Balancing policy objectives in Asia: leverage vs long-term economic growth

Remarks on the Policy Panel

Deepak Mohanty[1]

I will limit my remarks to challenges of corporate financing in our region. In recent discussions, attention has been drawn to high corporate leverage in the Asian region, including my own country, India. This is considered as a significant financial stability risk. It could also have growth implications. As corporate leverage increases, it impairs the ability of firms to invest, adversely impacting overall economic growth.

What drives corporate investment? How do corporates finance their activities? Hyman Minsky gave an interesting characterisation of corporate finance. He categorised corporate financing into three types: hedge financing, speculative financing and Ponzi financing. Under hedge financing, cash flow exceeds all debt payment obligations. Under speculative financing, total expected cash flow in the foreseeable future exceeds all debt payment obligations but falls short in the near term. One example of speculative financing, in the Minsky analogy, could be infrastructure financing. It is not that infrastructure projects cannot be financed commercially, but positive cash flow occurs much later in the project. At the same time, if the assumptions about the project outlook go wrong, it could result in significant debt servicing issues. Under Ponzi financing, cash flow falls short of near-term interest payment; hence, reliance on short-term borrowings rises, and consequently debt grows. One could think of real estate investment in a scenario of ever-increasing asset prices as Ponzi financing. If the expectation of real estate price remains buoyant, it could draw substantial investment further bidding up prices. As long as prices continue to rise, such investment seems viable. But once asset prices fall, the debt burden becomes unsustainable.

In a Minsky world, financial stability or instability depends on a mix of these three types of financing. Once the market expects that the given mix is unsustainable, there is a rush to reduce debt levels leading to a fall in asset prices and profits. Bankruptcy rises. In an extreme scenario, there is precipitous fall in general activity and overall price levels due to debt deflation.

In the present world, corporate financing can also be broadly conceived along the lines Minsky suggested. Corporate investment is driven by expectations about the future prospects of growth and profit. These expectations, however, may not always materialise. Some projects may become unviable because of exogenous shocks, for example, a commodity price shock, while others could go bad because of a worsening economic outlook.

Against this useful stylised pattern for looking at corporate financing, let me turn to the stress in India' banking sector, which has arisen largely due increased leverage

1 Executive Director, Reserve Bank of India.

in the corporate sector. The gross non-performing loans (GNPLs) of commercial banks increased sharply from 5.1% of their gross advances in September 2015 to 7.6% by March 2016 following a special asset quality review (AQR) by the Reserve Bank of India (RBI). Is it that asset quality earlier was misreported? Not really. What happened was that a significant part of standard restructured advances got reclassified as non-performing loans (NPLs) on a more rigorous scrutiny. Consequently, there was largely a compositional shift: overall stressed advances, which include both NPLs and restructured standard advances, rose marginally from 11.3% in September 2015 to 11.5% in March 2016. In addition, in order to address any possible ambiguity of interpretation in future, the accounting practice was changed so that all incremental restructured assets would be classified as NPL from the financial year 2015–16, starting from 1 April 2015.

The stress in banks' balance sheets arose because of several factors such as their increasing exposure to the infrastructure sector, the downturn in the mining and metal sectors and weakness in credit risk assessment. Industry analysis showed that industries such as iron and steel, construction, power, telecommunication and transportation, all of which had high leverage, also suffered from high interest burdens that exacerbated the stress in the banking sector. The AQR, by improving the transparency of banks' balance sheets, had several positives. First, it was welcomed by the market, as reflected in improved stock prices for banks. Second, bank balance sheets became stronger with greater provisioning against NPLs. Third, it prompted a process of gradual deleveraging in the corporate sector as banks became more discerning in their lending decisions.

It is one thing to recognise asset impairments early and provide for that. At the same time it is important to put in place a framework for banks to proactively engage with firms to seek out ways for a going concern to recover from financial distress. Such initiatives could be less disruptive, and at the end prove to be growth-enhancing. In this context, I may highlight two initiatives by the RBI.

First, to strengthen the ability of lenders for deep financial restructuring, the RBI has introduced a scheme for sustainable restructuring of stressed assets (S4A). Under this scheme, the lenders are required to partition loans into sustainable and unsustainable components. The portion of the loan that can be serviced through the existing cash flow is defined as sustainable debt. The unsustainable part of the debt is converted into equity or equity-related instruments. As a result, both the debt burden of the borrower and promoter's equity stake are reduced. The idea behind the scheme is that banks would get the upside if the company recovers, and it also gives the borrower another opportunity to turn around the company.

Second, a major challenge for many emerging market economies is the overreliance of corporates on bank credit, partly due to the inadequate development of the corporate bond market. In order to induce large borrowers to partly meet their resource requirements beyond a limit from the capital market, the RBI has introduced prudential measures to disincentivise banks from their incremental exposure to large borrowers as from the financial year 2017–18. If a large corporate is unable to achieve a reasonable mix of bond and credit financing, incremental lending by banks to such corporates will attract higher provisioning and risk weights.

While corporate debt levels still remain high, straining firms' debt-servicing capacity, I believe that that the recent initiatives will enhance transparency and promote financial stability.