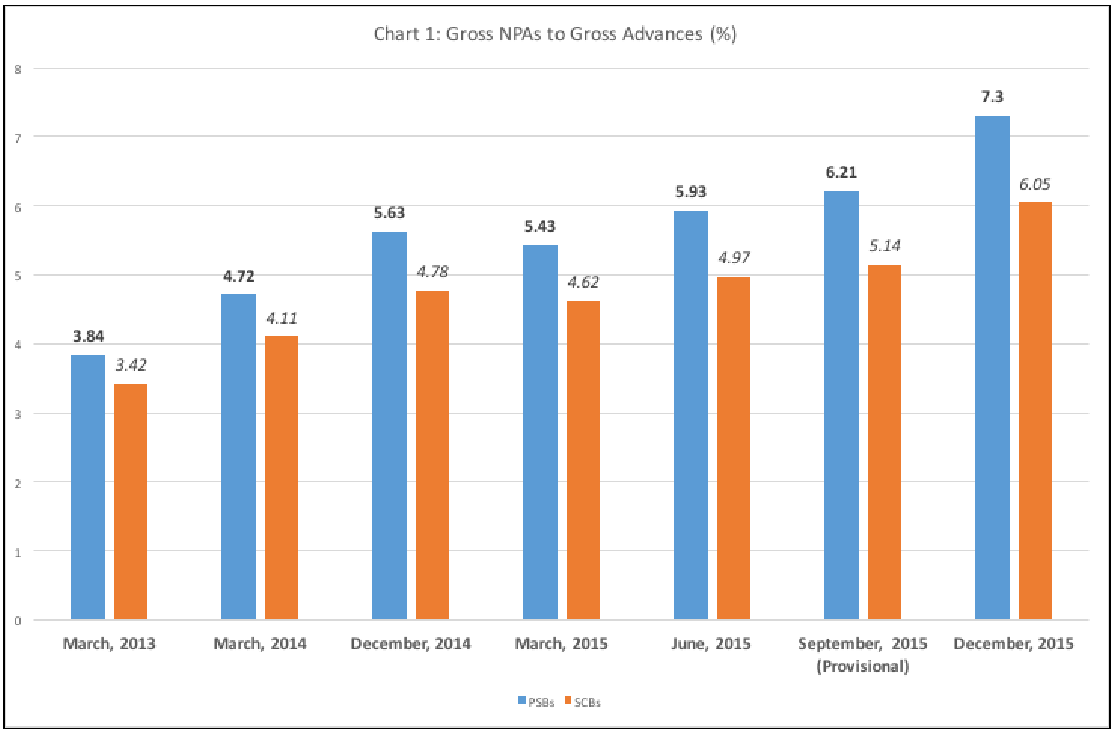
Bad Loans, Lending Behaviour and Growth*

C.P. Chandrasekhar and Jayati Ghosh

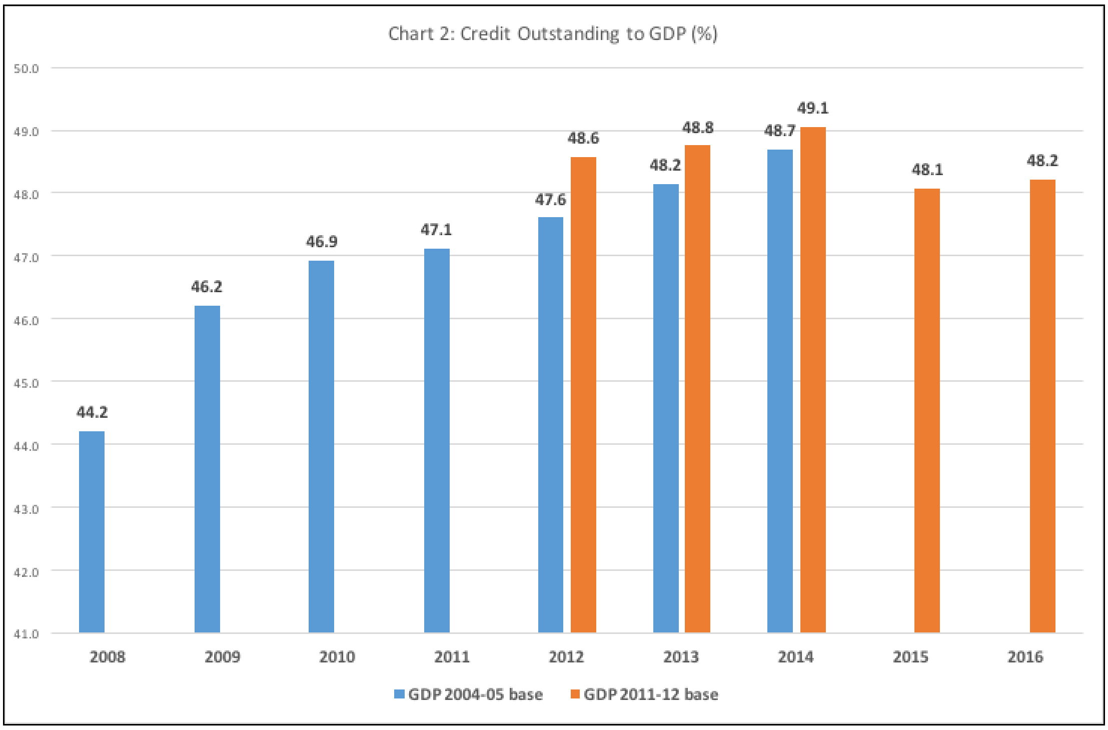
The attention of the media, Parliament and interested observers of the financial sector is focused on what may be the most important immediate problem facing the Indian government. That problem is the presence of non-performing assets totalling Rs. 4,01,590 crore in the balance sheets of commercial banks at the end of December 2015 and the rapidity with which these have risen over the previous three and a half years from Rs. 1,75,882 crore at the end of March 2013. Relative to Gross Advances by the scheduled commercial banks (SCBs), Gross Non Performing Assets (NPAs) have risen from 3.4 per cent at the end of March 2013 to 6.1 per cent at the end of 2015. The problem afflicts in particular the public sector banks, in whose case the corresponding figures are 3.8 per cent and 7.3 per cent (Chart 1).



Expectations are that the NPA problem will only worsen rapidly in the coming months, for at least three reasons. The first is that since individual loans to infrastructure are large, banks confronted by potential default that could damage their balance sheets have resorted to loan restructuring. Many of those restructured loans have in recent months turned sour, and are still doing so, despite the easier loan conditions instituted as part of the restructuring process. Second, banks have been understating their NPAs until recently, when the Reserve Bank of India (RBI) mandated a guideline-based, asset quality review. This unearthed large volumes of unreported stressed and non-performing assets, resulting in a sudden build up in NPAs on the books of banks. Finally, GDP figures notwithstanding, there is much evidence that growth is slowing, which too is adversely affecting borrower ability to service debt and increasing bank NPAs.

The factors that led to this accelerated accumulation of NPAs have been discussed before in this column. One was a rapid rise in the credit provided by the banking sector, driven by a huge build-up of excess liquidity in the economy. The other was the forced allocation of this additional credit to new avenues such as personal loans (housing, automobiles, credit card receivables, education, and much else) and lending to infrastructure, which was the focus of the government's post-liberalisation growth strategy. During the years between 2003-04 and 2008-09 that preceded the global financial crisis, this debt splurge paid dividends in the form of high growth rates.

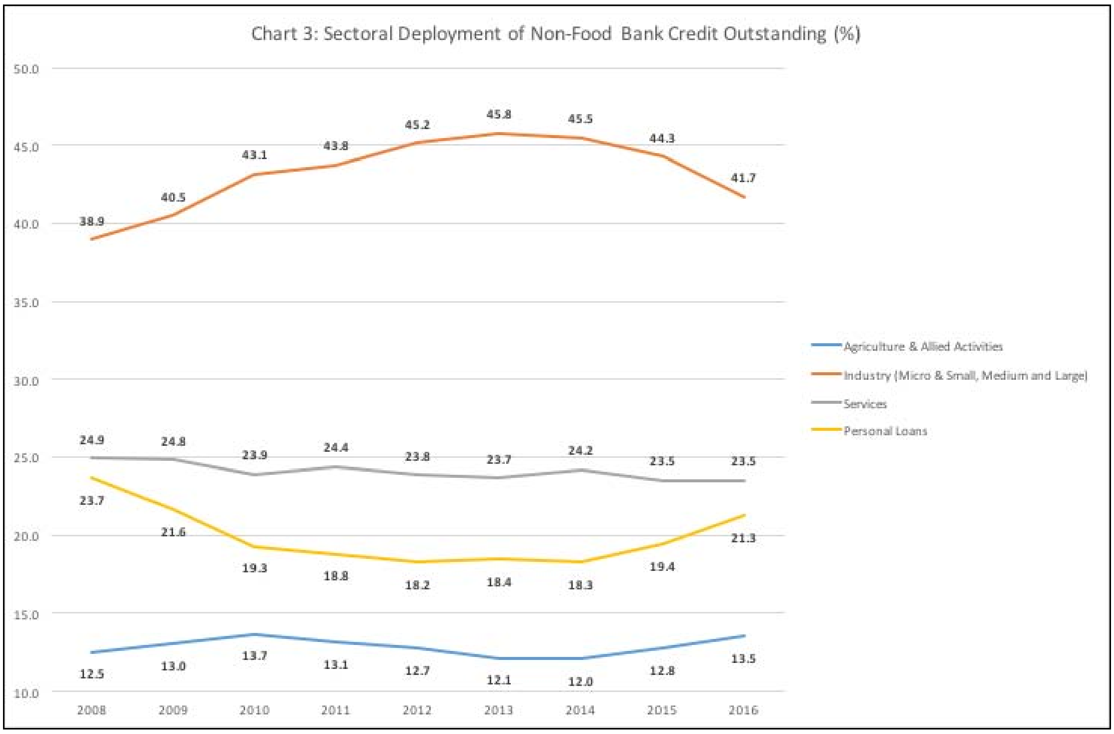
What is surprising is that the credit splurge seemed to continue even after the global crisis tripped India's flight along a runaway growth rate trajectory. With hindsight, the reason seems obvious. After a brief period when capital inflows were adversely affected, monetary easing that was aimed at rescuing the banks in the developed countries restored cross-border capital movements and led to the resumption of the liquidity and credit splurge.



There is, however, an internal difficulty in sustaining this growth process. This stems from the fact that when credit growth accelerates, not only do some borrowers receive 'abnormally' large loans relative to their own asset position, but the universe of borrowers must expand, bringing in those whose likely future incomes do not guarantee the ability to service increased exposure to debt. The result is an increase in defaults that can be all the more damaging because of the over-exposure to a few borrowers and sectors. One explanation for the rising NPAs in the banking sector is this internal tendency to default associated with credit growth.

When defaults do begin to occur, lenders turn wary. This affects not just the rate of growth of lending but specifically lending to sectors where exposure has been high. To the extent that such lending and exposure was responsible for triggering and sustaining growth, this retraction aimed at reining in leverage can be damaging for growth as well. Was India in the period after 2008 subject to this kind of debt driven growth cycle?

As Chart 2 shows, SCB credit outstanding relative to GDP, which continued to grow after 2009, peaked in 2014 and then has declined significantly. While part of this decline may be the result of an inflation in GDP figures resulting from the revision in methodology for computing domestic product, credit growth itself is in all probability slowing relative to GDP growth. Initially, this slow down affected the personal loan segment, since that was the area that received the bulk of additional lending during 2003-08, leading to a sharp increase in retail loans in total SCB advances. As evidence of excess exposure to the retail segment accumulated, banks turned wary, and shifted away from this sector to infrastructure, influenced perhaps by the idea that such lending has sovereign backing. What is now clear is that this shift was even more damaging, contributing hugely to the NPAs of banks.



This time the response of the banks has been that of holding back on further lending to infrastructure and writing off large, defaulting infrastructural loans. The share of NPA reduction through writing off bad loans or compromising with debtors increased from 38 per cent of NPA wipe out in 2013 to 42 per cent in 2016. One consequence is a decline in the share of advances directed to industry (Chart 3), which includes infrastructural areas and industries like steel and textiles that have been receiving a large share of these loans and account for a substantial share of NPAs. Ironically, the retreat from infrastructural lending is seeing a return in retail lending, whose share since 2008 follows a U-shaped trajectory, as Chart 3 makes clear. But given past experience, it is likely that such lending will soon reach saturation levels, especially given signs of sluggish demand and a growth slowdown.

The overall slowing of credit growth, the shift away from infrastructural lending that accompanies it and the likely recurrence of saturation in retail lending have implications for economic growth as well, especially industrial and services growth. To the extent that a credit-financed splurge in investment and consumption was responsible for growth of demand and output in these areas, growth is bound to slow. That could only lead to increased defaults on past debt and increased stress on the banks. There is indeed much in terms of economic performance that the inflated GDP figures conceal.

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