

What do banks (not) do?

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I. Bank Credit in India

In 2000 and 2001 we spent a few days visiting branches of an Indian public sector bank. The bank then had, as it still has, a reputation for efficiency: Indeed everyone we met seemed busy and the managers sounded like they knew what they were doing. We did notice that everyone's desk was strewn with memos, circular and bulletins, full of instructions, exhortations and prohibitions, but we still thought that this was going to be different.

Which is why the data we collected from the bank surprised us: In 64% of the cases, we found that the amount of credit a firm got from the bank was exactly equal to the amount that it got in the previous year. In 1999, that fraction was as high as 70%. To put this numbers in perspective, in 73% of the cases, sales had gone up, suggesting that the firm might need more working capital, but the actual loan only went up in 30% of the cases. Moreover, most firms (more than 80%) were already hitting their credit limit.

Indeed, the bank's own notings in the firm's credit file clearly register the fact that the firms needed more credit: Every year the bank is supposed to do an assessment of the firm's credit needs based on its lending formula, and meet the legitimate credit needs of the firm. In fact, not every file had the notings, suggesting that these files had not even been touched, but even among the ones that did, in 60% of the cases, the loan granted (technically the credit limit granted) was less than the limit that the bank's loan officer had calculated. To make matters worse, when we tried to figure out how the loan officer had come up with the limit based on the bank's very explicit instructions about how to go about calculating it, we found that the calculated limit was typically less than what the bank's rules permitted. The bank's rules allow the limit to be 20% of the predicted sales of the firm, but based on the officer's own calculation of predicted sales, the granted limit was only 67%

of this number. The bank, or at least the bank's officer, knows that it is not lending enough and that its rules permit it to lend a lot more if it wants to.

Of course, there are other banks---perhaps the firms are getting as much as they need from somewhere else. To look at this question, we made use of the fact that early in 1998, the government had relaxed the so-called "Priority Sector Regulation", to permit banks to count lending to firms with plant and machinery of less than Rs. 3 crores as part of their required lending to the priority sector,¹ when before they could only include firms below Rs. 65 Lakhs. Our bank clearly thought that this was an opportunity to balance its portfolio, and the newly included firms saw the growth rate of their borrowing from the bank go from about half of the corresponding rate for firms below Rs. 65 Lakhs that were already in the priority sector in 1997, to about 50% more in 1998. If the firms were already sated with credit, we saw no signs of it. It could be however, that this credit was cheaper---after all, the bank wanted to lend more to these firms. Perhaps the firms just borrowed from our bank to pay down its debts elsewhere. The fact, however, was that when we looked at sales growth, we see a pattern that exactly mirrors the pattern we saw for credit: Sales growth speeds up in these newly included firms, relative to the firms that had been included in the priority sector all along. The elasticity of sales with respect to credit was 0.75, implying that one percent faster growth in credit lead to three quarter of a percent more growth in sales. Moreover we have good reasons to suspect that this is an under-estimate. The corresponding figures for profits were even more impressive: a 1% increase in credit growth generated a 1.8% increase in profit growth.

Unexpectedly, we got a chance to check that that these numbers were actually right: In the beginning of 2000, just our data had started coming in, the government decided to scrap this new

¹ All banks , whether private or public, have to lend 40% of their portfolio to the priority sector.

credit policy and go back to a limit of Rs 1 crore in investment in plant and machinery to be eligible for priority sector credit. So we had another “experiment” to study. We waited almost two more years, collected data again, and held our breath while the results came in. It turned out that we were either very lucky or we had stumbled on that rare thing, a hard fact. When we compared the newly *excluded* firms with the rest, we found that cut in credit growth resulting from the exclusion had indeed hurt their sales, and the elasticity was 0.73, almost exactly what we had found before. The impact on profits was also extremely similar, the elasticity being 1.89.

The fact that a one percent increase in credit increases profits by 1.8%, meant in our data that a one *rupee* increase in credit increases firm profits by about 90 paise. One would imagine that something quite so obviously lucrative would have no problem getting funded, if not from our bank, from somewhere in the system. And if this is how these relatively large firms with proper balance sheets and official papers are getting treated, one can imagine what must be happening to firms in the informal sector, who usually know better than to even try to get a bank loan.

II. What is going on?

Why is a banking sector that was nationalized in order to “(meet) the needs of planned growth and equitable distribution of credit, which in privately owned banks was concentrated mainly on the controlling industrial houses and influential borrowers; (and to meet) the needs of growing small-scale industry and farming regarding finance, equipment and inputs;”, in the words of Prakash Tandon, a former Chairman of Punjab National Bank, starving the firms of credit?

If you ask bank officers, they usually say that this has something to do with non-performing assets (NPAs). NPAs are indeed a serious problem for banks in India and it is easy to see why a bank might hesitate to lend if the loan has a high risk of going bad. In the year ending in March 2003, gross NPAs represented 4.6 percent of public sector banks’ total assets.

However there is no evidence that at the margin, the banks are saving themselves from NPAs by rationing credit to *these firms*. The expansion of credit to the larger firms that came with the change in the priority sector rules in 1998, did not increase the rate at which these loans became NPA, but the unexpected shrinking of credit in 2000 did. This is not to say that lending too much cannot be a danger, but these banks are not obviously anywhere close to that margin.

Indeed, we essentially got nowhere when we tried to link the bank's reluctance to give additional credit to its clients to some strategy for avoiding NPAs. Who gets extra credit and who does not, turns out not to be correlated with increases in the firm's current assets; yet the current assets typically go up because the firm's inventories or receivables have gone up, which means the firm has money coming in, which ought to make it more credit-worthy. It is also entirely unrelated to whether the firm is profitable, notwithstanding the fact that in an environment like India, where asset-stripping is common and default often goes unpunished, profits are probably the lender's best friend---firms typically do not default if their regular business is making lots of money.

Our hunch is that the main source of NPAs is not what the banks do but what they do not do. The usual thing for a bank officer to do with loan file is to not do anything. This is true not only when they review firms that are growing, but also true when they review firms that are losing money. Like almost everyone else, firms that loose money get exactly the same loan as they got last year---except that, they, of course, should probably get a lot less. A lot of the NPAs probably come about because bankers systematically fail to pull the plug when it is still possible to get out with their capital intact.

In our view then, it all comes down to the fact that bankers are lending when they should not, and not lending when they should. If this sounds strange, think of what a public sector banker gains by taking the right decision: Promotions and raises are largely routinized and depend only

mildly on performance. On the other hand, if he cuts someone's credit line, he (or more likely, his boss) is liable to get complaints or worse. And if he lends more and the loan somehow goes bad, then he is last person to take an active step on the loan, and therefore he is in trouble: Employees of public sector banks come under the anti-corruption legislation which states that any government functionary who *takes a decision* that results in direct financial gain to a third party is prima facie guilty of corruption and must prove her innocence. If, instead, he had simply continued what his predecessor had done, he would typically not be in the line of fire.

That this is not simply our imagination running away, is confirmed by the report of the M.S. Verma, Committee on lending practices:

“the diffidence in taking credit decisions with which the banks are beset at present... is due to investigations by outside agencies on the accountability of staff in respect of some of the NPA”

This effect is actually strong enough to show up in the data: In work with Shawn Cole, a Ph.D. student at MIT, we showed that in the month after there is an investigation for corruption in a particular bank, lending by that bank drops by 3-5 percent compared to all the other banks.

III. Where now?

There is an almost gratuitous perversity about some of what goes on in an Indian bank. It cannot be hard, for example, to make bankers care about profits. It should also be possible to alter the rules for who gets investigated: A lifetime of probity should buy people some protection for their occasional mistakes.

Reducing public control of the banks is probably one way to get to this, though there is no guarantee that this would change things a lot. As we noted, the firms are starved of credit, even though there is nothing to stop them to borrow some more from a private lender. This might mean

that the private banks have inherited the culture of the public banks, in which case changing control will not help. Or it could mean that the private banks are worried that the clients of the public bank who come to them might be exactly the ones they do not want, in which case turning the public bank into a “private” one will improve things. However, it may still be that private incentives are not enough to get banks to lend to small firms at reasonable rates: We may want some version of the priority sector regulation to remain, though it should probably apply to new firms rather than just small firms.

In many ways the banking system in India, including the regulatory apparatus, remains a product of the planning years: It seems to be a system that was conceived for a world where people were expected to do what they were told, and things happened to as they were meant to. The real challenge, whether public control remains or not, is to create a banking system for a world where investors take risk and sometimes fail, where bankers need to take initiative and use their judgment. We need incentives for bankers that reward success but make allowances for bad luck, and which at the same time guard against the temptation to be irresponsible or corrupt.