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www.sib.co.in

ho2099@sib.co.in

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Theme 203
GLOBAL FINANCIAL CRISIS
PART - I

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Head Office
SIB House, Mission Quarters
Thrissur, Kerala, Pin - 680 001
Website: www.southindianbank.com
Toll free 1800-843-1800 (India)
mail: customercare@sib.co.in

SOUTH INDIAN Bank
Experience Next Generation Banking
The South Indian Bank Ltd., H.O. : 'S.I.B. House', Thrissur, Kerala

SIB STUDENTS' ECONOMIC FORUM

OCTOBER 2008

Theme No. 203 : GLOBAL FINANCIAL CRISIS - PART I

The sub prime crisis has spread rapidly in unanticipated ways and is wreaking havoc at the core of global financial system. Bankruptcies of top mortgage and investment banks in the US came as a shock to the global financial system and jolted the world's faith in the efficacy of capitalism. Global economy is on the verge of a great crisis as per IMF President Sri. Dominic Stros Kahan. It is due to the fear about the safety of the big financial organizations in U.S. and Europe. Now fears are mounting about global recession.

1. What is the origin of the present financial crisis?

The crisis began one year ago in the US sub prime home-loan market and has spread into a global credit squeeze, dragging down world economic growth. Sub-prime lending are loans made to borrowers who are perceived to have high credit risk. While the US remains the focal point, financial institutions in other countries have also been affected, reflecting unreliable global financial conditions. The crisis happened due to weakness in risk management systems and prudential supervision. The IMF warned that the global economy was being hit by a serious slowdown and its report indicated that total losses related to US risky loans could reach $1.4 trillions. It predicted dire consequences for banks and financial systems if financial regulators and banks did not act quickly.

2. What are the factors that contributed to the fall of investment banks in USA and Europe?

Five large investment banks based in Wall Street, New York, do not exist in its original form now. They had tremendous influence over financial markets all over the world. Four of them have offices in India and their recent woes are considered largely responsible for the downfall of the Indian stock market. Of the five, Lehman Brothers was wound up. Merril Lynch and Bear Sterns were taken over by other commercial banks. Goldman Sachs and Morgan Stanley have now become commercial banks.

All these five investment banks became the victims of the sub prime bubble and the current financial turmoil in the US.

The great stock market crash of 1929 in the US brought about drastic changes in the financial sector, the most important of them being the Glass Steagall Act, 1933 which separated commercial banking from Investment banking (I-banking). This was based on the premise that investment in markets was too risky for commercial banks to undertake. From then onwards till late 1990s banks were prohibited from engaging in share-broking or investing in shares. This gave a fillip to I-banks to fill in the void and expand their activities. In fact, Morgan Stanley was started after this Act. The Act was repealed by Gramm-Leach-Bliley Act of 1999 in the US and now commercial banks there can be universal, viz., can engage in investment banking also. The GLB Act was implicitly designating certain institutions as "Too Big to Fail".

I-banks could not, however, access funds from public by way of deposits, but raised money in the markets, by way of commercial paper, bonds etc. These funds were, in turn, provided by commercial banks, mutual funds and even members of public. Thus, I-banks became one more tier between savers (depositors) and investors (borrowers). However, Federal Reserve Bank in the US had no control over I-banks.

Commercial banks were tightly regulated by authorities the world over. But, I-banks which borrowed from commercial banks were lightly regulated by SEC (Securities and Exchange Commission) in the US (the counterpart of our SEBI). It is reported that SEC had, in the last few years, removed the ceiling of 12 times capital placed on the borrowing limits of I-banks. The result was that the I-banks went on a borrowing spree and with the money easily available, they invested in sub-prime mortgage loans. A secondary factor was the way the underlying mortgages were transferred into complex securities such as Collateralized Debt Obligations (CDO's), which became impossible to value once house prices started to fall. In structuring these transactions, it is alleged that the leading credit rating agencies also played a part, by categorizing a pool of loans as good, without full enquiry. The sub-prime mortgage loans given by commercial banks were sold to I-banks as CDO's. I-banks in turn borrowed from commercial banks and thus the vicious circle was complete. A total of 15 I-banks/

commercial banks were closed down in USA during this year.

In Europe also Governments have to rescue banks and mortgage lenders from collapse. Large European banks Dexia and Fortis were bailed out. West LB bank and mortgage lender Hypo Real Estate were rescued by German Govt. Briton has nationalized Northern Rock, a major bank and seized control of mortgage lender Bradford & Bingly. So European claims to good, prudential regulations are highly suspect.

3. What is its impact on the global financial system?

Today, the global financial system is under increasing strain and risks to financial stability remain imminent. The global financial crisis clearly reflects a combination of three factors : weakening balance sheets of financial institutions, continuous fall in asset prices and the weakening global economic growth. The financial crisis coincided with the decline of the dollar, rising inflation and booming commodity prices. The impact of the US housing crisis is not only widespread, the turbulence it has created is still deepening across the world financial systems. The crisis is not limited to USA and Europe alone, but has affected markets in several developing countries as well. China and India are also seeing lower housing prices after a period of steady increase. Economists expect that the housing market ripple effect could hurt more than just individual economies and could also damage the general global economic growth. Emerging and developing economies will be tested and continue to be tested by the spillovers of this crisis. After witnessing higher GDP growth rates, developing countries too are showing early signs of a slowdown already this fiscal. Today, the most common problem for many emerging and developing economies is to contain inflation, and addressing the vulnerabilities remains a key priority.

4. What are the steps initiated by USA and other countries to tide over the present financial crisis?

The US Senate passed a $700 billion package to bailout the debt-stricken financial system. The ceiling on federal insurance for bank deposits was raised from $100,000 to $2,50,000. Subsequently US president announced that out of $700 billion package, $250 billion will be used by the Govt. to buy shares in the nations leading banks. These efforts are designed to stabilize the financial system and helping the economy to recover.

The U.K. administration came up with GBP 500 billions bailout package for banking sector. The bailout packages from different governments globally are nearing $ 3 trillions mark - about three times the size of Indian economy.

5. What more needs to be done internationally to avoid a global recession?

United Nations Chief Ban Ki Moon has welcomed the steps taken by the major economies, but called for more global action to ensure that poor states are not impacted adversely. More co-ordinated approaches including direct intervention by Governments of the major economies, are necessary to recapitalize the banking system and guarantee the savings of the ordinary people. He welcomed the initiatives of the World Bank and the International Monetary Fund (IMF) to provide new emergency liquidity provisioning to poor countries. He also called for reform of the international financial institutions and effective regulatory frameworks in financial markets. Other areas that require critical attention include improved risk monitoring and crisis avoidance as well as management better suited to the realities of contemporary global financial integration. There is a growing demand that the IMF should be replaced with a more effective international financial watchdog.

The UN expects World Gross Product (WGP) growth to decline to a recessionary pace below 2% for 2008, down from the 3.8% of 2007, implying zero growth in world per-capita income and likely fall in income for a large proportion of the population, particularly the poor. The outlook for 2009 will be even worse, with the growth of WGP expected to drop to about one per cent. Growth in developing countries and economies in transition is expected to decelerate on average by about 2% in 2008, from the previous year, and by another 1% or so in 2009.

The root cause of the global financial crisis is deeply embedded in policy deficiencies in the international financial system and in the unsustainable fundamentals of the world economy. The prospect of a systemic world financial breakdown and, consequently, a long lasting economic slowdown seems real. Now the complete financial deregulation of U.S. and Europe stands discredited. The British Government has already bought shares in British banks and the US Government has decided to buy. This will enable the Government to have a place on the boards and to effectively control the financial institutions.

Mortgage Securitization Process

Mortgage Broker

Lender

Loan Proceeds

Loan

Borrower

Loan

Cash

Monthly Payments

Servicer

Monthly Payments

Issuer

Trustee

Underwriter

Rating Agency

Credit Enhancement Provider

Securities

Cash

Monthly Payment

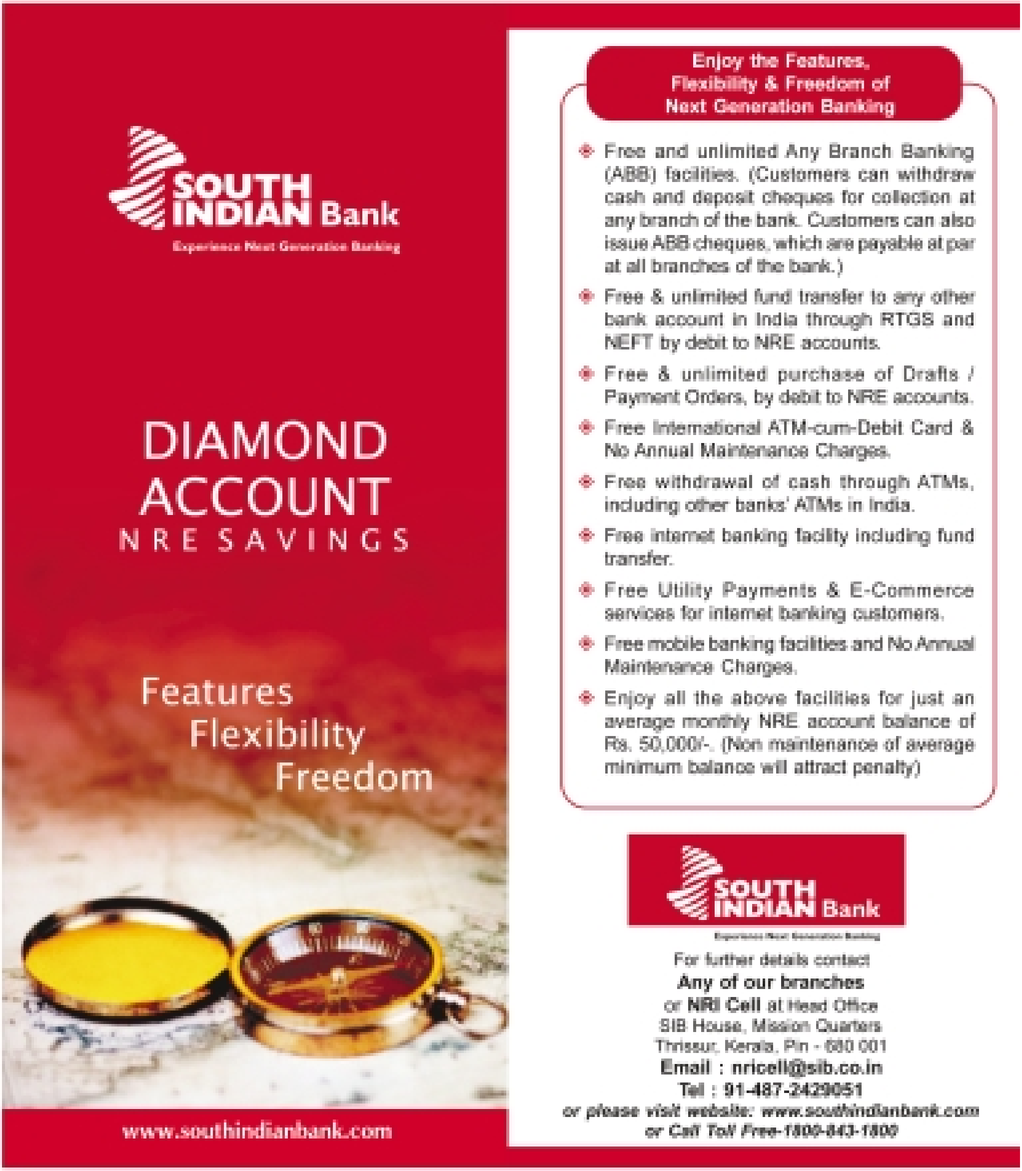
Investors

Step -1 The Borrower obtains a loan from a Lender. This may be done with help from a Mortgage Broker. In many cases the Lender and the Mortgage Broker have no further interaction with the Borrower after the loans is made.

Step 2 - The Lender sells the loan to the Issuer and the Borrower begins making monthly payments to the Servicer.

Step 3- The Issuer sells securities to the Investors. The underwriter assists in the sale, the Rating Agency rates the securities, and Credit Enhancement may be obtained.

Step 4- The Servicer collects monthly payments from the Borrower and remits payments to the Issuer. The Servicer and the Trustee manage delinquent loans according to terms set forth in the Pooling & Servicing Agreement.



Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur, Kerala 680 001 or by E.mail: ho2099@sib.co.in