Credit Policy, Systems and Culture*

Y.V. REDDY

Coming to the Institute kindles a feeling of festive occasion and it is a privilege and an honour to be here with you. There have been significant achievements, in training, in diversified fields, with new initiatives and a wider coverage in the area of research and consultancy. Admittedly, there is more of sponsored research now. Incidentally, one of my former colleagues Ms. Indrani Banerjee, who along with others worked with me on a money-laundering Report in the Reserve Bank, is with the Institute now. I am happy that the Institute is beginning to use RBI's human resources productively. The exchange of knowledge resources amongst our institutions is bound to provide increasing returns to both. It is good to note that distinguished banking colleagues are taking advantage of the services of the Institute and surely they will continue to do so in a greater measure in the years ahead.

There is a reference in Dr. Saha's report to the possibility of making our presence felt in the neighbouring countries and this seems very appropriate because we have a SAARC Finance Group which is likely to meet in April 2004. Also, as Dr. Saha knows, Ms. Anne Krueger, the first Deputy Managing Director of the IMF who was also the Chief Economist of the World Bank 10-15 years ago, is visiting this Institute shortly. She will deliver a lecture on January 21, which would also provide this Institute an opportunity for exploring further avenues of learning through collaboration and interaction with others.

Financial Deepening

Among the major indicators that we would have to look at from a longer term perspective of financial sector development, are some of the financial ratios that signify the nature and extent of financial deepening. The data shows that banking and insurance as a percentage of GDP has grown from just about 1.6 per cent in 1969 to 6.5 per cent. Within the services sector, its share has grown from about 4.2 per cent to 11.8 per cent indicating that the financial sector has rapidly gained prominence in the overall economic activity. The flow of funds accounts for the Indian economy which are available till 1995-96, show that the finance ratio, *i.e.,* the ratio of total financial issues to national income, has grown four times between 1969-70 and 1995-96 from 10.4 per cent to 41.1 per cent indicating considerable financial deepening. It is interesting that the intermediation ratio has grown at a much lesser pace *i.e.,* 57.8 per cent to 70.2 per cent during the same period. This means that although the Indian financial system is largely bank-oriented, the financial deepening has been supported, both by

* **Speech delivered by Dr.Y.V. Reddy, Governor, Reserve Bank of India, at National Institute of Bank Management (NIBM) during the NIBM Annual Day celebrations on January 6, 2004, Pune.**

financial intermediaries as well as financial markets. We have to constantly take note of some of the characteristics of the financial deepening and the nature of development of the financial markets.

Of particular interest to our country is the share of commercial banks in rural household debt which rose from barely 0.3 per cent in 1961 to 29 per cent in 1991. The question that arises is what has been happening thereafter. There is some quantitative indication and certainly a strong perception that commercial banking activity for the rural households may not be increasing at the same pace as before 1991. It is good to note that during the reform period, the role of capital markets improved but is it good to learn that the presence of banks in the rural households is not increasing commensurately? This leads to the real issues of credit delivery mechanisms, which we flagged in the monetary policy this time. What are the constraints which are affecting the flow of credit? What is the role of credit flow in a deregulated financial environment in an emerging country? 'Emerging country' by definition, has structural or institutional bottlenecks. In such a situation, how to maintain a balance between deregulation that brings about medium to long term efficiency gains and the credit flow that is urgently required to various sectors? It is critical at this juncture, to address these issues at this stage of our economic development and state of financial sector.

Monetary, Credit and Regulatory Policies

Basically, there is a recognition about the differentiation as well as the link between monetary and credit policy. In India, we now call our policy statement as Monetary and Credit Policy Statement. Upto 1992, our statement was called Credit Policy Statement and the Cell (in RBI) was called Credit Planning Cell. Beginning 1998, it is renamed as Monetary Policy Department. This denoted the shift in the policy from a planned and administered interest rate system to a market-oriented financial system but while making the shift, we have been sensible enough not to discard the importance of credit and focus only on conducting monetary policy. The real issue is to define the nature of the link between monetary and credit policies, how it is changing and how we have to manage it. Past experience shows that credit allocation and administered pricing certainly ensure a reasonable level of credit flow in the desired direction at the desired price, but at a cost along with inefficiencies as well as distortions. In such a situation, the cost has to be borne in different ways – including pre-emption through Cash Reserve Ratio (CRR), which at the time of initiation of reforms had touched the statutory maximum of 15 per cent (excluding the incremental CRR on incremental NDTL) and Statutory Liquidity Ratio (SLR) at 38.5 per cent, almost touching the statutory maximum of 40 per cent. Since the reform, the focus of the policy environment has been to remove most of these constraints but the question is whether the purpose of credit delivery at a reasonable price of credit has been served and whether the new system is admittedly superior in all respects?

Recent experience shows that policies of liberalisation, deregulation and enabling

environment of comfortable liquidity at a reasonable price do not automatically translate themselves into credit flow. There are glitches or hurdles in a well intentioned monetary policy to be translated into desired credit system, and these, I believe, are the linkages to be explored.

There is another aspect to the issue of credit pricing and credit delivery flagged in the Mid-term Review of Monetary and Credit Policy statement this time. The regulatory policies relating to banks have a bearing on credit flow. For example, tightening of the regulatory policies in particular cycles, especially the downside cycle, will sometimes worsen the situation. The regulatory regime has a tendency to be pro-cyclical and, therefore, it has implications for both, monetary and financial stability, especially when the regulatory regime itself is transforming. In brief, there is an imperative need to clearly discern the links between monetary policy, credit policy, and regulatory regime in a dynamic situation, involving the overall structural transformation of the real sector, the financial sector and the opening of the economy. As you are aware, RBI is also regulator of banks, non banking financial companies, Primary Dealers, government security markets and money markets. Therefore, in policy making, RBI now looks at what may be called the 3 by 3 matrix and see how we can capture these linkages. The 3 by 3 matrix consists of three policy–objectives and three policy-instruments.

Let us start with the objectives. What are the policy-objectives that the Reserve Bank of India has? The central bank, until a decade ago, was focusing on growth and price stability and the trade-off between growth and price stability. A more recent addition reflecting the developments in the financial markets has been the third objective, *viz.,* financial stability. The monetary policy looks at this third objective also and there are certain trade-offs involved between the three objectives, particularly in the short run. There are also complementarities between the three more so over the longer run.

While there are three objectives with their own interrelationships, we also have three instruments – monetary policy, credit policy and regulatory policies. The three instruments are also used interchangeably to serve different objectives. For instance, interest rate changes serve as monetary policy signal, while at the time changing the price of credit as also ensuring stability in asset prices. The use of instruments results in short-term trade offs, requiring some other complementary measures. In highly integrated economies with no institutional bottlenecks, monetary and regulatory policy co-ordination is essential, but for us, because of transitional problems and transactional costs, we have to have a credit allocation policy and, therefore, one should look at the changing dynamics of these relationships in what may be called the 3 x 3 matrix.

Credit Systems

There are three pillars on which our credit system was based in the past – one was fixing of prices of credit or interest rate and on occasions even quantum linked with

purpose; second, insisting on collateral; and third, prescribing the end-use. One pillar relating to interest rate prescription and fixing quantum has been significantly reduced. There are issues in security-based or collateralised lending and how do we handle that? What will happen to the services sector, which accounts for slightly more than 50 per cent of GDP if we keep insisting on collateral? Similarly, if technology is more important than the material component what is the role of collateral? The third is the end-use specification. Given the fungibility of resources, multiple sources of flow of resources, as well as application of funds, are end-use restrictions relevant and operationally feasible? I would solicit views of the bankers so that we can move forward with changes.

There is another issue relating to the link or absence of the link between formal and informal sectors which is still persisting. Normally, in a fairly liberalised environment, if markets are reasonably integrated, the divergence in credit terms, especially interest rates, between the formal and informal sectors should not be large. However, almost everybody in our country concedes that significant divergence in lending terms between the two sectors still persists. The interest rate in informal markets, particularly in rural areas, is 3 per cent per month or annualised rate of over 38 per cent whereas in formal sectors, it is 10 or 12 per cent per annum. The persistence of divergence means that, with all the deregulation, the formal credit mechanisms are not able to pierce the informal system. The incentives emanating out of the divergence in terms of credit is such that the borrower will take recourse to the more costly informal finance in preference to the formal lender if the borrower has shortage of funds. Currently, since there is no way for the formal sector to be able to cater to all the credit requirements, especially for consumption purpose, perhaps we should think about what suits our own culture such as family-based credit in rural areas rather than consumption credit, production credit, *etc.* Ultimately, we should try to bring about a degree of convergence between formal and informal sectors perhaps by pushing the supply of credit from the formal sector in a supply leading approach to reduce the price or interest. How do we go about it? We would appreciate suggestions from the bankers and others assembled here.

Micro-finance is in a way bringing about the convergence. In micro-finance, whereas there are no collaterals and, interest rates are high, the level of NPAs is low. Is there a lesson for our banks? A possible explanation is in terms of what is called “apparent cost” and “total real cost”. “Apparent cost” is what is shown on the loan document, whereas the “total real cost” includes cost incurred on formalities including documentation *etc.* The number of photocopies that are required, trips to the Sub Registrar’s office, the paper work, the aspect of timeliness – if all those are added to the apparent cost, then it becomes the “total real cost”. There is a view that the divergence between the formal and informal is only because of the differences in the “apparent cost” indicated in informal sector and total real cost in the formal sector. These are some important areas of studies in credit systems, that should perhaps be undertaken.

Another aspect with which we have been going along till now is that credit business has to be a stand-alone credit business and I think we have had the purist approach, *viz.,* that bank credit should not be contaminated with other business. The telecom revolution was started with STD kiosks, which in reality rendered several other services. There is need to think of combining credit with physical supplies of inputs/outputs. Perhaps, in considering credit delivery in rural areas, we have to look at the delivery mechanisms, by studying production, distribution and consumption processes, especially their linkages.

Credit Information

A Credit Information Bureau has been set up, but it collects information only about the borrowers and their track record and makes it available to banks. We are passing a law where Credit Information Bureau will give credit information that is needed by the bank. But there is no similar publicly-available information about banks to the borrowers. The same Credit Information Bureau should be able to give information about banks to the customers, such as, on the interest rates that are available for different types of loans, the requirements for loan *etc.* Where the borrower's track record is given to the bank, the borrower should also have the track record of all the banks in dealing with borrowers. This is an issue which has been rarely addressed because we are oriented more to handling the bank's problem rather than the bank's customer's problem. Is there an asymmetry? From a social point of view, if there is a credit, there are two sides of the credit – the lender and the borrower. I am sharing the above thoughts with NIBM for a possible inclusion of the action points stemming therefrom in its research agenda.

Micro Aspects

Between March 2001 and end 2003, *i.e.,* over the last two and a half years, while the lending rates of banks have been reduced by about 1 per cent, the deposit rates of 1 to 3 years duration have been reduced by about 3 per cent. It is difficult to justify this. While it can be said that the term deposit rates are fixed for two to three years and so are less flexible as compared to lending rates which are far more flexible, the divergence should have been bridged over time. This asymmetry in the treatment by banks, between depositors and borrowers needs some analysis.

One has to recognise that there is a widespread perception about the asymmetrical treatment by the financial intermediaries, as between different borrowers also. That the size of the borrowing, as well cost of service, do warrant some amount of differential pricing is known, justifiable and acceptable. But if there is a feeling that such a differential pricing is not justifiable or that it has reached such proportions that the difference is not justifiable, there could be a backlash.

I shall give you an illustration of what has happened more recently. Essentially, PLR was meant to be the prime lending rate for prime borrowers. A facility has been given to charge below PLR in exceptional cases. On this assumption, a particular interest rate was fixed for the Food Corporation of India

(FCI) as the average of PLRs of five banks. When the FCI found in the last four years that all the market interest rates have been moving down, whereas the banks' PLRs have not come down as much, they have expressed their preference to raise funds from the capital market. As Reserve Bank of India, we have no way in which to say, that the FCI cannot raise funds from the market. The FCI argues that they have a virtual government guarantee; have not defaulted and have virtually no NPAs. Hence in their view, it is not justifiable for banks to charge them even PLR. This shifting away from banks may start with big customers but there will be small customers also responding in different ways. In other words, it is not only bottom line calculation that is relevant in banking business; but banking is based on trust on both sides – trust from the people, who are depositing money in the bank, and trust from the people who are borrowing money from the bank. Similarly, some of the State Governments started relating the banks subscription to debt papers issued with State guarantees at different interest rates to the extent of their default in the last five years. The State Governments contend that though default is negligible, the rates of interest charged are way above those applied to large corporates. They claim that they are honouring their guarantees of borrowings by State level enterprises reasonably well and yet corporates who have the options of debt restructuring, rescheduling of debt, *etc.* are able to get loans at 300 basis points less than State guaranteed debt. It is necessary to be able to explain the basis of such differences in pricing of credit to different classes of borrowers by banks.

Another interesting point which has been raised about NPAs is that there is an impression that priority sector lending has large NPAs. The statistics may or may not confirm this. If you take priority sector and remove the government-sponsored programme on the one side and if you remove public sector (IOC, ONGC, other banks) component from non-priority sector, there may be only a marginal difference in NPAs of banks lending to priority sector and banks lending to private corporate sector (many of whom incidentally enjoy rescheduling or restructuring facilities that are not reflected in the risk premium). Therefore, the issue that needs to be addressed in this context is whether the risk premium charged to different segments of borrowers is disproportionate to the difference in the NPAs that have been generated in the past or on reasonable assumptions?

The issue is similar in respect of small industries. Many small industrialists have mentioned to me that in the last 10 years despite servicing interest and principal regularly they are still charged 11 per cent - 12 per cent. On enquiry, I was told that there is a thumb rule of some sort in banks – small industry means 11 per cent, agriculture means 10 per cent, "somebody else" means 7 per cent. Is it possible that we have still not developed the systems for risk assessment of the individual customer? Is it possible that as a result of the old administered interest rate structure, inspite of deregulation of

interest rates, banks have moved from administered interest rate into category-wise specification of interest rate which is consistent with the age-old culture of India? According to Manu, the interest rate for Brahmin per month was 2 per cent, for Kshatriya, 3 per cent per month, for Vaishya, it was 4 per cent per month and for Shudras it was 5 per cent per month. So charging interest rate on an attributable basis of a category rather than actual assessment of risks of each case is both consistent with the ancient culture and legacy of planned administered interest rate. We have to get out of that, if deregulation and competition has to really make sense. Banks should, therefore, analyse systems of risk assessment not only for their own satisfaction but to be able to justify to the borrowers the basis on which the risk assessment is made.

Another interesting aspect I found is that the share of public sector banks in the deposits is more or less maintained, but lending is coming down. They have 79 per cent of the share in deposit and 74 per cent in credit, in the system, but foreign banks with 5 per cent deposits lend 7 per cent. Private banks with 16 per cent deposit, lend 19 per cent. Is it that in a way some banks are gradually becoming only deposit-taking banks and others are becoming only lending banks? This may or may not be good, but I have a problem from a policy point of view with the way the existing branch network is spread over the country, with wide geographical and sector-wise coverage only for some banks. Given this type of spread of branch network, if some banks become deposit-taking, then the banking system will become a conduit to channel deposits from one area, say rural, and one sector, say agriculture to lend to another sector (urban or industries) which counters the intention of the public policy.

Institutional Aspects

We have to look at the monetary policy, real sector policy, and financial stability but we also need to do further work on the legal and institutional structures to see what needs to be changed. For example, State Financial Corporation (SFC) Act enables seizure of and sale of property of borrower by SFC. I remember many banks wanting a similar power to be vested with them. But, as many of you may be aware, most of the SFCs are sick. So, the power by itself is no answer to the issue of NPAs. Further, if one sees the total amount realised by SFCs, by invoking such powers, it is barely 20 per cent, on average, whereas one-time settlement of the banks has given an average of 40 per cent to 60 per cent. So the empirical evidence is not in favour of such powers, but still we persist with the same approach. Is it that banks want power to be able to do something? We have to look at it very carefully.

Similarly, many people seem to believe that to stop something that is considered to be bad for the financial system, make it a “crime” and the problem will be solved. We had Foreign Exchange Regulation Act (FERA), a tough legislation, under which one could be easily put in jail. As long as we had the apparatus of stringent FERA, foreign exchange virtually went underground and we even had several foreign exchange crises.

We removed the FERA, realigned several policies consistent with appropriate incentive framework for compliance, and introduced FEMA which is far less stringent and we have no forex crises or forex shortages. In other words, the issue is that prescribing a serious punishment by law does not automatically discourage illegal activity. Criminals may be fraudulent people but they are also good rational analysts of costs and benefits as well as probabilities. They analyse the probability of being caught, the probability of being taken to court, the probability of being punished, the degree of punishment and when the punishment is likely – in their lifetime or after! Once they examine these probabilities as they exist and operate now, what we state in law often appears at best irrelevant and occasionally useful for harassing. So one must look at this in a realistic way and work on the basis of incentives to comply or otherwise and not proceed on the basis that enactment of law would ensure compliance. I am mentioning this in the context of demand from some bankers to make diversion of funds a criminal offence and to imprison willful defaulters.

I want to be quite open in terms of the constraints on monetary and credit policy as they relate to institutional structures. The dominant players in Indian banking system are the public sector banks (PSBs) and the dominant role in the banking system is that of the PSBs. From a regulatory point of view, a regulator cannot proceed with any policy change without taking into account the possible response from this biggest chunk of regulated entities. How far does the biggest chunk *(i.e.,* PSBs) have adequate manoeuvrability to compete? In fact, the “overhang problem” of problem ridden banking sector in other countries was isolated first. They created a level playing field between private and other banks or new private banks, old private banks, by solving the overhang problems *i.e.,* the non-performing assets, *etc.,* and then there was competition. In our banking system, the “overhang problem” of the NPAs, staff regulations, *etc.,* of PSBs has been left to the public sector banks themselves. The public sector banks are required to absorb the overhang problem over a period. So in a sense there cannot be a situation where opening up is envisaged without a level playing field. These are the dilemmas which have to be resolved, if a central bank, as a regulator of banks has to move ahead with full-fledged competition in banking industry. No doubt, PSBs have the advantage of large branch network and established relationship with savers and borrowers.

Sometimes, and of late, one notices that there is less of a relationship banking and that savers will always be with banks. If banks want to be in business, the base is the savers, and they have to be taken care of. Banks may have to revisit the relationship between banks and savers if they want to continue to be in business of banking, particularly in the context of the recent trends in the capital markets. The sensex has now surpassed 6000 mark. If equity premium in relative asset returns rises, banks should consider its potential impact on the core banking business. Then, regarding borrowers, the most important aspect that needs to be recognised by banks is the

system of risk assessment of individual borrowers and realistic pricing of risks. The whole idea of banks *vis-à-vis* other financial intermediaries in the intermediation business has to be considered. Therefore, the whole issue of credit culture and credit system should encompass the legal and institutional aspect of the policy environment, the way the saver or depositor and the borrower – both small and big are treated and the way banks position themselves to face these challenges.

Credit Culture

Finally, let me complete with the issue of credit culture in a broader sense. We, the students of economics, assume that human beings are rational and they work on the basis of enlightened self-interest. But, the reality is that in every human being, in the context in which one is maximising "self-interest", there is also a strong sense of fairness. The sense of fairness also influences economic behaviour. I can give an illustration first with taxes and then pose it as an issue for credit. When tax is being paid by an individual, there is a tendency to not just look at the tax rate in isolation but also to compare whether (a) it is excessive? (b) others are paying reasonably? (c) these taxes are unnecessary? and, (d) the money which is collected as tax is used appropriately. These are all the factors that influence tax compliance. Now the same principle can be applied to credit. In credit, is honest repayment by a borrower honoured, recognised or are others who are not as good, being charged less interest?. Though policy environment is very critical, there are several aspects to credit culture. Credit culture is a question of sense of fairness in India, since people repay loans out of moral compulsion as there are difficulties in forcing borrowers to pay, in view of the complications and delays in legal processes. Now, if we do not ensure a sense of fairness, this moral compulsion may be eroded. Therefore, we should apply our mind to the issues of credit culture in addition to institutional, legal changes and policy initiatives. We have to work towards evolving a conducive credit culture and perhaps the critical factor on which it anchors is fairness. Are we fair to savers? Are we fair to borrowers? Are we fair to all employees ? Are we fair *inter se* ? I leave the thoughts for your best judgement.