduced the attractiveness of carry trade positions during the financial turmoil. The Japanese yen appreciated sharply against the US dollar, while the pound sterling and the euro depreciated. Currencies of most EMEs which had weakened during 2008 and early 2009 against the US dollar, appreciated during the second quarter of 2009.

• With uncertainties in the financial markets, investors switched to commodity markets to hedge against a depreciating US dollar and higher inflation. This reinforced a build-up of the commodity price bubble. The prices of all commodities - oil, non-energy commodities and food - remained volatile throughout 2008.

• Housing property and commercial property prices declined in the US and in most euro area countries during 2007 and 2008. However, decline in housing prices in emerging Asia was moderate and the local prices were not affected by other countries.

1.5.3 (2) Impact on Financial System

The flawed institutions and practices of the new financial architecture – characterised by a globally integrated system of giant bank conglomerates and the “shadow banking system” comprising investment banks, hedge funds and bank created Special Investment Vehicles – were the possible factors behind the global financial crisis of 2007-08. Therefore, the most severe impact of the crisis was also felt by these financial institutions.

• During the initial phase of the crisis, commercial banks mostly faced funding pressures and mark-to-market losses. As the macro-economic situation worsened from September 2008, they faced increasing pressure on earnings and mounting losses on their credit risk exposures. Later, economic slowdown and borrower defaults led to higher bank losses and write-downs. Bank profits declined globally, in the US, in many European countries and in Japan. However, banks in emerging Asia and Latin America, cushioned with strong capital positions and comfortable capital adequacy ratios, could resist the financial turmoil to some extent.
• **Investments banks** had to take a very severe blow of the financial crisis. Their losses reached very high levels as all lines of business were negatively affected. Net revenue fell, securities underwriting declined, large holdings of high-risk structured securities and unhedged exposures were marked down, balance sheets shrank in size and huge staff was retrenched. Some investment banks were liquidated, some sold off and some turned into commercial banks.

• During the crisis, **insurance companies** faced adverse conditions on both sides of their balance sheet due to lower long term interest rates and asset price declines. The crisis affected their financial performance and not the premium income. The market capitalisation also came under pressure due to exposure to risky assets and as a result of weakening macroeconomic conditions.

• **Hedge funds** performed very poorly during 2008 with almost all investment strategies showing negative results as returns in asset markets plummeted and the cost of funding soared. Assets under management shrank by more than one-third, investors withdrew funds, industry contracted sharply and so a number of funds were closed. Outflows of foreign capital from emerging equity markets and subsequent depreciation of their currencies also led to the dismal performance of global hedge funds.

1.5.3 (3) **Impact on External Sector**

In the globally integrated economies, the global financial crisis had an impact as a result of the contagion. The impact on the external sector is explained below.

• **International trade** declined sharply since October 2008. As households in the US and Europe cut their discretionary spending due to decrease in liquidity and loss of wealth, imports in these countries declined. Thereby EMEs experienced declining exports. Export volumes and export prices declined sharply due to fall in demand.
- **Trade in various commercial services** like transportation and travel was negatively affected. The world export of commercial services declined, transportation services contracted, port traffic reduced due to withdrawal of vessels from service and international tourism was negatively impacted due to the crisis.

- **Remittances** are one of the largest international flows of financial resources. As the crisis gathered strength in the US and in Europe where many migrants work, the flow of remittances to many EMEs declined slowly towards the end of 2008 and in 2009.

- **Current accounts** of most developing economies were negatively affected during 2008 as their current account surplus either decreased or current account surplus turned into deficit or current account deficit increased. During 2009, however, reductions in the current account surplus of China and deficit of the US helped to contract the global imbalances to some extent.

- **Global capital flows**, magnified the overall impact of the crisis across countries. Net private capital inflows to EMEs in the form of bonds and equity declined, whereas capital outflows from EMEs increased as investors and multinational companies in developing countries acquired assets and invested in debt markets abroad.

- **Net foreign direct investment** (FDI) flows to EMEs remained steady, reflecting the longer term view of FDI investors on EME growth potentials and the soundness of the financial system. FDI inflows to China and India, in fact, increased. Even FDI outflows increased, possibly to take advantage of the attractive investment opportunities thrown up by the equity market corrections in the advanced economies during the crisis. However, there was a mixed effect on net FDIs in advanced economies.

- There was a massive reversal in equity **portfolio inflows** to EMEs, particularly Asia, which led to weakening of emerging market currencies, widening of spreads on international sovereign bonds and a sharp rise in domestic bond yields in many EMEs. Portfolio outflows from many developed economies fell significantly and turned negative, implying liquidation of positions held abroad and repatriation of money back to home countries.
• In international debt markets, primary issuance froze and secondary trading of emerging market bonds was greatly reduced. Corporate borrowings and emerging market bond issuance declined as corporate borrowers lost access to international capital markets. As exchange rates depreciated sharply against the dollar or the euro, corporations with international debt suffered heavy losses.

• Many international banks either did not allow rollover of the credit or cancelled funded overdraft facilities without warning. Many exporters also restricted the trade credit to customers as a result of reduced access to capital and increased concerns about customer creditworthiness. This problem was felt more by EMEs.

• Flows of short term debt to developing economies were strong during the first half of 2008, became negative in the third quarter of 2008 and later registered a sharper drop in the fourth quarter of 2008. The sharp drop in short term debt strained trade finance.

• International banks started to withdraw funding from some emerging markets or reduced loans to EMEs in order to overcome severe liquidity shortages in their home markets. Major global banks sharply reduced interbank credit to Asian banks, which led to tighter credit conditions and severe foreign currency liquidity shortages in some emerging East Asian economies.

1.5.3 (4) Impact on Real Economy

Consumer and business confidence declined substantially as a result of systemic banking crises during the crisis. The impact on the real economy is given below.

• The decline in asset prices resulted into the end of a housing construction boom in several countries, tight credit market conditions, fall in consumer and business sentiment and contraction in household expenditure in the advanced economies.

• Signs of weakening also emerged in the corporate sector, particularly those exposed to consumption or housing construction or those with significant exposure to energy prices.
• The crisis pushed the global economy into a severe and synchronised recession. Though EMEs looked relatively resilient during the initial months of the crisis, with slowdown in the economic activities in advanced economies, shrinking global trade and intensified turbulence in global financial markets, the contagion spread to the EMEs. World GDP growth contracted by 0.6% in 2009.

• Fall in global economic activities and decline in international commodity prices from mid-2008 had significant downward pressures on inflation, even sparking fears of deflation in many countries.

• With the weakening of economic activity, quality of bank loans deteriorated, adversely affecting their capital positions and their willingness to extend credit to the private sector. This in turn, constrained the pace of economic activity and the ability of the private sector to service its debts, thus completing the vicious circle.

• The erosion of economic activity and depressed economic environment led to rapid lay-offs, both in private corporate businesses and factories. Unemployment rates touched all-time highs in advanced as well as emerging economies. Fall in output and productivity led to further declines in income, consumption, savings and investment.

1.6 SELECTION OF THE TOPIC

The global financial crisis of 2007-08 affected the entire world economy. Starting with banks in the advanced economies, the contagion spread to other parts of the world and affected all sectors in varying degrees as discussed above.

Indian economy too felt the tremors of this global financial crisis of 2007-08. It is believed that Indian commercial banks were resilient in the initial phase of the crisis. But as the crisis deepened, they were affected to some extent. But there has been considerable divergence in the performance of the various banking institutions in the country as also among the public sector and private sector banks in India. What was the actual effect on various banks, especially public sector and private sector banks in
India? How did the crisis affect their growth, soundness, liquidity, fund management, profitability and productivity?

Given this scenario, this research attempts to study the impact of the global financial crisis on the financial performance of selected public sector and private sector banks in India. Therefore, the topic for the research is, “Impact of Global Financial Crisis on the Financial Performance of selected Private and Public Sector Banks in India”.

1.7 OBJECTIVES OF THE STUDY

The current research has been undertaken with the following objectives.

(1) To study the growth of public sector and private sector banks in India in the post-independence period
(2) To study the impact of global financial crisis on the fund management of selected public sector and private sector banks in India
(3) To study the impact of global financial crisis on the financial performance of selected public sector and private sector banks in India
(4) To study the viewpoint of the bank managers on the impact of global financial crisis on the banking sector
(5) To make suggestions to improve the performance of banks

1.8 CHAPTER PLAN OF THE STUDY

The thesis has been divided into eight chapters. The details are given below.

Chapter 1 Introduction

This chapter gives a detailed history of Indian banking and its evolution from banking in ancient times to its structure at present. It throws light on the importance of banking in the modern Indian economy and how it contributes to the betterment of lives of common people and corporates alike. The chapter also discusses at length the meaning of financial crisis, types of financial crises and the causes of financial crises.
It gives a detailed account of the Global Financial Crisis of 2007-08, its causes and its global impact.

Chapter 2  Literature Review
This chapter summarises various articles and research papers reviewed in the course of the study to identify the research gap. These articles are mainly with regards to various aspects of banking viz. growth of the banking sector in India, their fund management, financial performance, profitability and efficiency. Various articles related to financial crises in general and the Global Financial Crisis of 2007-08 to be specific have also been reviewed. This has been done to understand how the Global Financial Crisis has affected India and other countries.

Chapter 3  Research Methodology
This chapter gives the details of the methodology adopted for the current study. After discussing the significance of the study, it enumerates the objectives of the study, the hypotheses and the scope. It gives the details of the selection of the sample and data collection. Various analytical methods used for the study have been discussed in detail. It mentions how the study will be useful to the society at large and also the limitations of the study.

Chapter 4  Growth of public sector and private sector banks in India
This chapter discusses the growth of commercial banks in India after independence upto 1969 and that of public sector and private sector banks from 1969 to 2015 with reference to various parameters of growth.

Chapter 5  Impact of global financial crisis on fund management of public sector and private sector banks in India
This chapter discusses the fund management in the selected public sector and private sector banks, and how it has been impacted by the global financial crisis. Deposits, investments, advances, gross NPA, net NPA and total assets of these banks and ratios showing the soundness, liquidity and fund management of the sample banks have been studied for the 10 year period.
Chapter 6  Impact of global financial crisis on financial performance of public sector and private sector banks in India

This chapter analyses the financial performance of the selected public sector and private sector banks. Various financial parameters like owned funds, interest income, other income, interest expenditure, operating expenses, net interest income, operating profit and net profit of these banks and various profitability and productivity ratios have been studied to understand the impact of the global crisis on the financial performance of the sample banks.

Chapter 7  Analysis of bank managers’ views on impact of global financial crisis on the banking sector in India

This chapter analyses the primary data collected from bank managers as regards deposits, advances, non-performing assets, management, customers and technology in the banks, and also about the impact of the global financial crisis on various aspects of banking. Opinions of the managers to improve banking services have also been analysed.

Chapter 8  Conclusions and Recommendations

This chapter gives conclusions on the basis of the earlier analysis and also provides suggestions to improve the financial performance of Indian banks and thereby strengthen the Indian banking sector.

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REFERENCES


ANNEXURE 1.1
Names of Banks nationalized in India

Names of 14 banks nationalized in 1969
1. Central Bank of India
2. Bank of Maharashtra
3. Dena Bank
4. Punjab National Bank
5. Syndicate Bank
6. Canara Bank
7. Indian Overseas Bank
8. Indian Bank
9. Bank of Baroda
10. Union Bank
11. Allahabad Bank
12. United Bank of India
13. UCO Bank
14. Bank of India

Names of 6 banks nationalized in 1980
1. Andhra Bank
2. Corporation Bank
3. New Bank of India (acquired by PNB in 1993)
4. Oriental Bank of Commerce
5. Punjab and Sind Bank
6. Vijaya Bank

Source: Report on Currency and Finance, RBI, 2006-08
ANNEXURE 1.2
Scheduled Commercial Banks operating in India on 31-3-2016

Public Sector Banks

(a) SBI and its associates (6)
1. State Bank of India (SBI)
2. State Bank of Bikaner and Jaipur
3. State Bank of Hyderabad
4. State Bank of Mysore
5. State Bank of Patiala
6. State Bank of Travancore

(All 5 associate banks were merged with SBI with effect from 1-4-2017)

(b) Nationalised Banks (21)
1. Allahabad Bank
2. Andhra Bank
3. Bank of Baroda
4. Bank of India
5. Bank of Maharashtra
6. Bharatiya Mahila Bank Ltd. (merged with SBI with effect from 1-4-2017)
7. Canara Bank
8. Central Bank of India
9. Corporation Bank
10. Dena Bank
11. IDBI Bank Ltd.
12. Indian Bank
13. Indian Overseas Bank
15. Punjab and Sind Bank
16. Punjab National Bank
17. Syndicate Bank
18. UCO Bank
19. Union Bank of India
20. United Bank of India
21. Vijaya Bank

Private Sector Banks

(a) Old Private Banks (12)
1. Catholic Syrian Bank Ltd.
2. City Union Bank Ltd.
3. Dhanlaxmi Bank
4. Federal Bank
6. Karnataka Bank Ltd.
7. Karur Vysya Bank
8. Lakshmi Vilas Bank
9. Nainital Bank
10. RBL Bank
11. South Indian Bank
12. Tamilnad Mercantile Bank Ltd.

(ING Vysya Bank merged with Kotak Mahindra Bank with effect from 1-4-2015)

(b) New Private Banks (9)
1. Axis Bank
2. Bandhan Bank
3. DCB Bank Ltd.
4. HDFC Bank
5. ICICI Bank
6. IDFC Bank
7. IndusInd Bank
8. Kotak Mahindra Bank Ltd.
9. Yes Bank Ltd.
Foreign Banks (45)

1. AB Bank Ltd
2. Abu Dhabi Commercial Bank
3. American Express Banking Corp
4. Australia and New Zealand Banking Group Ltd
5. Bank of America NA
6. Bank of Bahrain & Kuwait BSC
7. Bank of Ceylon
8. Bank of Nova Scotia
9. Bank of Tokyo-Mitsubishi UFJ Ltd
10. Barclays Bank PLC
11. BNP Paribas
12. Citibank NA
13. Commonwealth Bank of Australia
14. Cooperative Rabobank UA
15. Credit Agricole
16. Credit Suisse AG
17. CTBC Bank
18. DBS Bank Ltd.
19. Deutsche Bank AG
20. Doha Bank QSC
21. Firstrand Bank Ltd.
22. Hongkong and Shanghai Banking Corporation Ltd.
23. Industrial Bank of Korea
24. Industrial and Commercial Bank of China
25. JP Morgan Chase Bank NA
26. JSC VTB Bank
27. KBC Bank NV
28. KEB Hana
29. Krung Thai Bank Public Company Ltd.
30. Mashreq Bank PSC
31. Mizuho Bank Ltd.
32. National Australia Bank
33. National Bank of Abu Dhabi PJSC
34. PT Bank Maybank Indonesia TBK
35. Royal Bank of Scotland NV
36. Sber Bank
37. SBM Bank (Mauritius) Ltd
38. Shinhan Bank
39. Societe Generale
40. Sonali Bank
41. Standard Chartered Bank
42. Sumitomo Mitsui Banking Corporation
43. United Overseas Bank Ltd
44. Westpac Banking Corporation
45. Woori Bank

Source: Statistical Tables relating to Banks in India, RBI, 2015-16