RBI Working Paper on Asset Quality and Credit Channel

Why in News

Recently, a **Reserve Bank of India (RBI)** working paper on 'Asset quality and credit channel of monetary policy transmission in India' has been released.

RBI **introduced the RBI Working Papers series in March 2011**.

Key Points

- **Credit Channel:**
  - The credit channel of monetary policy transmission is **robust in India** and **operates through changes in lending**.
    - There are **two ways** the credit channel can work: by affecting overall bank lending (the **bank lending channel**) and by affecting the allocation of loans (the **balance sheet channel**).
- **Credit Deceleration:**
  - Credit growth deceleration in India **since 2013** is explained by **asset quality stress** in the banking system, **slowdown** in economic activity and **moderation in bank deposits**.
  - The **growth rate in credit offtake** has steeply **declined to 5.8% in November 2020**, as against **14.2% in 2013**.
  - A **wide divergence** has also been observed in **credit growth of public and private sector banks**.

- **Potential Determinants of Credit Growth:**
  - **Asset Quality Stress:**
    - Since the **early 2010s**, asset quality of banks in India **has worsened gradually**, impacting their profitability.
    - Asset quality of Scheduled Commercial Banks (SCBs) is **measured as a ratio of gross non-performing assets (GNPAs) to gross advances**.
  - **Nominal GDP Growth:**
    - **Higher growth** in nominal Gross Domestic Product (GDP) **increases the demand for credit**.
    - The decline in credit growth post 2013 was mainly due to a surge in bad loans, accentuated by a slowdown in GDP.
    - Nominal GDP is an assessment of economic production in an economy that includes current prices in its calculation.

      Nominal **differs from real GDP** in that it includes changes in prices due to inflation, which reflects the rate of price increases in an economy.
  - **Deposit Growth:**
    - Deposit growth has **remained highly volatile**, especially from the second half of 2015.
    - It needs to be noted that **a financial institution with a greater availability of funds** will be in a better position to provide **more credit to borrowers**.
  - **Investment Growth:**
    - The **surge in investment growth** has also added to the **slowdown in credit growth**.
    - To the extent **banks invest in securities, lower resources** would be available for **extending as credit**.
    - In India, **investments by banks** include both investment in government securities as prescribed under the statutory obligations (**statutory liquidity ratio** or SLR) and voluntary investments held in government securities and bonds/debentures/shares of corporate bodies.
  - **Interest Rates:**

    Higher the interest rates, **higher will be the cost of borrowing** and hence, **lower would be the demand for credit**.
  - **Other Bank-specific Characteristics:**

    Such as the **size of the bank and capitalisation** (an estimation of the value of a business).

- **Measures Taken:**
  - The **accommodative stance of monetary policy** and **reduction in the policy repo rate** (starting from 2019) helped cushion the credit deceleration.
    - An accommodative stance means **a central bank will cut rates to inject money** into the financial system whenever needed.
    - **Repo Rate,** or repurchase rate, is the key monetary policy rate of interest at which the central bank or the Reserve Bank of India (RBI) lends short term money to banks.
      1. Everything from interest rates on loans to returns on deposits is influenced by this crucial rate set by the RBI.
      2. The central bank **has slashed policy repo rate by 350 basis points to 4%** now from 7.50% in March 2013.
  - After the Asset Quality Review (AQR), since 2015, many hidden bad loans had surfaced, forcing the government to enact the **Insolvency and Bankruptcy Code (IBC)** for resolution of bad loans.
  - Despite the lockdown, layoffs and closure of many units in the wake of the **Covid-19 pandemic, gross NPAs of 31 banks witnessed a decline of 5.25%** in absolute terms as the **RBI allowed relaxation in the computation of bad loans** and announced **a loan restructuring scheme**.

Way Forward

- In a **bank-dominated financial system** such as India, the **credit channel plays a critical role** in transmitting monetary policy impulses to the credit market and from thereon to the real economy.
- Controlling for asset quality, in the short-run, the credit channel of monetary transmission **of public sector banks is stronger** relative to that of private sector banks.
- For monetary policy actions to have their full impact on the credit channel, it is imperative that the **asset quality concerns of banks are addressed** and that their **capital positions are strengthened**.

Source: IE