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GLOBAL FINANCIAL CRISIS: AN INDIAN CONTEXT.

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Abstract: *The financial crisis that originated in the United States in 2007-08 became a global financial crisis unprecedented since the Great Depression of the 1930s. Since mid-september of 2008 financial markets had collapsed and the world entered into possibly the worst recession of the post-second world war period. We shall consider the probable cause of the financial crisis and also the likely influence of the financial crisis on the Indian economy. Section I discuss the contributing factors behind the financial II considers the impact on the Indian economy.*

Keyword: Financial Crisis, Bankrupt, Markets, Contributing, Management.

Introduction: On 15th September 2008 lehman Brothers, 158 years old investment bank having branches all over the world, applied to the Bankruptcy Court for declaring it bankrupt. On 26th September Washington Mutual, another large investment bank declared itself bankrupt. Two housing bank, federal National Mortgage association (popularly known as Fannie Mae) and federal Home Loan Mortgage Corporation (popularly known as Freddie Mac), suffered huge losses and the U.S. Government had to take over them. American International Group (AIG), a giant Company offering insurance and other financial services suffered so badly that Federal Reserve had to come forward to help it survive. Merry1 Lynch, one of the largest wealth management banks of the world became so sick that it had to be taken over by the Bank of America. Apart from these big banks large number of small mortgage banks and investment banks also became bankrupt. As a result of these failures of banks there was crash in the stock market also. The crisis started in the U.S. economy but it spread to other countries of the world.

Consider now the *contributing cause* of the financial crisis in the U.S. economy. The seeds of the crisis were sown in the good times, characterized by a lax monetary policy and a free macroeconomic environment. Monetary policy of low interest rates was initiated in response to the collapse of the new economy "bubble" and then the post-9/11 recession of 2001. In 2001 Fed rate was reduced from 6 per cent to 1.75 per cent (Fed rate is the rate at which Federal Reserve System lends

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money to the commercial banks. It is similar to repo rate in our country). In 2002 it was reduced to 1.25 per cent and in 2003 it was reduced to 1.00 per cent which was the lowest in 50 years. An enormous amount of liquidity was pumped into the global monetary system during 2001-05. In fact, in order to deal with the economic down turn following the stock market crash, the Fed has driven the cost of capital significantly below the natural rate for over four years. The artificially low interest rate made excessive risk taking possible, leading to the *sub-prime crisis.*

Sub-prime Crisis: Let us first explain sub-prime crisis. When a bank gives loan it gives priority to prime borrowers. Prime borrowers are those borrowers who have good credit rating and whose past records on loan repayment are satisfactory. The rate of interest charged on lending to prime borrowers is known as *prime lending rate* (PLR). This PLR is comparatively low because there is less risk in lending to prime borrowers. Sub-prime borrowers are those borrowers whose credit rating is not high and who do not have satisfactory credit history. Many of them may be first time borrowers who do not possess any credit history. It is obvious that there is greater risk associated with sub-prime lending and consequently the rate of interest charged on such loans is also high.

While giving loans banks will prefer prime borrowers. But the number of prime borrowers is not very large and all banks try to extend loans them. Prime borrowers then bargain for lower interest rates. Hence banks have to find new borrowers to give loans as they have huge funds and they can also get funds from the Fed at very low rate of interest. The banks then turned to sub-prime borrowers who mostly belonged to lower middle class. Marketing agents of banks made them agreeable to take loans from banks. Most of these loans were housing loans. Apart from housing loans there were also car loans, credit cards. Loans for household consumer durables etc.

In the USA, however, there is a system of giving loans to sub-prime borrowers. There are certain banks who have earned proficiency in giving loans to the sub-prime borrowers. There are also provisions for giving some loans to sub-prime borrowers by banks and other financial institutions. If the sub-prime borrowers repay their loans regularly they will be treated as prime borrowers next time when they take loans. However, without any discrimination banks and other lending institutions began to give more and more loans to the sub-prime borrowers. Most of these loans were housing loans. This is so because after food and clothing, housing is the third necessity. Everybody tries to have a home of his own. When housing loan is granted by a bank, the house purchased is kept as mortgage with the bank. If the borrower defaults to pay back the loan the bank will sell the house to get back money. No body likes to lose own house and hence it is expected that loan repayment will be regular.

The government also encouraged housing loans. It has been alleged that Bill Clinton (1993-2001), after coming to power, extensively rewrote the rules of Fannie and Freddie and pushed the social case for wider home owning. The scenario did not change much during the regime of George Bush also. With incentives for aggressive loan disbursements, banks poured billions of dollars of loans into poor households often with incomplete documentation. The share of mortgage originations that were sub-prime increased from 5% in 2001 to more than 20% in 2006. Housing prices continued to increase up to the middle of 2006 and there was bubble in the housing market. Between 2001 and 2005, US home owners enjoyed an average increase of more than 54% in value of their houses.

Unfortunately, a considerable part of the large amount of money advanced as loan to the sub-prime borrowers became bad debts. The borrowers were financially weak. Moreover, soaring oil prices and food prices and the high rate of inflation crippled the purchasing power of the borrowers. They became unable to repay housing loans. Banks then took the possession of mortgaged houses and tried to sell them in order to get back the money lent. The banks could not recover the amount due because house prices were now falling. Banks suffered a serious liquidity crunch and a crisis arrived which is known as the sub-prime crisis.

Now, the question is : *why should a bad loan taken by a lower middle class family in the USA lead to an unprecedented global financial crisis?* After all, we know that if a borrower is unable to repay a loan taken from a bank, then the bank has to make provision for this bad debt. If the bank does not make provision for this bad loan, it is the duty of the bank inspector to catch this failure. Were both banks and bank inspector lax?

Securitization: The sins of a bad loan got translated into a global misfortune through a complex process known as *securitization.* Let us now first explain this process. Gone are the days when the loans given to customers continue to sit on the balance sheet till when the borrowers repay the loan. As this was seen as keeping the asset idle in the balance sheet, an innovation called securitization took place in the commercial and investment banking industry. The process of securitization can be explained with the help of an example. Suppose Bank A gives housing loan of Rs. 1,00,000 each to 10 borrowers for 20 years at the rate of interest of 10% p.a. Then bank A can get interest income of Rs. one lac p.a. from these loans. Instead of waiting for 20 years for the repayment of the loan by the borrowers Bank A creates a security return from which a equal to the annual interest income of the housing loan i.e. Rs. One lac. Bank A sells the security to Bank Bwhich will get the interest income from housing loan offered by Bank A for 20 years. The value of the security will be around Rs. 20 lac. Suppose Bank B purchases the security for Rs. 16 lac. It is profitable for Bank A because it will not have to wait for 20 years. It can also avoid the credit risk. It can now give new loans from the money received from the sale of securities and can again engage in securitization. Bank B can again mortgage the security with Bank C and can take loans. If Bank B is an important bank it is possible that it can get loans of more than Rs. 16 lac on the basis of mortgage of security of Rs. 16 lac. Bank B can invest this sum and on the basis of income to be earned from this investment, Bank B can also create new securities which it will sell to other banks. In this way large number of securities can be created on the basis of initial housing loans granted by Bank A. The values of these securities are delivered from the value of home loans granted by Bank A and for this reason this securities are called derivatives. Now, if for any reason, the borrowers of home loans of Bank A become defaulters, the securities held by Bank B become valueless. The securities mortgaged by Bank B also become valueless. In this way all the derivatives created in successive stages become valueless when the borrowers of Bank A fail to pay interest on home loans. If home prices fall Bank A cannot even recover its principal sum by selling the mortgaged homes. Securities created in different stages on the basis of home loans granted by Bank A form, as if, a house of cards. The house collapses when the base card is withdrawn. Then all banks do not want to give further loans. This results in a financial crisis.

Securitization in the U.S.A.: Let us now she how this securitization process has worked in the U.S.A. The U.S.A does not have a system of preferential lending rates for small housing. Instead it has *government sponsored enterprises* (GSEs). The GSEs tend to enhance the availability of credit and reduce the cost of credit to the three targeted borrowing sectors-agriculture, housing and education. The largest GSEs operate in the residential mortgage borrowing sector. Apart from the government owned corporation, Government National Mortgage Association (known as Ginnie Mac), Fannie Mae and Freddie Mac are the two GSEs in the housing finance market. Fannie Mae and Freddie mac stand behind mortgages in two ways. First, they purchase mortgages, bundle them together, and then sell claims on the cash flows to be generated by these bundles. These claims are known as *mortgage backed securities* (MBS). *Second*, they buy mortgages or their own mortgage backed securities outright and finance those purchases by selling debt directly in the name of the GSEs. Thus, the GSEs can either sell the mortgage backed securities to other investors or retain the securities for themselves.

Although both Fannie and Freddie are private companies, as GSEs established by federal law, they receive special privileges. The most important of these privileges is the nation of an implicit guarantee so that the investors tend to believe that if these GSEs are threatened with failure, the federal government will come to their rescue. The implicit guarantee implies that profits are privatized but losses are solicited. If Fannie and Freddie do well, their stock holders reap the benefits, but if things go badly, Washington picks up the tab. “Heads they win, tails taxpayers lose” type of situation is this.

High Leverage: The US and the advanced countries’ mortgage market during 1990s were flooded with scrutinized products like MBS. The process involved parting of loans on the part of the banks (who extended the loans) to GSEs or investment banks, who after bundling them into MBS, would sell them to investors, who again could turn them into derivative instruments like *Collateralized Debt Obligations or Structural Investment Vehicles.* Since each of these processes highly leveraged, at each stage the value goes higher so that finally the total value of the structured products becomes a multiple of the value of the original home for which the initial loan was disbursed to begin with. For example while commercial banks cannot leverage their equity more than 15 to 1, Lehman Brothers had a leverage of more than 30 to 1. Zingales noted that with such a high leverage, a more 3.3% drop in the value of assets could wipe out the entire value of equity and make the company insolvent. Thus high leverage, the lack of paper work, absence of transparency, all made these derivative products toxic. Billion of dollars have been invested by investment banks and financial institution from all over the world in these toxic products. The life blood of these products lies in the loan repayment of the housing loans. When these borrowers defaulted, the banks giving loans were in trouble. So were the position of investment banks who dealt with derivative based on home loans.

Fair Value Accounting (FVA): It has been alleged that the credit crisis has been accentuated by the introduction of *Financial Accounting Standard No. 157, Fair Value Measurement* in September,2006. This standard defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". Since the market for a number of structured products became non-existent during the period of the financial meltdown financial institutions suffered huge losses on account of valuation. For example Lehman Brothers announced losses (mark to market losses) approximating $7 billion on residential and commercial mortgage related positions immediately preceding the company's downfall. It has been argued that fair value accounting aggravated the meltdown in the banking system and forced investment and commercial banks to write down well over $100 billion in asset.

Investment bankers held three criticisms against fair value accounting. *First.* The reported losses are misleading because they are temporary and will reverse as markets return to normal. *Second,* as fair values are difficult to estimate there are issue relating to their reliability. *Third,* reported losses have adversely affected market prices yielding further losses and increasing the overall risks of the financial system.

However, to blame the huge losses of the sub-prime crisis on the FVA is patently unacceptable. "Blaming FVA for the credit crisis is something like going to a doctor for a diagnosis and then blaming him for telling you that you are sick".

Role of Credit Rating Agencies: The role of credit rating agencies in the financial crisis has also been mentioned. As many structured products like MBS or CDOs do not have a market *per se*, their valuation depended heavily on the rating agencies. The blame placed on the rating agencies came from the downgrading of different structured products. It has been argued that the rating process is not transparent. The rating agencies did not always document significant steps in the rating process. The rating agencies cannot, therefore, avoid their responsibilities for the financial crisis of 2007-08.

Consider now the impact of the global economic crisis on the Indian economy. Some impacts can be mentioned.

First, one private bank of India had purchased some securities of Lehman Brothers and this bank has been adversely affected but the loss is not very high.

Second, export trade of India has also been adversely affected because of global economic crisis. Adverse effect is also visible on information technology and B.P.O. sectors which cater to foreign clients.

Third, because of liquidity crunch in their own countries, foreign institutional investors (FIIs) have sold their holdings of Indian stocks in the Indian stock exchanges. As a result of these sales share prices have fallen considerably and this has been reflected in the falling sensex.

Fourth, along with falling sensex there has been fall in the value of Indian rupee in terms of U.S. dollar. This is because foreign institutional investors are purchasing U.S. dollars by offering rupees. There is an excess demand for dollars leading rise in the price of dollars in terms of rupees.

Fifth, as FIIs are selling Indian rupees to purchase dollars, rupees are surrendered to the RBI. As a result money supply with the public decreases. This has created a liquidity crunch in India also. Banks in India are giving less loans and investment in several sectors is decreasing. There has set in a recessionary tendency in several sectors such as automobiles, real estate, air transport, hotels, shopping malls, banks, insurance etc. the rate of growth of industrial production has slowed down which is an indicator of recession.

It should be noted that public sector banks and other financial institutions in India are more protected from crisis than the U.S. banks. This is so because banks and financial institutions in India cannot take too much risk like U.S. banks. Bank in India are subject to many restrictions imposed by the RBI and the Ministry of Finance of the GOI. These restrictions protect our financial system from exposure to too much risk. In 1997 also when there was a crisis in the Asian economies, Indian economy was more or less insulated from that crisis.

Some commentators argue that the influence of the recessionary tendency in the Indian economy is limited to organized private sector, affecting only the higher echelons of the society. It will not percolate to the lower levels. Moreover, the recession has little or no effect on agriculture and public sector. Hence the recession cannot be strong in India. This view is, however, not true. When recession affects sectors like banks, insurance, information technology, exports, B.P.O etc, large number of persons lose their jobs in these sectors. This loss of employment and consequent income loss will affect the market for commodities. There is lower demand for cars, durable consumer goods, houses, occupancy in hotels, air travel etc. Many people in the unorganized sector such as construction works, employees working in hotel and restaurants, car drivers, security etc will also be adversely affected by the recession in the organized sector. Even if we assume that the recession will not affect agriculture and public sector it is not sufficient to save the economy from the clutches of recession because the contribution of agriculture in GNP is about 25% and the importance of the Public sector has also declined considerably after the adoption of the new economic policy of liberalization, privatization and globalization since 1991. Moreover, international exposure of the Indian economy has increased very much after the introduction of globalization. Hence it can be said that unless appropriate measures are adopted by the government, Indian economy cannot avoid the effects of global economic crisis. To get rid of the crisis the government will have to prepare a comprehensive plan of action.

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