Managing Credit Needs to Boost Growth

What is the issue?

- The financial developments in the FY14-18 have changed the credit scenario in India, with imbalance in shares.
- This calls for managing the credit needs better than now, with right mix in growth among banks, bonds, HFCs, and NBFCs.

What is the current credit scenario?

- Estimates of unmet credit needs of creditworthy Indian companies and small entrepreneurs range from $500bn to $1tn.
- In comparison, India's current GDP is about $2.8tn and total outstanding credit is about $1.8tn.
- Closing this gap would clearly boost economic growth materially.

- In this context, private sector leverage in India (as measured by total private credit to GDP) is only a fraction of that in other large economies.
- This calls for paying attention to managing the quality of credit growth and of the delivery channel.

Why is the recent credit crisis?

- FY09-14 witnessed substantial amount of credit going for very large projects with lengthy durations for return of capital.
- Notably, too much of banks' balance sheets were utilised for these long-term projects, which should have ideally been fulfilled by bond markets.
- But following the 2008 financial crisis, these large projects eventually led to vast majority of NPAs.
- So in recent years, RBI went for tightening of norms for bad-loan recognition, and also imposed Prompt Corrective Action (PCA) on about half the public sector banks.
- Due to this, the period FY14-18 has been one of significant deleveraging for Scheduled Commercial Banks (SCBs).
- This refers to the reduction in the leverage ratio of banks, which is the percentage of debt in the balance sheet.

- So during the FY14-18 banking deleverage, the bond markets and HFCs (housing finance companies)/NBFCs (Non Banking Financial Companies) initially filled some of the gap.
- However, in 2018, bond issuance slowed down, driven by rising yields, reducing issuer appetite.
- Subsequently, accelerating growth in credit from NBFCs/HFCs was also affected by the recent IL&FS crisis.
- The commercial paper market too dried up and several HFCs and NBFCs had to sharply curtail disbursements.

What is the optimal credit share?

- As a proportion of GDP, bank credit is roughly the same in India and the US which is the world's broadest and deepest capital market.
- However, total private credit is three times the proportion of GDP in the US relative to India.
- This suggests that the big gap between outstanding credits in the two countries is primarily in bonds and NBFCs.
- So credit from banks should continue to grow modestly faster than nominal GDP in India.
- However, it is bonds and NBFCs that could grow significantly faster at this point.

What is the challenge?

- The ways to shift the large project loans away from banks to corporate bonds is a huge challenge before India.
- However, the shift can reduce asset-liability mismatch at banks as well as get banks to provide many more mid-size and smaller loans.
- Perhaps India has not been innovative enough to expand credit without the corresponding increase in risks.

What can be done?

- **MSMEs** - The MSME sector provides employment to 40% of the workforce and contributes about 37% of GDP.
- It is in this underserved market that the gap between demand for and supply of credit is the greatest.
- Also, key enablers (credit scores, formalisation of the economy, and the emergence of HFCs and NBFCs as low-cost origination channels) have emerged in this market.
- So enabling credit growth to MSMEs (micro, small and medium enterprises) is a wise option.

- **MUDRA** - The RBI's threshold is significantly higher for using MUDRA refinancing than classifying a company as an NBFC.
- The criteria for MUDRA should be revised to enable a broader selection of NBFCs to qualify for refinancing MUDRA loans.
- **HFCs/NBFCs** - On HFCs and NBFCs, the government and regulator need to take note of the changing landscape.
- Currently, HFC and NBFC data is available from the RBI with a very significant lag.
- It is not detailed enough to detect many inflection points and trends.
- So monthly data reporting on sources of capital and on end-market credit exposure would help mitigate the build-up of unnecessary risk.
- **Bonds** - Choice of bonds available to banks and insurance companies could be broadened.
- Broadening the pool of potential buyers of bonds would likely boost the Indian corporate bond market and accelerate GDP growth.
- In all, a significant portion of the Indian economy could grow a lot faster if its credit needs were better met.

Source: Business Standard