GLOBAL FINANCIAL CRISIS AND RESILIENT INDIAN BANKING SECTOR

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Abstract

In the times when banking sector had to face financial crisis worldwide and many banks had to be closed in USA and UK or survived on government bailout, it is really an achievement that Indian banking sector remained unaffected. Various authoritative reports on the crisis, such as Turner Review (2009) and Larosiere Report (2010) including latest Financial Crisis Inquiry Commission of the US (2011) have attributed the eruption of a financial crisis of such vast magnitude and impact to serious lacunae in the financial regulatory and supervisory framework. In the times of financial meltdown Indian banks could perform well mainly because of regulatory, supervisory and precautionary measures taken by the regulator. Worldwide, the shift to the better regulatory and supervisory framework, Basel II is to be adopted. Already all Indian Scheduled Commercial banks (SCBs) including foreign banks in India are ready to take Basel III from January 1, 2013 in phased manner which will further improve the soundness and resilience of Indian Banking Sector. This paper gives the overview of soundness and resilience of Indian Banking Sector even in the times of financial crisis based on the parameters of Capital Adequacy, Asset Quality, Return on Assets (RoA) and Return on Equity (RoE).

Introduction

The Global Financial Stability Report in Sept. 2011 has cautioned that for the first time since October 2008, the risks to global financial stability have increased, signaling a partial reversal in the progress made over the past three years. The US banking system, which showed signs of improvement in credit growth and profitability in 2010, now faces a serious question about whether this revival in the banking system would continue in the near future. The banking system in the Euro Zone, as a whole, stands vulnerable to mounting credit, market and funding risks as a result of severe deterioration in public finances in certain European countries. Further, many of these banks require recapitalisation to cushion them from the risk of sovereign defaults. In the UK too, banking system continues to be beleaguered by high leverage and weak asset quality. The impact of this financial crisis was so severe that many banks in USA and UK had to be closed or survived on government bailout. Table 1 below, shows the number of bank failures in the US. For the banks survived on government bailout the risk of sovereign defaults has increased. For the economies showing slight signs of improvement the question whether this improvement will continue in future, still remains unanswered.

Table 1: Number of Bank Failures in US

Year	No. of Bank Failures
2003-2007	11
2008	25
2009	140
2010	157
2011	92
2012 up to January	7

Source: FDIC (Federal Deposit Insurance Corporation)

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In 2010, the performance of the **US Banking System** showed signs of recovery since the time of the financial crisis but by historical standards, this recovery continued to be weak. The assets of the US banking sector showed an overall growth of 2.1% in 2009-10 from a negative growth of 3.9% in 2008-09. Credit was worst affected in the balance sheets of US banks due to the crisis. Growth in credit of US banks turned negative since Sept. 2009, and entered the positive zone only after a year in Aug. 2010 but showed signs of slowing down again in 2011. As per Annual Report of the Federal Reserve 2010, high levels of non-performing loans, particularly in the real estate sector, remained weakest spot in the US banking system. The deliquency rate (defined as loans past due for thirty days or more and still accruing interest as well as those in nonaccrual status) for real estate loans hit a high of 10% in the second quarter of 2010.

In **Euro Zone Banking System** concerns about revival in growth and credit to small and medium enterprises (SMEs) in the Euro Zone, rising sovereign risks have increased funding risks for Euro Zone banks. This is evident from a rising trend in Euribor (Euro Inter-bank Offered Rate) since mid 2010. Apart from their exposure to sovereign debt of their own country, cross border exposure to sovereign debt is also high for banks in some of the Euro area nations as shown in table below:

Table 2: Exposure to Sovereign Debt of Banks

(in Euro Million)

Country	Greece	Ireland	Portugal	Italy	Spain
Greece	56,148	-	-	-	-
Ireland	-	5,322	257	-	-
Portugal	1,739	839	17,707	1,179	345
Italy	1,778	239	304	1,44,856	1,383
Spain	1,016	-	6,807	6,017	2,03,310
France	11,624	2,476	4,864	48,185	6,592
Germany	18,718	12,922	10,888	72,717	31,854
UK	4,131	5,580	2,571	10,029	5,916
Netherlands	3,160	559	2,272	10,313	1,685

Note: The listing of select countries in the Euro area covers the major sources and destination of sovereign debt and is not exhaustive.

Source: Blundell-Wignall, A. and P. Slovik (2010), "The EU Stress Test and Sovereign Debt Exposures"*, OECD Working Papers on Finance, Insurance and Private Pensions,* No. 4.

UK banking system, in 2010-11 showed moderate de-leveraging but despite de-leveraging, the level of leverage still remained high for UK banks, which was cause of concern along with private credit growth remained considerably weak. Credit risks continued to be at elevated levels. In **Chinese banking system** weakening of asset quality was the main concern.

Soundness of global banks remained a concern on account of a slow process of deleveraging and increasing levels of NPAs. At the end of 2009, about 24 per cent of the top-100 global banks were highly leveraged with a Capital Adequacy Ratio (CAR) – a measure of financial leverage – of less than 4 percent; the percentage had come down moderately by 5 percentage points to 19 per cent at the end of 2010. There was a general weakening of the asset quality of top global banks.

Worldwide a serious thought was given on why this crisis happened at all. Various authoritative reports on the crisis, such as Turner Review (2009) and Larosiere Report (2010) including latest Financial Crisis Inquiry Commission of the US (2011) have attributed the eruption of a financial crisis of such vast magnitude and impact, to serious lacunae in the financial regulatory and supervisory framework. **The Turner Review: A regulatory response to the global banking crisis March 2009,** highlighted that Capital, accounting, and liquidity related issues played a central role. Inadequate capital against trading book positions allowed excessive leverage: changing patterns of maturity transformation created system-wide liquidity risk: mark-to-market accounting helped fuel a self reinforcing cycle of irrational exuberance. And when the crisis broke, banks did not have sufficient capital buffers to absorb losses, creating the danger of a self-reinforcing feedback loop between weak lending capacity, economic recession, and credit losses.

The High Level Group on Financial Supervision in the European Union chaired by **Jacques de Larosiere** says in its Report that “This report is published as the world faces a very serious economic and financial crisis. The European Union is suffering an economic recession, higher unemployment, huge government spending to stabilize the banking system, financial regulation and supervision have been too weak or have provided the wrong incentives. The report further says that repair is necessary and urgent and action is required at all levels – Global, European and National and in all financial sectors”. The report gives causes of the financial crisis which are as follows:

- Ample liquidity and low interest rates have been the major underlying factor behind the present crisis.
- Very low US interest rates helped create a widespread housing bubble. This was fuelled by unregulated, or insufficiently regulated, mortgage lending and complex securitization financing techniques.
- In the US, personal saving fell from 7% as a percentage of disposable income in 1990, to below zero in 2005 and 2006. Consumer credit and mortgages expanded rapidly.
- The credit expansion in the US was financed by massive capital inflows from the major emerging countries with external surpluses, notably China. By pegging their currencies to the dollar, China and other economies such as Saudi Arabia in practice imported loose US monetary policy, thus allowing global imbalances to build up.
- increase in leverage and even more risky financial products.
- The rapid recognition of profits which accounting rules allowed led both to a view that risks were falling and to increases in financial results. This combination, when accompanied by constant capital ratios, resulted in a fast expansion of balance sheets and made institutions vulnerable to changes in valuation as economic circumstances deteriorated.
- There have been quite fundamental failures in the assessment of risk, both by financial firms and by those who regulated and supervised them.
- This was aggravated further by a lack of transparency in important segments of financial markets – even within financial institutions – and the building up of a "shadow" banking system.
- Basel I framework did not cater adequately for, and in fact encouraged, pushing risk taking off balance-sheets. This has been partly corrected by the Basel II framework.

  The other reasons are categorized in various forms such as role of credit rating agencies, corporate governance failures, regulatory, supervisory and crisis management failures.

Indian Banking Sector in the Times of Crisis

Worldwide Basel II has been adopted or is to be adopted for better Capital Adequacy, Banking Supervision, Disclosure Norms / Market Discipline. These rules entered into force on 1 January 2008 in the EU and in the US on 1 April 2010. All Indian commercial banks, including foreign banks in India, migrated to the Basel II framework by March 31, 2009. This is because of these reforms that in the time of risks to global financial stability Indian banking sector could perform well and showed signs of stability. According to the assessment in the RBI Report on Trend and Progress in Indian Banking 2008-2009, some of the reasons for India's insulation from the consequential damage from the international banking and financial crisis are:

- The nascent stage of development of the credit derivatives market.
- Regulatory guidelines on securitization do not permit immediate profit recognition.
- Perseverance of prudential policies which prevent institutions from excessive risk taking and financial markets from becoming extremely volatile and turbulent.

Also in second FSR (Financial Stability Report), released by the Reserve Bank in December 2010, it is said that the financial sector remained stress-free notwithstanding intermittent volatility. The stress testing on credit, market and liquidity risks indicated a reasonable degree of resilience of the banking sector in India. Different aspects of financial soundness of the banking sector such as **capital adequacy, asset quality, leverage, credit booms and liquidity** show that Indian banking sector is sound in spite of global financial instability which has been explained in subsequent paragraphs.

Capital to Risk Weighted Assets Ratio (CRAR) -- The **CRAR** of all bank groups under Basel I and II remained well above the stipulated regulatory norm of 9 percent (though it is 8% under Basel norms and set at 9% by RBI) in 2010-11 as below:

Table 3: Capital to Risk Weighted Assets Ratio under Basel I and II – Bank Group-wise

(as at end – March)

				(Percent)
Bank Group	Basel I		Basel II	
	2010	2011	2010	2011
Public sector banks	**12.1**	**11.8**	**13.3**	**13.1**
Nationalised banks*	12.1	12.2	13.2	13.5
SBI group	12.1	11.0	13.5	12.3
Private sector banks	**16.7**	**15.1**	**17.4**	**16.5**
Old private sector banks	13.8	13.3	14.9	14.6
New private sector banks	17.3	15.5	18.0	16.9
Foreign banks	**18.1**	**17.7**	**17.3**	**17.0**
Scheduled commercial banks	**13.6**	**13.0**	**14.5**	**14.2**

* : Include IDBI Bank Ltd.

Source: (Report on Trend and Progress of Banking in India 2010-11)

Even with the proposed Basel III framework, which will become operational from January 1, 2013 in a phased manner, Indian banks will not have any problem in adjusting to the new capital rules both in terms of quantum and quality. Quick estimates based on the data furnished by banks in their off-site returns, showed that the CRAR of Indian banks under Basel III will be 11.7 per cent (as on June 30, 2010) as compared with the required CRAR under proposed Basel III at 10.5 per cent.

Asset Quality -- The **asset quality** of the banking sector improved in 2010-11 over the previous year. The gross NPAs to gross advances ratio declined to 2.25 per cent in 2010-11 from 2.39 per cent in the previous year. The improvement in asset quality was visible in both private sector banks and foreign banks. Public sector banks, however, witnessed deterioration in asset quality in 2010-11 over the previous year. This was mainly due to deterioration in asset quality of the SBI group. Among the bank groups, SBI group reported the highest GNPA ratio followed by foreign banks in 2010-11. Foreign banks, however, registered a decline in gross non-performing loans in 2010-11 over the previous year. During the year 2010-11, the banking sector has written off almost ten per cent of the outstanding gross non-performing loans (as at end-March 2010), which helped in limiting the growth of gross non-performing loans. The extent of write off was lower in 2010-11 as compared with the previous year, however, in comparison with 2008 and 2009, the ratio was on the higher side. This indicated that during the last two years, writting off of NPAs was an important factor in maintaining the asset quality of the banking sector at tolerable levels.

Recovery of GNPAs is another important component of asset quality management in the banking sector. During the year 2010-11, the banking sector recovered 57 per cent of the outstanding GNPAs (as at end-March 2010) through various recovery channels. The restructuring of advances undertaken by the banking sector during the recent years also helped in reducing the GNPA ratio of the banking sector. **Slippage ratio** calculated as addition of gross NPAs during the year as a per cent of outstanding standard assets of the previous year is another important indicator of asset quality. The slippage ratio, which increased consistently since 2008, witnessed an improvement in 2010- 11, broadly reflecting the recovery of growth.

Leverage Ratio -- Despite the higher growth in balance sheet during 2010-11, the **leverage ratio**, as in the previous year, remained constant at 6.6 per cent in 2010-11 owing to the corresponding growth in the capital base of the banking sector.

Credit Boom -- From the point of view of banking sector stability, it is important to monitor the development of credit bubbles in the economy. Credit booms can seriously undermine the financial soundness of the banking sector owing to deterioration in credit quality. As per the Coricelli methodology, a credit bubble or boom is present when the cyclical component of credit exceeds 1.5 times the standard deviation of the cyclical credit. The analysis indicated that the robust credit growth during 2010-11 did not lead to development of any **credit boom** in the economy both at the aggregate and sub-sectoral level.

Liquidity -- During 2010-11, banks were operating under tight liquidity conditions. The Liquidity Adjustment Facility (LAF) window of the Reserve Bank, which had remained in surplus mode for nearly 18 months, switched into deficit mode at end-May 2010 and largely remained in deficit for rest of the financial year 2010-11. Autonomous factors like the centre's surplus balance with the Reserve Bank and currency in circulation were key drivers of liquidity conditions in 2010-11. The liquidity conditions have continued to remain in deficit mode during 2011-12 so far.

After the financial crisis, the BCBS (Basel Committee on Banking Supervision) has taken a number of initiatives with a view to improving the banking sector's ability to absorb shocks arising from financial and economic stress and to reduce the risk of spillover from the financial sector to the real economy. It may be recalled that the BCBS had issued certain enhancements to Basel II Framework, including amendments to the market risk framework in July 2009, which were implemented by the Reserve Bank with effect from March 31, 2010. In December 2010, the BCBS released a comprehensive package of further reforms which, together with the July 2009 enhancements, is known as the Basel III framework. This reform package aims at

(i) increasing the quality and quantity of the capital with greater emphasis on common equity;
(ii) increasing the risk coverage;
(iii) introducing a leverage ratio as a back stop to the risk-based capital ratio;

(iv) introducing capital conservation and counter-cyclical capital buffers to ensure build up of additional capital in good times, thereby protecting banks from the dangers of excessive credit growth. Besides, the Committee has also introduced liquidity ratios with a view to ensuring that banks maintain adequate liquidity buffers and reduce maturity mismatches.

RBI has already indicated that from January 1,2013 Basel III will be implemented in all Scheduled Commercial banks including Foreign Banks in India in a phased manner. These type of reforms will further improve the soundness and resilience of Indian Banking Sector. **Turner Review** has also stressed that the most fundamental changes required to create a sounder banking system for the future are those relating to capital adequacy, accounting, and liquidity policies. The review sets out the seven key measures required:
(i) Increasing the quantity and quality of bank capital.
(ii) Significant increases in trading book capital: and the need for fundamental review.
(iii) Avoiding procyclicality in Basel II implementation.
(iv) Creating counter-cyclical capital buffers.
(v) Offsetting procyclicaality in published accounts.
(vi) A gross leverage ratio backstop.
(vii) Containing liquidity risks: in individual banks and at the systemic level.

India has adopted the international regulations timely and effectively after the guidelines were issued by the RBI after careful examination and evaluation of the same. The Reserve Bank has developed a framework to conduct the Supervisory Review and Evaluation Process (SREP) in banks under Pillar 2 of Basel II. One of the major objectives of SREP is to evaluate whether the capital maintained by the bank is adequate keeping in view its risk profile and to determine the supervisory capital ratio (SCR). The SCR would be determined for each bank separately. Under this framework, the adequacy of the risk management and internal control framework of banks would be subjected to in-depth assessment. In order to strengthen the supervisory process the SREP framework for banks from the inspection cycle 2010-11 has been implemented as an integral part of the Annual Financial Inspection (AFI) of banks. Further to ensure effective cross border supervision and supervisory cooperation it is planned to enter into bilateral MoU with overseas supervisory authorities within the existing legal provisions consistent with the BCBS principles. Though Indian banking sector seems sound and resilient there are many areas which needs to be strengthened such as penetration into rural areas, adopting financial inclusion in bank policies and strengthening itself through consolidation. Instead of large number of small banks we should have small number of large banks which will improve the capital base of the bank and can be competitive in International market. This will also enable them to lend for large infrastructure projects as well as withstand the credit risks involved in such lending. Though quality wise Indian banks have sound capital, it lags behind in terms of quantity in comparison of top banks of the world. The new and latest methods for risk assessment and evaluation should be adopted. The use of latest technological tools should be enhanced in banking. Already sound and resilient Indian banking sector can match the world order and compete with the top global banks to find its place there in near future.

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