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# **RETAIL PARTICIPATION IN MUTUAL FUNDS** **SINCE 2008 CRISIS**

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& SHREYA MUKHERJEE

## **INTRODUCTION**

The 2007–2008 financial crisis, often known as the global financial crisis (GFC), was a major global economic disaster. Prior to the COVID-19 recession in 2020, many economists anticipated it to be the worst financial crisis since the Great Depression. Predatory lending to low-income homebuyers, excessive risk-taking by global financial institutions, and the implosion of the US housing bubble all combined to create a "perfect storm." Mortgage-backed securities (MBS) backed by American real estate, as well as a massive network of derivatives connected to that MBS, have all plummeted in value. Financial institutions around the world were severely harmed, culminating in the collapse of Lehman Brothers on September 15, 2008, and a subsequent international banking crisis.

The crisis put the Indian mutual fund sector's durability to the test, since its asset base and returns had been increasing significantly faster than the worldwide industry average rates previous to the crisis. The industry's post-crisis performance was more or less stable, with overall assets under management (AUM) and gross aggregate inflows above the pre-crisis peak. Net fresh inflows, on the other hand, have stayed substantially below pre-crisis levels, with funds incurring large net outflows during years of increased economic uncertainty.

Before the financial crisis hit in 2008, regulations passed in the U.S. had pressured the banking industry to allow more consumers to buy homes. Starting in 2004, Fannie Mae and Freddie Mac purchased huge numbers of mortgage assets including risky Alt-A mortgages. They charged large fees and received high margins from these subprime mortgages, also using the mortgages as collateral for obtaining private-label mortgage-based securities.

One of the principle motives for the boom with inside the retail investor base may be attributed to a growth in cognizance approximately the inventory markets. In fact, Upstox, one of the

many bargain agents in India, suggested that approximately 80% of its overall patron base received at some stage in the pandemic length got here from Tier-2 and Tier-three cities. This statistics factor strongly shows a boom inside the penetration of proportion buying and selling and the inventory markets.

### **What happened before 2008 crisis?**

Before the financial crisis hit in 2008, regulations passed in the U.S. had pressured the banking industry to allow more consumers to buy homes. Starting in 2004, Fannie Mae and Freddie Mac purchased huge numbers of mortgage assets including risky Alt-A mortgages. They charged large fees and received high margins from these subprime mortgages, also using the mortgages as collateral for obtaining private-label mortgage-based securities .Many foreign banks bought collateralized U.S. debt as subprime mortgage loans were bundled into collateralized debt obligations and sold to financial institutions around the world. When increasing numbers of U.S. consumers defaulted on their mortgage loans, U.S. banks lost money on the loans, and so did banks in other countries. Banks stopped lending to each other, and it became tougher for consumers and businesses to get credit.

### **Reason for the economy crash in 2008**

We are aware of the financial crisis that occurred in 2008 also known as the recession, that occurred in 2008. It was considered worse than 1930s Great Depression. The mortgage crisis in USA in 2007 marked the beginning of this financial crisis.The collapse ofAlso the major investment bank Lehman Brothers collapsed on September 15, 2008, which led to a full-fledged international banking crisis<sup>1</sup>.

The primary cause of the financial crisis was the crash of the US housing bubble in the FY 2006-07. The terrorist attacks of September 11, 2001 assured the beginning of the crisis . As the US economy was entering into recession, the Federal Reserve System (Fed) reduced its interest rate to 1%. As 1% is really low interest rate the fixed income investors began to search for other investment options. Investment banks in the United States started applying some of their financial ideas to mortgages became aware of the situation and began to apply some of their financial wizardries to mortgages.Initially,the investment banks used to securitize into

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<sup>1</sup> <https://cleartax.in/s/why-economy-crashed-in-2008>

Mortgage-Backed Securities (MBS), a form of asset-backed securities. MBS was used by Investment banks in order to keep future returns from such investments as high as possible while lowering risk.

Almost all the nations in the world both developing or developed, has suffered thr wrath of the US financial crisis. In August 2007, it became significant that the problems had spread beyond the country's borders. It led to the shutdown of The inter-banking market fully shut down. As a result all the central banks and government all over the world started to fuse in together to overcome the global financial crisis. But sadly at the end of 2008, all of the world's major economies were either in or fighting to stay out of recession. The World Bank predicts a 0.9 per cent rise in global economic activity in 2009, the slowest growth rate since records began in 1970.

### **Reasons why Retail Investors Increased:**

There has been a lot of instances where we have seen that, during times of economic crises and recessions, investors from the retail and institutional categories have always maintained distance from investing in the stock markets. Instead, they have always preferred to safe-haven assets such as the U.S. Dollar and gold. But during the current economic crisis by the ongoing COVID-19 pandemic, the situation has been quite the opposite. In a surprising move, the number of retail investors has actually increased during this period of uncertainty.

#### **1. More awareness and easier entry**

One of the principle motives for the boom withinside the retail investor base may be attributed to an growth in cognizance approximately the inventory markets. In fact, Upstox, one of the many bargain agents in India, suggested that approximately 80% of its overall patron base received at some stage in the pandemic length got here from Tier-2 and Tier-three cities. This statistics factor strongly shows an boom withinside the penetration of proportion buying and selling and the inventory markets.

Also, with the creation of eKYC and Aadhaar eSign, nearly all stockbrokers have followed this methodology. This has made the buying and selling and demat account starting method without a doubt paperless and absolutely online, making the access into proportion buying and selling easy and seamless. Additionally, the various incentives and reductions furnished with

the aid of using brokerages have additionally performed a chief function in attracting a large retail investor population<sup>2</sup>.

## 2. Market crash and bottom fishing

The latest inventory marketplace sell-off in March 2020 spark off a kind of a frenzy among the investor population. Almost all of the sectors, industries, and groups confronted a great drop of their marketplace value. Both the essential Indian indices, Sensex and Nifty, dropped with the aid of using round 30% in a count of some buying and selling sessions<sup>3</sup>.

Many retail buyers possibly concept that with the aid of using getting into whilst the marketplace turned into bottoming out, they might experience a few short-time period profits whilst the markets sooner or later went on a upward push. This caused a massive wave of latest and first-time investors flooding the marketplace and attempting their hand at backside fishing. Even penny shares have been now no longer spared, with many such shares experiencing a by no means earlier than upward push of their inventory prices.

## 3. Retail investors getting out of busy schedules

Nations across the world, along with India, have been pressured to undertake stringent measures to fight the unfold of coronavirus. One such degree turned into the string of enormous lockdowns that actually pressured human beings to live interior for months. With nearly the whole operating populace operating from home, their schedules have been now no longer so busy anymore.

They unexpectedly had greater time on their fingers and therefore attempted to place it to appropriate use through moving into on a number of the inventory marketplace action. Hordes of retail buyers took out part of their financial savings and attempted their hand at proportion buying and selling. This in the long run caused a report quantity of buying and selling and demat account openings withinside the records of inventory markets.

## 4. Retail investors looking for alternative sources of income

As a outcome of the significant lockdowns, many organizations had been compelled to droop

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<sup>2</sup> <https://www.tatacapital.com/blog/wealth-management/why-has-the-number-of-retail-investors-increased-during-an-economic-crisis/>

<sup>3</sup> <https://www.investopedia.com/ask/answers/033015/how-did-financial-crisis-affect-banking-sector.asp>

their operations and needed to go through severe setbacks. This at once impacted the sales of many those who needed to cope with little to no remuneration at some stage in this phase. Some of them unexpectedly observed themselves laid off and with out a job.

Under such dire circumstances, many such people grew to become to the inventory marketplace searching out opportunity reassets of income. The boom in retail investor participation withinside the month of June 2020 is in itself clean proof of the upward thrust withinside the retail and excessive networth person investors' percentage withinside the inventory marketplace.

#### 5. Weak returns from other investment options

In the modern-day financial scenario, the returns supplied via way of means of many conventional funding options, barring gold, had been very lacklustre. The financial institution hobby prices are pretty low and the actual property quarter is suffering to get again on its feet. Considering those circumstances, extra range of people have became to the inventory markets withinside the hopes of producing a few short-time period income to meet their economic goals. This has brought about a growth withinside the range of retail buyers withinside the inventory market.

## **WHAT EFFECTS HAS THE CRISIS HAD ON INDIA**

India's financial markets - equity markets, money markets, forex markets, and credit markets - had all come under pressure from a variety of sources. First, as a result of the global liquidity squeeze, Indian banks and corporations saw their overseas financing dry up, forcing corporations to shift their credit demand to the domestic banking sector. In their hasty search for alternative financing, corporations withdrew their investments from domestic money market mutual funds, putting redemption pressure on the mutual funds and, ultimately, non-banking financial institutions.

Second, the forex market was impacted by a reversal of capital flows as part of the global deleveraging process. Simultaneously, corporations were converting funds raised locally into foreign currency in order to meet their external obligations. Both of these factors put downward pressure on the rupee.

Third, the Reserve Bank's intervention in the forex market to manage rupee volatility added to the tightening of liquidity. The transmission of global cues to the home economy has been relatively straightforward — via a drop in export demand.<sup>4</sup> The United States, the European Union, and the Middle East, to name a few which account for three-quarters of India's commodities and services trade are experiencing a coordinated decline. Service export growth is also expected to decrease in the near term as the recession intensifies and financial services businesses, which have traditionally been heavy users of outsourcing services, restructure. Migrant worker remittances are also expected to drop as the Middle East adjusts to lower petroleum prices and advanced economies enter a slump.

Aside from the above-mentioned financial and real channels of transmission, the crisis also expanded via the confidence channel. In sharp contrast to global financial markets, which were paralysed by a confidence crisis, Indian financial markets continued to function normally. Nonetheless, the tightening global liquidity position in the period immediately following the Lehman crisis in mid-September 2008, which coincided with a change in the credit cycle, raised the financial system's risk aversion and made banks cautious about lending.

Despite India being not a part of the financial sector problem, it has been affected by the crisis through the feedback loops between external shocks and domestic vulnerabilities by way of the financial and real channels.

## **HOW BANKING SECTOR WAS AFFECTED BY 2008 FINANCIAL CRISIS**

In the short term, the 2008 financial crisis impacted the banking industry by forcing banks to lose money on mortgage defaults, freezing interbank lending, and drying up credit to consumers and companies. Longer term, the financial crisis had an impact on banking by spawning new regulatory acts, both internationally through Basel III and in the United States through the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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<sup>4</sup> <https://www.cii.in/Economy.aspx?enc=LqAXY5bXIsb2PzUHQxy2iQ==>

### **BEFORE THE CRISIS –**

Prior to the 2008 financial crisis, rules implemented in the United States put pressure on the banking system to allow more customers to buy homes. Beginning in 2004, Fannie Mae and Freddie Mac purchased massive amounts of mortgage assets, particularly problematic Alt-A mortgages. They charged hefty fees and gained big margins on these subprime mortgages, which they also used as collateral for private-label mortgage-based products.

As subprime mortgage loans were bundled into collateralized debt obligations and sold to financial institutions around the world, several foreign banks purchased collateralized US debt.

When an increasing number of US consumers defaulted on their mortgage loans, US banks, as well as banks in other countries, lost money on the loans. Banks ceased lending to one another, making credit more difficult to get for households and businesses.

### **AFTER THE CRISIS –**

As the United States entered a recession, demand for imported goods fell precipitously, contributing to a global recession. Confidence in the economy plummeted, as did share values on global stock exchanges.

In the aim of averting another financial crisis, the worldwide Basel Committee published a set of suggestions for stricter capital and liquidity criteria for the global banking sector in December 2009. The Basel III changes were approved by the G-20 in November 2010, but the committee left it up to member governments to apply the rules in their individual countries.

According to the Dodd-Frank Act:

The Dodd-Frank Act, passed in the United States in 2010, requires bank holding companies with more than \$50 million in assets to adhere to tough capital and liquidity criteria, as well as additional prohibitions on incentive compensation.

The legislation also established the Financial Stability Oversight Council, which includes the Federal Reserve Bank and other authorities, to coordinate the regulation of larger, "systemically important" banks. The council has the authority to break up major banks that

may pose a risk due to their size. A new Orderly Liquidation Fund was formed to give financial help for the liquidation of troubled large financial organisations.

## **MUTUAL FUND PERFORMANCE DURING THE FINANCIAL CRISIS**

The subprime mortgage crisis, which began in late 2007 and grew into a global financial and economic catastrophe by late 2008, had an impact on both the volume of resources flowing into the mutual fund sector globally and the distribution of these resources across funds with varying degrees of risk. The worldwide mutual fund industry suffered a substantial setback during the crisis, with net assets and inflows remaining below the pre-crisis peak in all post-crisis years.

The crisis put the Indian mutual fund sector's durability to the test, since its asset base and returns had been increasing significantly faster than the worldwide industry average rates previous to the crisis. The industry's post-crisis performance was more or less stable, with overall assets under management (AUM) and gross aggregate inflows above the pre-crisis peak. Net fresh inflows, on the other hand, have stayed substantially below pre-crisis levels, with funds incurring large net outflows during years of increased economic uncertainty.

The mutual fund business is projected to play a critical role in financial intermediation in the Indian economy; thus, the aggregate ability of mutual funds to attract investment capital and the utilisation of those funds is of great interest. Unsurprisingly, the global financial and economic crisis that unfolded in 2007 had an influence on both the volume of money channelled into mutual funds around the world and the distribution of resources among mutual fund classes with varied degrees of risk.

### **TRENDS IN INVESTEMENTS BY MUTUAL FUNDS –**

Mutual funds' aggregate investments in financial markets are determined by the amount of resources mobilised, whereas their investments in different segments of financial markets are determined by investors' preferences for different classes of funds, such as debt or equity-oriented funds, and variations on these. The aggregate investments of 30 mutual funds in Indian stock and debt markets fell shortly after the crisis in the fiscal year ended March 2009.

Following that, their total investments returned more than 120% the following year, and another 40% the following year. This rise was primarily driven by significant growth in mutual fund investments in the debt market<sup>5</sup>.

Since the fiscal year ending March 2006, mutual funds have become substantial participants in the equity market, with net investments expanding dramatically over the preceding year. Since then, mutual fund investments in equity markets have changed drastically and stayed negative in the previous two fiscal years, reflecting sharp redemption pressures and the resulting net outflows encountered by these funds. Mutual funds' (net) equity market flows remained generally positive from June 2008 to August 2009, when FIIs were making a tentative return to Indian equity markets following the first phase of the global financial crisis.

However, since August 2009, when a new set of regulations pertaining to the charging of entry and exit loads by all mutual funds went into effect, the industry's deployment of funds in the equity market has suffered continuously for a **FIGURE 3 Equity Market Investments by Mutual Funds and Foreign Institutional Investors**. In the last two fiscal years, mutual fund investments in the equity markets have varied dramatically and remained negative. Following that, while equities prices in India improved in line with global financial market recovery and were fueled by strong FII inflows,<sup>32</sup> mutual fund flows to equity markets were negative practically every month in September (2009-2010).

During the fiscal year ended March 31, 2011, mutual funds' net equity disinvestments nearly doubled compared to the previous year. The sustained net outflows could be attributed to both net withdrawals from funds and profit-taking by equities fund managers whose profits have been squeezed as a result of the new SEBI regulations. With the large scale flight of FII funds from the Indian equity market in the latter half of 2011, mutual funds turned net investors in the Indian equity market, making small but positive net investments in most months between April and December 2011; this is consistent with possible value buying by investors and fund managers as well.

## **INCREASE OF NPA IN BANKS AFTER 2008**

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<sup>5</sup> <https://link.springer.com/article/10.1007/s12197-021-09541-z>

## FINANCIAL CRISIS

The reason of the rise in NPA can be traced back to the tremendous credit boom that the country experienced between 2003 and 2004. The outstanding non-food credit increased threefold between 2003-04 and 2007-08. It more than doubled between 2007-08 and 2011-12. It rose by 1.5 times over the next four years. In absolute terms, the rise in three successive years is 15 trillion, 22 trillion, and 26 trillion, and by 26 trillion throughout the three-year period (2016-19).

Furthermore, the assets under control of mutual funds and the loans given by NBFCs have grown dramatically. During these eras, nominal GDP expanded by 15.08 percent, 15.56 percent, 12.05 percent, and 11.3 percent, respectively. It should also be remembered that monetary policy was significantly tightened between 2004 and 2008. The repo rate was hiked from 6% in March 2004 to 9% in August 2008. The CRR was likewise raised from 4.75 percent to 9 percent during this time period. Thus, despite tightening between 2004 and 2008, lending expanded. However, in reaction to the global financial crisis, the repo rate and CRR were significantly reduced in 2008. Between 2009 and 2012, there was a little reversal. During 2014-19, the repo rate was reduced. Real growth slowed during this time period<sup>6</sup>.

Credit booms are usually followed by banking system stress. This has also occurred in India. Credit expansion was spectacular, with an average annual growth rate of 18.69% compared to nominal GDP growth rates of 12.62. It is true that during a moment of economic expansion, every initiative appears to be a success. Exuberance becomes all-encompassing, both reasonable and irrational. It has also been observed that there has been a significant flow of credit to particular industries such as infrastructure (roads, power, and telecommunications), iron and steel, mining, and aviation. While all of these industries are vital for growth, they have also seen significant production variations.

Because many institutions, whether large and small, public, private, and international, were part of the same consortium, attributing the problem to a lack of capabilities just among public sector banks is an oversimplification of the problem. There was also considerable regulatory slack. The Asset Quality Review, which was implemented in 2015, tightened the situation and increased transparency. It resulted in a one-year doubling of the NPA ratio. But, by then, the

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<sup>6</sup> <https://www.thehindubusinessline.com/opinion/some-key-lessons-from-the-npa-crisis/article30331406.ece>

damage had been done, and the banks were faced with a massive crisis that had no apparent solution. The resolution procedure is time-consuming.

## **CONCLUSION**

The subprime mortgage crisis, which began in late 2007 and evolved into a global financial and economic catastrophe by late 2008, had an impact on both the volume of resources flowing into the mutual fund sector globally and the distribution of these resources across funds with varying degrees of risk. The worldwide mutual fund industry suffered a substantial setback during the crisis, with net assets and inflows remaining below the pre-crisis peak in all post-crisis years.

The crisis put the Indian mutual fund sector to the test, since its asset base and returns had been increasing significantly faster than the worldwide industry average rates previous to the crisis. The industry's post-crisis performance was more or less stable, with overall AUM and gross aggregate inflows above the pre-crisis peak. Net fresh inflows, on the other hand, have stayed substantially below pre-crisis levels, with funds incurring large net outflows during years of increased economic uncertainty.

In response to the global reaction, Indian mutual funds fled to safety in the immediate post-crisis era. Gross flows into liquid money market funds and gilt funds increased sharply, whereas resource flows to equities mutual funds decreased. As a result, mutual funds' investments in the Indian equities market decreased throughout the period, while their investments in the debt market increased.