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Is India Heading Towards a Situation Similar to the U.S. Subprime Crisis of 2008?

Executive Summary

The U.S. Subprime Crisis of 2008 remains one of the most significant financial collapses in modern history. What began as aggressive mortgage lending eventually evolved into a systemic banking crisis that destabilised global financial markets.

At first glance, India appears far removed from such a scenario. Indian banks operate under tighter regulatory oversight, lending standards remain comparatively conservative, and prudential regulations are significantly stronger than those that prevailed in the United States before 2008.

Unlike in the United States prior to the 2008 crisis, where mortgage loans were extensively packaged and sold to investors through securitisation, Indian banks generally retain the credit risk of the loans they sanction. Consequently, they have a strong incentive to maintain prudent standards and monitor asset quality. Nevertheless, excessive reliance on collateral values, shrinking borrower margins, and inflated valuations can still weaken credit discipline and create vulnerabilities within the banking system.

The purpose of this article is not to predict a crisis but to examine whether some of the behavioural patterns that contributed to the U.S. housing collapse are emerging in a different form within the Indian lending ecosystem.

Understanding the U.S. Subprime Crisis

The origins of the 2008 crisis lay in the belief that real estate prices would continue to rise indefinitely.

Financial institutions aggressively expanded mortgage lending, including to borrowers with weak repayment capacity. Several distortions gradually emerged:

- Credit standards weakened.
- Borrower repayment capacity received inadequate attention.
- Excessive dependence was placed on collateral appreciation.
- Loan originators (similar to DSAs- Direct Selling Agents) were rewarded for loan volumes rather than loan quality.
- Property valuations became increasingly optimistic.
- Risks were underestimated because rising prices appeared to provide protection.

As long as property values continued to increase, these weaknesses remained hidden. Once prices stagnated and subsequently declined, defaults accelerated, and recovery values collapsed.

The lesson was simple: when lending discipline is compromised, collateral values alone cannot protect the banking system.

The Indian Context

India's banking environment differed significantly from that of the United States in 2008. The Reserve Bank of India has generally maintained conservative prudential standards. Banks are required to assess repayment capacity and maintain provisioning buffers (amounts set aside by banks out of their profits to absorb potential future losses on loans and advances). In simple terms, it is a financial cushion created by banks to protect themselves against loan defaults and adhere to prescribed Loan-to-Value (LTV) norms. In recent years, regulatory and banking practices have increasingly shifted from Market Value to Realisable Value as the basis for determining lending exposure, thereby strengthening the margin of safety available to lenders.

Unlike the United States prior to the 2008 crisis, Indian banks continue to retain the credit risk of the loans they sanction. Consequently, they have a stronger incentive to ensure prudent lending and effective monitoring of credit exposures.

For these reasons, the likelihood of a crisis identical to the U.S. subprime collapse remains relatively low.

However, financial crises rarely repeat themselves in identical form. They often emerge through different mechanisms while sharing common behavioural roots. Excessive reliance on collateral values, shrinking borrower margins, and inflated valuations can gradually erode discipline and create vulnerabilities within the banking system.

The Shift from Market Value to Realisable Value

Recognising the need for greater prudence, banking regulators and institutions gradually shifted from relying solely on Market Value to emphasising Realisable Value. The rationale was straightforward.

Market Value represents the estimated exchange price under normal market conditions. Realisable Value reflects the amount likely to be recovered after accounting for disposal costs and transaction expenses.

This change was intended to:

- Reduce loan exposure.
- Increase borrower contribution.
- Strengthen recovery resilience.
- Create a larger safety cushion.

In principle, the policy represented sound risk management.

How Prudential Intent May Be Getting Diluted

The difficulty arises when operational pressures conflict with prudential objectives. Suppose a property has:

- Market Value: ₹100
- Realizable Value: ₹90
- LTV: 70%

Under the earlier framework, loan eligibility would be ₹70.

Under the revised framework, loan eligibility is reduced to ₹63.

This reduction is precisely what policymakers intended.

However, if lending expectations remain anchored to earlier loan amounts, pressure may arise to inflate the assessed Market Value so that the resulting Realisable Value yields a loan amount broadly equivalent to that available under the earlier framework. By inflating Market Value to ₹112:

- Realisable Value becomes approximately ₹101.
- Loan eligibility returns to around ₹70.

Formally, the transaction complies with Realisable Value-based norms. Substantively, the intended conservatism disappears. The form of prudence remains, but the substance of prudence is lost.

The Erosion of Borrower Margin

Borrower margin is one of the most important safeguards in secured lending. A meaningful margin ensures that:

- Banks possess a recovery cushion.
- Borrowers retain economic commitment.

- Speculative purchases are discouraged.
- Credit discipline is preserved.

When valuations are stretched to support higher lending, borrower contribution automatically declines. In effect, a larger portion of the investment risk is transferred from the borrower to the bank.

This phenomenon resembles a critical feature of the U.S. housing bubble, in which borrower equity gradually diminishes and risk increases. The greater the leverage, the greater the vulnerability when market conditions weaken.

Particular Concern in Primary Sales

The issue becomes especially significant in primary sales directly from developers. In many contemporary transactions:

- Sale agreements are executed at transparent prices.
- Payments move through banking channels.
- Developers continue to hold unsold inventory at identical rates.
- Market information is readily available.

Under such circumstances, substantial upward deviations from actual transaction values require careful scrutiny.

If a developer is willing to sell a unit for ₹1 crore and similar inventory remains available at the same price, an assessment of ₹1.12 crore requires compelling justification.

Otherwise, valuation ceases to measure risk and begins to facilitate higher lending. Valuation is intended to protect the lender, not to maximise loan eligibility.

The Danger of Over-Reliance on Collateral

One of the principal lessons of the U.S. subprime crisis was the danger of excessive dependence on collateral.

Many lenders implicitly assumed:

"If the borrower defaults, the property will cover the loan."

Such assumptions become dangerous when collateral values are optimistic.

The primary source of repayment remains:

- Business cash flows.
- Borrower income.
- Financial strength.
- Management capability.

Collateral should remain a secondary source of recovery, not the primary basis for credit decisions.

Whenever lending decisions become increasingly collateral-driven, risk begins to accumulate beneath the surface.

Are Warning Signs Emerging?

Several developments deserve careful attention:

1. Pressure for Credit Growth

Banks operate under legitimate pressures to expand lending and improve profitability. However, growth targets must not dilute prudent lending standards, including proper credit appraisal, realistic valuation, adequate borrower margins, and sound risk assessment.

2. Valuation Expectations

There are increasing instances in which valuation outcomes appear to support desired loan amounts rather than independently assess market reality.

3. Reduced Borrower Contribution

Higher valuations often translate into lower effective borrower margins and increased leverage.

4. Competitive Lending

Competition among lenders can encourage progressively aggressive credit structures.

5. Real Estate Optimism

Periods of sustained appreciation often foster the belief that property values will continue to rise indefinitely. History repeatedly demonstrates the dangers of such assumptions.

The Role of Independent Valuation

Valuation serves a critical public purpose. Banks are engaged in the prudent dispensation of public money entrusted to them by depositors and shareholders. The valuer's responsibility is therefore not merely technical; he plays a critical role in safeguarding the prudent dispensation of public money .

An independent valuation provides: .

- Objective risk assessment.
- Protection against excessive lending.
- Transparency in credit decisions.
- Safeguards for public funds.

When valuations are influenced by desired lending outcomes, the entire architecture of secured lending begins to weaken.

Conclusion

India is not facing a subprime crisis today. Nor are the conditions identical to those that existed in the United States before 2008.

However, the lessons of that crisis remain relevant. Unlike in the United States prior to the 2008 crisis, Indian banks generally retain the credit risk of the loans they sanction. Nevertheless, excessive reliance on collateral values, shrinking borrower margins, and inflated valuations can still weaken credit discipline and create vulnerabilities within the banking system.

The greatest risk is not abandoning prudential standards. It is the gradual dilution of those standards while preserving the appearance of compliance.

When inflated valuations neutralise the intended conservatism of Realisable Value-based lending, borrower margins shrink, recovery cushions weaken, and risk accumulates silently.

Sustainable banking rests upon three non-negotiable foundations:

- Realistic valuations.
- Meaningful borrower margins.
- Independent professional judgment by valuers.

If these foundations remain intact, India can avoid the mistakes that triggered the U.S. subprime crisis. If they are compromised, the warning signs should not be ignored.

