Sustaining growth potential – Focus on key Sectors[1]

I am privileged to speak before this learned audience at this conclave on the theme of 'Top priorities of the new regime – Growth strategies'. The topic is of special relevance for emerging economies like ours, particularly in the current context.

As is well recognised, the Indian economy has enormous growth potential, and can be one of the economic powerhouses in the current millennium. The economic dominance of India along with China looks all the more likely in view of the shift in the epicentre of growth to emerging Asia after the crisis. While concerns about current global turmoil and its impact on macro-economic risks is much talked about and is also relevant, we should not be losing focus from the longer-term issues and agenda to address the welfare of our people.

In my address today, I would raise some of the issues that are relevant to the banking system for sustaining our growth potential. But, before doing that, a brief macro overview could be useful.

The growth rate of 8.8 per cent average in the Indian economy during 2003-08 the highest ever recorded is only next to China, in the contemporary world. The high growth emanated from the upsurge in domestic savings rate (23.5 per cent in 2001-02 to 37.7 per cent in 2007-08) supporting the step up in investment rate (from 22.8 per cent to 39.1 per cent) in an environment of moderate inflation and macro-economic stability. However, contagion from the global economic crisis brought the growth rate down to 6.7 per cent in 2008-09 with growth in the second half of 2008-09 at 5.8 per cent largely because of lower export demand and shrinking foreign liquidity. The economy is unlikely to revert back to trend growth soon, as recession in the advanced economies would persist with global growth projected to contract by 1.4 per cent by the IMF with a more sizeable fall in world trade by 12 per cent. The Indian economy is expected to grow by 6 per cent as per the latest

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[1] Keynote address by Smt. Usha Thorat, Deputy Governor, Reserve Bank of India at the inaugural session of the "Conclave of CEOs and CFOs" organised by Institute of Public Enterprise & NMDC Ltd, CII (AP) & CEO Clubs India at Hyderabad on September 11, 2009. The contribution by Shri Rajib Das in preparing this keynote address is acknowledged.

assessment made by the RBI. GDP growth in the first quarter of 2009-10 is broadly consistent with that (6.1 per cent).

The current focus is to bring back the economy to the high growth path as a key means to ensure higher living standard for all. The Planning Commission in the Eleventh Five Year Plan Document (2007-12) identified a number of priorities to fasten an inclusive growth process so that the economy can grow at a rate of around 9 per cent during the plan period. One of the key requirements of growth is capital formation and for this it is imperative that more and more of household savings are directed to financial savings thereby facilitating capital formation. Currently financial savings constitute 48.5 of total household savings. If this share is to go up, there is need for much greater penetration of the banking, insurance and capital market products in the country. The policy of financial inclusion is therefore critical for greater capital formation to ensure higher and sustained growth.

I would like to specifically touch upon the issues of ensuring adequate credit for agriculture, MSME and infrastructure, all of which are critically important to achieve sustainable and inclusive growth. These are rightly placed as growth engines in the current workshop.

Agriculture

After recording robust and above trend growth during 2003-08, overall agriculture output decelerated during 2008-09 despite a record level of food grains production at 233.9 million tonnes. Higher production was aided by rabi output, while kharif output was affected by floods in some states. Production of coarse cereals, pulses, oilseeds, showed slippage and output of sugarcane and cotton declined over the year. Diversification of Indian agriculture towards horticulture, livestock and fisheries has been evident for some years with their joint share reaching close to 60 per cent of the agriculture and allied GDP. Allied sector is expected to grow between 5 per cent and 6 per cent during 2008-09. Although there has been a drop in the share of agriculture in the GDP from 36.4 per cent in the 1980s to around 17.0 per cent now, the number of people dependent on agriculture for their food and

livelihood remains largely unchanged at nearly 60 per cent underscoring the importance of agriculture to sustain growth in the country.

Various studies predict that in the long term, the increased demand due to population growth and rising per capita income, would outstrip the supply of cereals, pulses, edible oil and sugar. Key issues that need addressing in this context have been identified as follows. Firstly, irrigation is the key to the removal of Indian agriculture's dependence on the monsoons. The actual net irrigated area in the country is 62.31 MH, which is only 43% of the net sown area of the country. Secondly, yield comparisons of major crops over the last 3 decades shows mixed results. While wheat yield has increased from 82% to 93% of world average, paddy yield has stagnated and maize yield has drastically dropped by 98% to 40% of world average. Third, the average size of farm holdings has steadily declined. Out of India's 116 million farmers, about 60% have less than 1 hectare and together they farm just 17% of the land. Thus, many of the very small farms are subsistence holdings with low investment and low productivity. Fourth, the imbalance in the use of nitrogen–phosphorus–potassium (NPK) fertilizers is creating problem of soil degradation and adversely affecting productivity. Fifth, the increasing subsidies have suppressed investments.

Gross capital formation in agriculture relative to agriculture and allied GDP improved slightly from 11.2 per cent in 1999-2000 to 14.2 per cent in 2007-08. The rise is largely contributed by the public sector whose share rose from 6.0 per cent 1999-2000 to 8.2 per cent in 2006-07; the corresponding share from the private sector fell from 10.2 per cent to 7.0 per cent.

From point of view of agricultural credit, the broad policies followed are:

- Mandating that 18% of commercial bank credit is lent to agriculture of which at least 13.5 % has to be for direct agriculture. Policy of doubling of agricultural credit in three years started in 2004-05.
- With effect from 2006-07, GOI has provided interest rate subsidy for crop loans given by public sector banks RRBs and cooperative banks. The rate has been increased from 2% to 3%. Subsidies for the last three years amounted to Rs. 6,019 crore.

- Strengthening of the regional rural banks and rural cooperative credit structure
- Greater branch expansion in rural and semi urban areas and encouraging use of intermediaries and IT solutions for greater banking penetration
- RIDF investments against shortfall of priority sector and weaker section lending. Cumulative disbursement till June 2009 was Rs. 58,041 under the various RIDF since its inception in 1995-96.
- Debt waiver program of the Union Budget for 2008-09 resulted in write off of loans for farmers enabling them to re access the banking system

The policies have led to significant increase in share of agricultural credit to agriculture and allied GDP from 22.7 per cent in 2004-05 to 33.3 per cent in 2008-09. The compounded annual growth rate of agriculture credit was 28.4 per cent during 2003-08 as compared to 24.5 per cent for overall bank credit in this period. The fact that overall private capital formation in agriculture has declined during this period would suggest that most of the incremental credit has gone for production and not for investment. This is an issue which needs more study to understand the factors that are impeding private capital formation in agriculture. These would be obviously closely linked to the factors identified as impeding growth in agriculture.

Micro and Small Enterprises (MSEs)

While non financial factors may be more important in the agricultural sector, in the MSE sector, credit is a vital input for growth. As per the data on micro and small enterprises (MSEs) in the Annual Report of Ministry of Micro, Small and Medium Enterprises, 2006-07, the sector accounted for around 39 per cent of total industrial production, 34 per cent of the exports in the industrial sector and around 35 per cent of total employment among units engaged in manufacturing and services. The sector registered a robust annual average growth in value of output, exports and employment at 16.8 per cent, 20.0 per cent and 4.4 per cent, respectively during the expansionary phase of 2003-07, before showing signs of slowing down in 2007-08 particularly in respect of employment growth to 2.9 per cent.

According to the Annual Report of Ministry of Micro, Small and Medium Enterprises, 2006-07, fixed investment in the sector constituted 37.8 per cent of the value of production from the sector in 2005-06 (decline sharply from 59.9 per cent in 1999-2000 and 51.6 per cent in 2002-03). Credit to the sector as share of GDP of the sector however rose marginally from 55.0 per cent in 1999-2000 to 56.7 per cent in 2006-07. In terms of overall bank credit, credit to MSEs declined from 14.5 per cent in 1999-2000 to 7.2 per cent in 2006-07. Although annual growth rate of credit to this sector was more than 20.5 per cent in this period, credit to the system as a whole grew by 30.3 per cent. Share of MSE increased to 11.4 per cent in 2008-09, but this is not comparable with the past data because of definition changes..

The problems cited by MSE borrowers in obtaining access to bank finance are insistence on collaterals /guarantees, limited outreach of banks, rigid approaches, high interest and other costs, complex documentation, lack of supporting business development services and so on. From the banker's point of view, the critical factors affecting credit delivery to this sector are low equity base, absence of marketing tie up, diversion of funds, poor management and book keeping, higher NPAs, mounting of receivables due to delay in payment of bills especially during downturn.

The major policies in regard to credit delivery to this sector

- Measures to increase flow of credit leading to almost three fold increase in the credit to this sector from public sector banks from Rs.67,600 crore as on March 31, 2005 to Rs.1,90,958 crore as on March 31, 2009.
- Inclusion of MSE (as per revised definition) in priority sector with sub limits for the micro units
- Stipulation that collateral should not be taken for loans up to Rs.5 lakh to MSE units
- Providing credit guarantee for collateral free loans from the Credit Guarantee Trust Fund administered by SIDBI

The sector attracted funding from all categories of banks in the boom period 2003-08. As many leading manufacturers in the automobile and other sectors started

sourcing their inputs and supplies from the small enterprises, banks and NBFCs found that lending to such small enterprises was good business. In many cases the banks were already financing the large manufacturers and could tie up the delivery and recovery mechanism through them. Hence the model that came to be called invoice financing or channel financing led to surge in credit to the small enterprises. However, at the time of the down turn, the receivables and inventories piled up with the small units and banks were chary of lending more to them leading to difficulties for many units. It was at this stage that the GOI and RBI took several measures to ensure holding on operations and support for the units affected. Banks were advised on October 31, 2008 to consider restructuring of the dues of MSEs wherever warranted, and continue to disburse loans against the sanctioned limits. Special refinance limits for assisting the MSE sector were introduced and SIDBI was provided a limit of Rs 7000 crore. State Level Bankers' Committee (SLBC) convenor banks were advised to organise special meetings to address the problems of the MSE sector. Regional /Zonal Offices of banks advised to closely monitor flow of credit to MSEs and also institute a help desk at key centres.

Unlike the larger companies, small enterprises access to capital markets for raising equity and long term funds is limited. Further, such units require handholding and business development and support services in the initial stages. Very often, they also need assistance to prepare project reports and proper accounts. For new ventures without track record, venture capital or start up funding is mostly through friends and relatives and this is an area where the demand far exceeds the supply. Delay in or inadequate working capital can derail operations. For dealing with large numbers, banks need bulk risk scoring models and IT capacities. The transaction cost need to be reduced if the overall cost of raising funds has to be reduced. While many banks have specialised branches and schemes for facilitating quick processing and sanctions to the sector, there are huge expectations from banks as also several challenges before them.

Infrastructure

The Eleventh Five Year Plan envisages stepping up of the gross capital formation in infrastructure from 5 per cent of GDP in 2006-07 to 9 per cent of GDP

by end of the Plan period in 2011-12, which could be critical for achieving the 9 per cent growth. It has estimated an investment requirement of US$ 502.88 billion (Rs.20,11,521 crore) in infrastructure, around 30 per cent (about 6 lakh) of which is expected to be financed by the private sector.

Banks' exposure to infrastructure lending has grown nearly fourfold since March 2005, from 6 per cent to about 9.25 percent of bank credit in March 2009. While public investment would dominate the sector, the challenge is to attract private funding to this sector. In most countries, infrastructure financing has taken place by the government itself or with explicit or implicit guarantees from the State. To attract private investment, many countries have offered policy guarantees, refinance and maturity extension guarantees, viability gap funding etc. Credit insurance was also provided by monoline insurers.

Multifaceted risks are involved in bank-funding of infrastructure viz. asset liability mismatches -leading to liquidity and interest rate risks- which could translate to credit risk, implementation delays leading to cost/ time over runs, expected cash flows based on use and cost recovery not materialising, financial conditions of ultimate purchaser of the services becoming uncertain despite cash flows being escrowed, concentration risk of too many projects being executed by the same group and so on. In India, implementation risk and user charges recovery risk are perceived to be more relevant. Unbundling of risk through structured products have to be carefully thought through out to avoid undue leveraging and building of risk in the banking system or in interconnected entities as the recent global crisis has so eloquently demonstrated.

RBI has provided a number of measures for facilitating infrastructure finance, such as allowing banks to enter into take-out financing arrangement, freedom to issue long term bonds for financing infrastructure, some relaxation of single and group borrower limits for additional credit exposure in infrastructure sector, flexibility to invest in unrated bonds of companies engaged in infrastructure activities within the overall ceiling of 10 percent of non-SLR securities, excluding from capital market exposure promoters' shares in the SPV of an infrastructure project, permitting banks to extend finance for funding promoter's equity where the proposal involves

acquisition of share in an existing company engaged in implementing or operating an infrastructure project in India. We have recently revised the definition of commercial real estate by linking it to source of repayment rather than the collateral so that hotels hospitals SEZ projects of certain types etc can be classified as not falling under commercial real estate (CRE).

To stimulate public investment in infrastructure, a special purpose vehicle - India Infrastructure Finance Company Limited (IIFCL) was set up for providing long-term financial assistance to infrastructure projects. The Union Budget for 2009-10 announced that IIFCL in consultation with banks will evolve 'take out financing' scheme to facilitate lending to the infrastructure sector. To ease the financing constraints for infrastructure projects under the PPP mode, the Government has decided that IIFCL would refinance 60 per cent of commercial bank loans for PPP projects in critical areas over the next fifteen to eighteen months. IIFCL was authorised to raise Rs.10,000 crore through Government guaranteed tax free bonds by the end of 2008-09 and an additional Rs.30,000 crore on the same basis as per the requirement in 2009-10. The refinancing option is expected to leverage bank financing for PPP programmes to the extent of about Rs.1,00,000 crore. Given the huge financing requirement of the infrastructure sector, IIFCL needs to assume direct credit risk. Further IIFCL could explore leveraging their capital and budgetary allocation for raising tax free bonds to provide credit enhancements, risk mitigants, back stop liquidity and take out financing thereby attracting more private funding (including bank funding) for infrastructure.

As infrastructure projects are of huge size and are very often executed by few large groups, bank funding is necessarily limited because of exposure limit requirements. A suggestion sometimes made is to relax exposure limits –especially the group limit- where the projects are executed by an entity through an SPV and cash flows emanating from the project are separately escrowed. Exposure limits for groups are intended to minimise concentration risk. It is difficult to envisage that problems faced by groups will not spill over to the associated entities or vice versa or that the support from the group is not a factor that encouraged the financing in the first instance. In any event the issue is whether additional risk requires additional safeguards and this is something we are examining. Having said that, borrowers too

need to accept the fact that their requirements cannot be met by a few banks or banking system and they will have to explore syndicated structures and corporate bond issuances for their large project requirements.

In this context, it is argued by some that for development of corporate bond market, banks should provide credit substitutes such as guarantees. Experience of other countries, particularly Korea and China has not been encouraging – while the former has made its bond market a 'no bank guarantee' market, the latter is stated to be placing curbs on such guarantees. The current regulatory policies in India do not allow banks to guarantee corporate bonds. There are several reasons for this. Issuance of a tradable bond with 100 per cent bank guarantee inhibits the development of corporate bond market in many ways. First, such a product places the entire risk of the exposure on the banking system and is akin to a bond issued by a bank itself. Second it distorts the pricing of corporate bonds. Third, such a practice also discourages institutional and retail investors to appraise and assume credit risk. Any credit enhancement or protection needs to be offered and priced separately. A policy framework for introduction of credit derivatives is being developed taking into account the lessons learnt from the global crisis.

There is also a view that corporate bond markets will only develop if RBI allows repos in such bonds. At the outset it must be recognised that development of the long term corporate bond requires long term institutional investors such as insurance companies and pension funds. Several measures are being taken by the Government to promote insurance and pension sectors. While , to some extent banks can undertake the maturity transformation, to mitigate the risk of such transformation beyond acceptable limits, the only option is for government itself or government entities like IIFCL to provide appropriate risk mitigants till natural long term institutional investors emerge in a big way.

To come back to repos in corporate bonds, RBI has already set out the pre-conditions for allowing repos in corporate bonds: viz., an efficient and safe settlement system based on DvP and availability of fair prices. The permission to the clearing houses of the exchanges to open a transitory pooling account with the RBI is the first step taken to provide an environment for an efficient and safe settlement

system. Draft guidelines for allowing repos in corporate bonds will be placed shortly on RBI's website for wider dissemination and comments.

Take out financing is one method of addressing the ALM issue. Some argue that take out financing has not worked because of the higher capital requirements that needs to be maintained, both by the financial entity offering the asset for takeout as also the bank financing the infrastructure. In case of organisations like IIFCL offering take out, this should not be an issue. However we are having a relook at this constraint.

Issuance of long term bonds by banks with special incentives for investors is another suggestion that is made for addressing the problem of asset liability mismatch. While this is being examined, it needs to be mentioned that the recent introduction of the 10 year future on the exchanges can perhaps help in developing products to mitigate the interest rate risk for infrastructure projects.

To conclude, there is need to address the non credit issues in agricultural credit , credit and credit plus issues in MSE financing and a variety of innovative risk mitigants in infrastructure financing to make sure that the Indian banking system can play its due role in capital formation in these three vital sectors of the economy so critical for sustainable inclusive growth.

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