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The financial crisis and Indian banks: Survival of the fittest? ☆



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The Indian banking system was initially thought to be insulated from the global financial crisis owing to heavy public ownership and cautious management. It was thus a surprise when some banks experienced deposit flight, as depositors shifted their money toward government-owned banks and specifically toward the State Bank of India, the largest public bank. While there was some tendency for depositors to favour healthier banks and banks with more stable funding, the reallocation of deposits toward the State Bank of India cannot be explained by these factors alone. Rather it appears that the implicit government guarantee of the liabilities of the country's largest public bank dominated other considerations.

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1. Introduction

The Indian banking system was initially thought to be insulated from the global financial crisis owing to heavy public ownership and conservative management. But to the surprise of many observers, private banks in particular experienced a sharp increase in interbank borrowing rates and deposit flight from mid-2008. Between June and December 2008, deposits in the largest private

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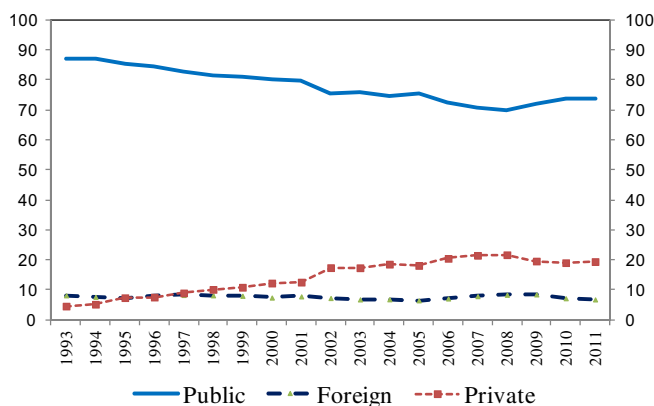


Fig. 1. Share in assets across ownership groups.

bank, ICICI, dropped by a tenth as depositors shifted their money to government owned and operated banks. Public banks meanwhile posted faster deposit growth than the system as a whole (Figs. 1 and 2).¹

We ask two sets of questions about this episode. First, which banks experienced deposit withdrawals and why? Did the reallocation of deposits reflect the health of individual banks as measured by publicly available indicators? Or was it a function of public versus private ownership pure and simple? Did deposits move to all public banks or only to select public financial institutions? Did public banks attract depositors because they enjoyed an explicit government guarantee, which was manifested by the public injection of bank capital where necessary, or because they enjoyed an implicit guarantee, reflecting the understanding that the government would not allow a public bank to fail?²

Our analysis confirms that private banks indeed experienced a slowdown in deposit growth during and after the crisis and that this slowdown was most pronounced in FY 2009 and 2010. Public banks, in contrast, did not experience a similar slowdown in deposit growth, while the largest and oldest public bank, the State Bank of India (SBI), experienced especially rapid growth in deposits.³

We consider several explanations for the differential response, including the source of funding, i.e. whether banks that relied more on wholesale funding experienced a sharper deposit slowdown; credit growth prior to the crisis, which may have been an indication of problematic lending standards; lower realized profitability as a measure of bank health; bank size as a proxy for capacity to diversify and too big to fail; and explicit capital support by the government.⁴ We look at the change in interest rates paid on deposits, since some banks could have raised interest rates in the effort to attract deposits.

¹ Apparently this shift to (perceived to be) safer public sector banks is not unique to India and has happened in other emerging markets as well as the advanced economies. Bertay et al. (2012) report that in high income countries the share of government ownership in banking assets increased from 7.3 percent in 2007 to 10.8 percent in 2009 (though retreated to 9.9 percent in 2010).

² Acharya et al. (2010) show that public sector banks outperformed private sector banks despite having greater systemic risk during the crisis and attribute this to the government backing of public sector banks. They also find that riskier public sector banks with high ex ante systemic risk and low Tier 1 capital received greater capital support from the government). They conclude that it was not just the implicit guarantee to the public sector banks but also explicit capital injections by the government that caused depositors to consider public sector banks safer.

³ Besides deposits we also look at credit growth, return on assets or capital ratio of the banks but do not find the relative effect of the crisis to be as sharp across banks under different ownership patterns.

⁴ We enter these variables in three ways: their historic (2004) values; their average values in three years prior to the crisis; and their values in the current and most recent year.

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