

Credit growth: getting it right

YIELD CURVE. Credit growth shouldn't go far beyond that of nominal GDP, banks must not be pushed into risky lending, appraisal and monitoring mechanism must be upgraded



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Credit growth, though not sufficient, is a necessary condition for economic growth.

But credit or money beyond a level can harm the economy. An analysis of bank credit growth over the last two decades (*businessline*, September 5; <https://tinyurl.com/blthinkcreditgrowth1>) offers lessons to regulators, policymakers and lenders.

Some economists argue that bank credit growth of 16-18 per cent is optimal, beyond which alone vulnerabilities in credit portfolios may build up. The RBI has projected real GDP growth of around 7 per cent and the central point of inflation target is 4 per cent. The experience of bank credit growth over the last two decades indicates that credit growth beyond nominal income growth may end up in high credit losses. Besides the banking system, well-rated corporates access non-bank sources like debt mutual funds, insurance companies, ECB, NBFC, etc. As of now, warning signal must be sounded when the credit growth crosses nominal income growth.

Secondly, it is important to have better understanding of interplay of monetary policy, fiscal policy, credit growth, investment rate and their impact on real economy growth. This is essential as each of these policies has its own objectives and targets. Economist Adam Tooze suggested, there is need for overarching intelligence that help connect all the dots and guide better policymaking. Regulators need to moderate even sectoral excesses through regulatory intervention.

Thirdly, there is concentration of credit expansion. Just five banks account for 60 per cent of incremental credit growth during the last few years.

Micro prudential regulation may be necessary. New risks are lurking in the corner on account of transition to net zero commitments and this needs proactive response so as to avoid nasty surprises.

LESSONS FOR GOVERNMENT

Firstly, the government should realise that mere increase in bank credit by itself will not deliver higher GDP on a consistent and sustainable basis. As mentioned earlier, high credit growth far beyond nominal GDP may end up in huge credit losses subsequently and also aid inflationary pressures.

Secondly, real economy growth and credit growth are bi-directional. Economic slowdown would amplify credit losses. Timely fiscal interventions are necessary.

Thirdly, reform of any sector should encompass the entire value chain as otherwise it would hamper the quality of credit growth. For example, power generation was deregulated but not the essential input, namely, coal. As the Supreme Court had cancelled coal block licences, the viability of the entire power sector and other related sectors like steel was in jeopardy, leading to huge credit losses for lenders.

Fourthly, pushing commercial banks

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to finance high risk infrastructure finance needs to be examined. Cost and time overruns are endemic. The Gati Shakti programme has been trying to address these issues, but there is still a long way to go.

Fifthly, the Department of Banking may spell out broader strategic objectives of credit growth and real economy needs and leave governance and regulation issues to the RBI and make the boards accountable.

LESSONS FOR LENDERS

There is need to relook at "risk pricing". The experience of the past one decade shows that some of the infrastructure sectors like steel and construction had impaired credit of nearly 40 per cent of the portfolio and this was evident from huge haircuts incurred ranging from 60-80 per cent.

'Loss given default' is very high, over 80 per cent in many cases. Delay in recognition and initiation of corrective/resolution action amplifies 'loss given default' and this needs to be avoided. The Insolvency and Bankruptcy Code (IBC) also needs an upgrade.

Lenders need to invest adequate resources, both digital and human, in appraisal and monitoring. They should invest in machine learning and AI tools to monitor and identify stress early. Intervention frameworks and models need to be in place. Lenders shall desist from group think. Small and medium lenders shall not rely on appraisal of big lenders. Risk appetite shall be aligned to internal underwriting capabilities besides owned funds and aggregate credit. Banks need to build specialist officer cadre across industries.

During 2003-08, the ratio of credit growth to nominal GDP growth was as high as 2.2. Of course, this period also witnessed very high GDP growth of over 9 per cent — for three years consecutively. But high NPAs followed which eroded some of these gains. This induced a long pause of low credit growth (2012-20), lower GDP growth. It is necessary to navigate credit growth round nominal GDP growth. As a guide, banks need to look at expected real GDP growth and inflation. The temptation to push credit growth far beyond real economy growth and certainly nominal credit growth needs to be resisted.

While the RBI indicates projections for GDP growth and inflation with quarterly updates, it does not indicate appropriate credit growth rate to help achieve these objectives. Credit growth forecasts are left to external professional forecasters (about 40 in number) and they are mentioned in RBI reports.

Instead, the RBI should seriously consider giving its own macro credit growth projections constant with GDP and inflation projections. This would help banks plan their resource mobilisation and draw up credit plans aligned to the real economy. Credit growth of individual banks hinges on, among other things, their capital adequacy ratio, level of NPAs, risk appetite, deposit growth and governance mechanisms.

Concluded

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