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ORIGINAL ARTICLE

IMPACT OF FINANCIAL CRISIS ON INDIAN BANKING SECTOR – A CASE STUDY OF STATE BANK OF INDIA

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Abstract:

Financial crisis has affected the world's banking sector very much. In this paper, we discuss the consequences of financial crisis on Indian banking sector by focusing on State Bank of India, one of the major bank of India. We focus on, how the functioning of State Bank of India gets affected by the crisis. We also look at the steps taken by the Indian government, central bank (Reserve Bank of India) and the State Bank of India to deal with the crisis. Further, we see the lesson learned from the crisis and future strategy of SBI to act effectively and safely in world market.

KEYWORDS:

Financial crisis , strategy of SBI , sub-prime mortgage .

INTRODUCTION

Recent financial crisis, which was started in the US, due to the problems that grew in large-scale defaults in the US sub-prime mortgage market and associated market for complex credit derivatives has affected the whole world's financial system and results in closing down of many financial institutions. In this paper, we will see how the Indian banking system gets affected by the crisis and the steps taken by Central banks and government to overcome the effects of crisis.

AIM AND OBJECTIVE

The main aim of the study is to investigate how the recent financial crisis affected the Indian banking sector by taking the example of State Bank of India and what are the measures taken by Indian central bank and government of India to deal with the crisis.

2Objective of the study is firstly, to understand the concept of financial crisis and its effects on State Bank of India. Secondly, is to find out the policies and planning of central bank and Indian government at the time of crisis. Thirdly, is to investigate the steps taken by State Bank of India (or central bank) and government to overcome the effect of financial crisis and fourthly, is to know about the further strategy of Indian bank to avoid any kind of crisis effects.

BACKGROUND

Due to the financial crisis there has been huge fall in stock markets across the world. Many countries responded aggressively and unconventionally way to maintain the stability of the market; many countries like Iceland, Ukraine are rescued by IMF (Mujumdar 2012). Financial crisis leads to the shortage of liquidity in the market, Reserve Bank of India had taken some steps to extenuate the liquidity risks (Mohan 2008). India experienced a reversal of capital inflow and also large downturns in the domestic stoke market due to heavy sell-off by foreign institutional investors (FIIs). Reduce interference of Indian entities to external funds and the withdrawal by FIIs results into the lack of dollar liquidity in domestic

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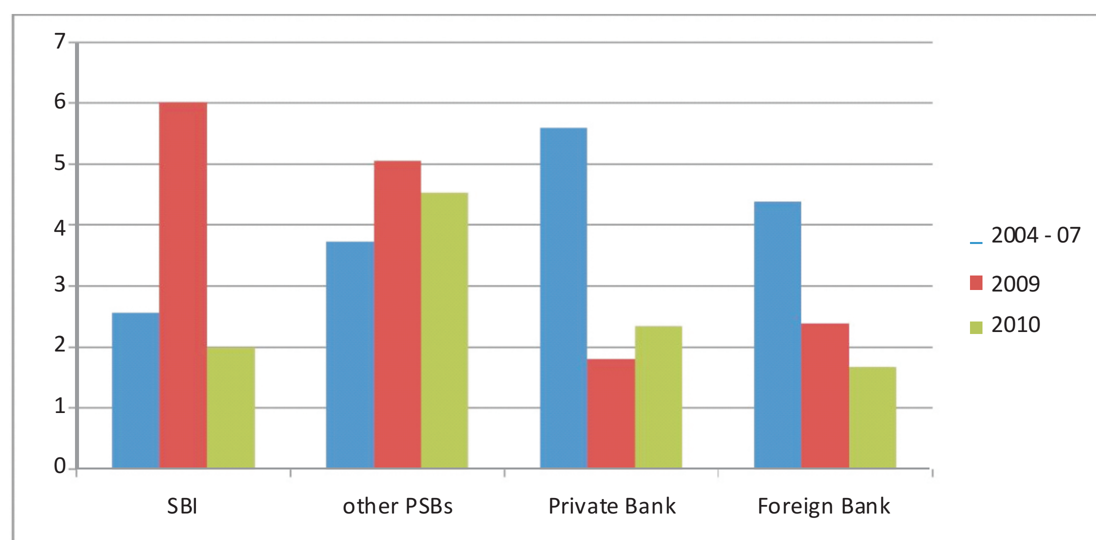
foreign exchange market. This further, adversely affected the balance of payment outlook, and leading to downward pressure on the Indian rupee and increased foreign exchange volatility. Financial sections like mutual funds and non-banking financial companies came under pressure because of cut down in foreign funding and subdued capital market. As the external source is drying up, the demand for bank credit had increased. In result of this, Reserve Bank of India entered with liquidity supplying measures and the government used fiscal stimulus measures in the form of tax relief encourage demand and increase in public project expenditure to create employment and public assets. (Sinha, Bajpai 2011).

LITERATURE REVIEW

Indian Banking Sector was not much affected by the sub-prime crisis of US, as Indian banks share in global exposure is small with international assets of 6% of total assets. The main problems of Indian banks are basically increased cost of borrowing, slow GDP growth, high interest rate and depressed capital market. Exceptionally, there have been certain Indian banks which suffered because of credit spreads on term liquidity due to sub-prime crisis (Karande, 2012).

3The crisis affects the deposit growth of the Indian banks. State Bank of India experienced rapid growth in deposit in the year 2009 but suddenly faced downfall in the year 2010. Private Banks indeed experienced slower deposit rate during and after the crisis. As the deposit of bank increases in 2009, the profit of SBI also increases from Rs.6,718.08 (in crore) in 2008 to Rs.9,124.18 (in crore) but had shown a slight downfall in profit of year 2011 of Rs.893.48 (in crore) from year 2010 (Economic Times). Crisis had affected negatively to Gross NPAs of SBI which declined marginally to 2.84% in FY-09 from 3.04% in FY-08, Net NPA level too was practically stable at 1.76% as against 1.78% in FY-08 (Bhatt, 2009).

Deposit Growth



Source: Gupta and Eichengreen, 2012

The reason behind the increase in deposit of State bank of India is neither only the tendency of depositors to favour healthy banks with stable funding, nor the explicit capital injection by the government. The main reason was that the investors go toward the SBI with the impression that their deposit enjoys an implicit government guarantee, while other banks will destabilized in the crisis period. As the other banks will have to hold more capital and maintain more liquidity to reassure depositors, which will affect their competitive advantage and it is not clear in extreme circumstances that any level of capital and liquidity will sufficient. In addition, the perception that public-sector banks, and larger public-sector banks 4especially, enjoy an implicit guarantee is a moral hazard that limits the incentive to enhance efficiency and may encourage excessive risk taking (Mostly Economics).

The rating of State Bank of India on October 4, 2011, was reduced to D plus from C minus by the Moody's —one of the big three rating agencies, Standard & Poor's and Fitch Ratings being the other rating agencies – on its financial strength (basically credit worthiness) because of SBI's over deteriorating asset

quality and adequacy of capital. The problem which SBI was facing is totally different from what banks in the advance countries were facing. In advance countries, most of them had contributed to the global financial crisis through their reckless lending and underwriting practices, especially in the sub-prime home loan mortgage segment. In contrast, SBI and other banks in India weathered the crisis admirably backed as they were by some enlightened regulation. Whatever the problems SBI was facing they were certainly not due to past recklessness. Yet, in a rising interest rate scenario and economic slowdown, the quality of its assets had come under strain. The Tier-I capital ratio of SBI at 7.6% as on June 30, 2011, was also below 8% that the government had committed to maintain for public sector banks (Narasimhan, 2011).

As a result of global liquidity squeeze, the overseas funding for bank and corporate were dried up, forcing corporate towards domestic banking sector for their credit demand. Due to global deleveraging process, the foreign exchange market came under pressure. Shortage of liquidity rises as the RBI intervenes in the foreign exchange market to manage the volatility in the rupee (Subbarao, 2009). The situation turned to worse by slowing economy and inflationary condition in India. Rising uncertainty and the depreciating value of rupee has negatively affected the India business market, which forced the RBI to take an anti-inflationary measure (Goenka and Dasgupta, 2012). As a controller of all public sector banks RBI took the following steps. The first step taken by the RBI in the first half of the year 2008-09 was related to controlling monetary expansion, in the view of evident relation between monetary expansion and inflationary expectations partly due to the perceived liquidity overhang. In the first six months of 2008-09, year-on-year growth of reserve money was higher than the growth of broad money. Several fiscal and administrative measures were taken by the government during the first half of 2008-09 to rein in inflation. The key policy rates of RBI thus moved to signal a contractionary monetary stance. The repo rate (RR) was increased by 125 basis points in three tranches from 7.75% at the beginning of April 2008 to 9.0% with effect from August 30, 2008. The reverse-repo rate (R-RR) was however left unchanged at 6.0%. The cash reserve ratio (CRR) was increased by 150 basis 5points in six tranches from 7.50% at the beginning of April 2008 to 9.0% with effect from August 30, 2008 (Bajpai, 2011). RBI imposed U.S. Glass-Steagal Act of 1933, which insulates banks from capital market exposure. The RBI implemented rigorous capital adequacy requirements and if any financial institution or bank exceeded the specified limits of exposure to stock markets, it would have to provide more capital (Karande, 2012).

In response of these, both conventional and unconventional measures were undertaken. The conventional measures included, first, a reducing the policy interest rates – the effective policy rate was brought down from 9% (repo rate) in September 2008 to 3.25% (reverse repo rate) in April 2009.Second, the cash reserve ratio was cut down from 9.0% in September 2008 to 5% in January 2009 with a view to injecting liquidity into the banking system. Third, huge amount of liquidity was introduced through purchase of government securities under open market operation (OMO) and unwinding of the balances under Market Stabilization Scheme (MSS) through buy-back, redemptions and de-sequestering. Fourth, refinance facilities for export credits were enhanced. Steps were also taken for increasing foreign exchange liquidity which included an upward adjustment of the interest rate ceiling on the deposits by non-resident Indians under FCNR (B) and NRE deposit accounts and relaxation in norms for external commercial borrowings (ECB). The unconventional measures taken by the Reserve Bank of India included; institution of a rupee-dollar swap facility for Indian banks to give them comfort in managing short-term foreign funding requirements of their overseas branches; special liquidity support to banks for on-lending to mutual funds and nonbanking financial companies; liquidity support to non-banking financial companies through a special purpose vehicle created for the purpose and expansion of the lendable resources available to apex finance institutions for refinancing credit extended to small industries, housing and exports. The measures undertaken by the Reserve Bank during September 2008- July 2009 have resulted in augmentation of actual/potential liquidity of Rs. 5, 61,700 cr. (Sinha).

Governor of RBI Mr. Subbarao has mentioned the some of the lesson learned from the recent crisis which we will see in a brief. Firstly, he stated the decoupling does not work in globalising world. Secondly, Global imbalance needs to be redressed for the sake of global stability. Thirdly, global problem require global solution. Fourthly, financial stability is not guaranteed by price stability and macroeconomic stability. Fifthly, micro prudential regulation and supervision need to be supplemented by macro prudential oversight. Sixthly, capital controls are not 6only unavoidable, but advisable in certain circumstances. Seventhly, economic is not physics and lastly, having a sense of economic history is not important to prevent and resolve financial crisis (Subbarao, 2011).

On the basis of lesson learned from this crisis, Dr. K.C. Chakrabarty, Deputy Governor of Reserve Bank of India lay down some key to design an effective crisis management framework. Firstly, responsibility for financial stability should be clearly assigned amongst different agencies and there should be proper coordination among them. Secondly, as every crisis is different from other, therefore crisis management plans need to be flexible. Thirdly, appropriate balance should be maintained between rules

and judgement through the framework of crisis management. While rules foster transparency and aid in avoiding moral hazard, use of judgment is critical as crises or crisis like situations differ from one another and warrant suitably "customised" solution. Fourthly, accessibility of accurate, relevant and timely information is the key for any effective framework for financial stability. Fifthly, crisis management framework needs to be dynamic and responsive to the evolving macro financial environment and developments in the financial markets. Most importantly, the framework should be, and should continue to remain, commensurate to the degree of complexity in the financial system. Sixthly, certain crisis management need to be coordinated, approved and acceptable internationally. As without adequate preparation and groundwork, efforts to manage crises by authorities in different countries could become a demonstration of the Prisoners' Dilemma where each country looks out for itself. Lastly, transparency in any framework of crisis management, especially during the crisis, helps to add credibility of policy initiative and can help prevent panic.

RESEARCH QUESTIONS

How the working of the State Bank of India was affected by the global financial crisis?
What are the strategies followed by the State Bank of India, Central Bank and the government of country to overcome the effect of financial crisis?
What are the lessons learned from this event?
What is the future planning of State Bank of India and the government in order to play profitably and safely in global market?

SIGNIFICANCE

To improve public understanding towards the effect of financial crisis on banking sector of India.
To act as a guideline for the reader to know how to deal with any kind of crisis.

METHODOLOGY

The research mainly focused on the effects of financial crisis on Indian banking sector by focusing on the State Bank of India, and the measure taken to overcome the effects of crisis by the SBI or central bank (RBI) and government of the country. Following sections will describe the way in which the current research has been conducted to fulfil the goal of the research.

Research Approach

Research is conducted by using mixed (qualitative and quantitative) approach, using the previous research material for collecting information and using that information as basis to investigate new development in the particular field of research.

Research Method

Survey research method is used to conduct this research. The reason behind using this particular method is that, the survey research method provides different kinds of way for collecting information from different geographical areas through interview, questioner, mail, internet, telephonic interviews etc. (Connaway and Powell 2010). The consequences of the crisis on Indian banking sector and the measures taken is described using the data collected from different source, statistical data of the changes in different interest rates and ratios are also mentioned to explain the situation and to support the theory. Purposive sampling technique is used to select the participants on the basis of their background experience and current positions (Cohen and Manion, 1994).

Population

The population involve in this study are mostly employee of State Bank of India and central bank from the different branches of State Bank of India in India and in London. Sample includes branch managers, Asst. managers, and General Managers of State Bank of India and Reserve Bank of India.

Data Collection

In the beginning, information will be collected through different journals published on the topic, official websites of bank and through academics books. Further, in the process of gathering information, questioner will be sent to different employees of State Bank of India through mail, telephonic interview will be undertaken with selected managers. For collecting information about working of SBI in foreign market, questioner and the interview will be undertaken of the mangers working in London branches of SBI. Detailed information of the effects and measures taken will be collected from the speeches delivered by the managers of Reserve Bank of India and State Bank of India on the related topics.

Data Analysis

The collected information will be analysed through various data analysis methods, depending upon type of data i.e. quantitative or qualitative. Comparative study will be under taken of the interest rates, different kinds of ratios, lending policies etc. before and after the crisis. The Statistical Package for Service Solution (SPSS) software will be used as per requirement.

Timescale

February 2012: Review of literature

March 2012: Research method selection and preparation of questioner.

April 2012: Data analysis and findings

May 2012: Completion of report

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