Chapter 87
The Effectiveness of Credit-to-GDP Gap as a Leading Indicator of Banking Crises in India

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ABSTRACT

As per the 15th progress report on adoption of the BASEL regulatory framework, published in October 2018 by Basel Committee on Banking Supervision, 26 member jurisdictions now have final rules in force for CCCB. In India, the final rules on CCCB came into force from 5th Feb, 2014; however, the buffer has not been activated by RBI till now as in its assessment, the Credit to GDP gap and other indicators currently do not warrant activation of the countercyclical capital buffer (CCCB). The Basel III regulatory framework for more resilient banks and banking systems, released in December 2010, had introduced the CCCB aimed at strengthening banks defense against the build-up of systemic vulnerabilities. The CCCB is a pre-emptive measure that requires banks to build-up capital gradually as imbalances in the credit market develop. The primary objective of CCCB is to avoid any banking industry stress resulting from wide fluctuations in the credit cycle using the credit-to-GDP gap. In doing so, it raises the cost of capital for banks resulting in moderation of credit demand as well as dissuasion of banks from participating in binge credit growth during the buildup phase itself. The authors have calculated the credit-to-GDP gap (which has been accepted as the main Indicator) for India using the available data and conclude that the buffer guide has historically worked as a reliable EWI in the Indian context. The authors have also concluded that while CCCB is an instrument to protect banks from the bust phase of the financial cycle, it is not an instrument to manage the financial cycle, even if it may potentially have a smoothing impact.

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An important implication of implementing CCCB using the credit-to-GDP gap as the main indicator for banks and EMEs is that it may hinder beneficial financial deepening, if it is used to actively manage the financial cycle. The authors recommend including the attribution of the Credit-to-GDP GAP w.r.t., the changes attributable to GDP growth, as well as attributable to changes in credit growth in the decision making process to activate CCCB.

1. INTRODUCTION

The global financial crisis of 2008 had its origins in the interaction of an asset price bubble with complex financial derivative instruments that masked the inherent risks (Baily, Litan & Johnson, 2008). This asset price bubble was fuelled by years of unabated lending without commensurate deliberation of ensuing risks. The crisis finally capitulated, resulting in a near frozen credit market globally. The initial crisis in the financial markets then percolated to the real economy and ultimately manifested itself through the sovereign insolvency of European peripheral countries (2010 through 2012). This whole episode became a harbinger of an emergent distrust in the accuracy and efficacy of Credit Ratings and the existing Regulatory Capital Directives. (Sorkin, 2010)

At the time when the financial crisis erupted, central banks globally had just begun with the phased implementation of Basel II regulatory capital accord that was finalised by the BCBS under the aegis of BIS in 2006. The Basel II accord was conceptualised as an improvement to the then existing Basel I accord. It was expected to be more effective in forewarning and to a certain extent in preventing any impending economic crisis, by ensuring the soundness of the global banking system (BCBS, 2006). But on the contrary, the magnitude of the financial crisis, forced the market perception of Basel II to be viewed as "inadequate" in dealing with the critical issues brought to the fore during the unravelling of this financial meltdown.

While Basel II was being perceived to have many short comings, however regulatory capital requirement was still considered to be the main pillar of banking sector regulation. Maintaining optimum capital adequacy greatly reduces the probability and severity of financial crisis. But the determination of this Optimum level of capital, if left entirely to the individual banks, may result in inadequate level of capital being maintained in the banking system. Thus, there was a consensus on prescribing minimum regulatory capital standards. These earlier stipulated regulatory capital requirements were to a large degree static, and thus were well suited to address the more permanent systemic risk. However, even before the financial crisis unfolded, there was a lot of deliberation on whether it may be desirable to have capital requirements that vary over time, in proportion to the perceived level of systemic risk, that were known to vary over time and also deal with pro-cyclicality.

In order to address the perceived shortcomings of the Basel II accord, BCBS in 2010, came out with further enhancements in the Basel framework, which came to be known as Basel III accord. The 3 pillars as envisaged in Basel II were carried forward into Basel III along with enhanced level and quality of capital, enhanced capital for trading book, introduction of leverage ratio and the liquidity framework. In the run up to Basel III, in December 2009, the BCBS also published a consultative document that considered a series of measures to address pro-cyclicality (BCBS, 2009), with the following four key objectives: