

Summary

The prolonged period of loose financial conditions in recent years has raised concerns that financial intermediaries and investors in search of yield may have extended too much credit to risky borrowers, potentially jeopardizing financial stability down the road. These concerns are related to recent evidence for selected countries that periods of low interest rates and easy financial conditions may lead to a decline in lending standards and increased risk taking.

Against this backdrop, this chapter takes a comprehensive look at the evolution of the riskiness of corporate credit allocation—that is, the extent to which riskier firms receive credit relative to less risky ones, its relationship to the strength of credit expansions, and its relevance to financial stability analysis for a large number of advanced and emerging market economies since 1991. The chapter focuses on the allocation of credit across firms rather than the aggregate volume of credit or credit growth.

The chapter finds that the riskiness of credit allocation rises during periods of fast credit expansion, especially when loose lending standards or easy financial conditions occur concurrently. Globally, the riskiness of credit allocation increased in the years preceding the global financial crisis and peaked shortly before its onset. It declined sharply after the crisis and rebounded to its historical average in 2016, the latest available year for globally comparable data. As financial conditions loosened in 2017, the riskiness of credit allocation might have risen further.

An increase in the riskiness of credit allocation signals heightened downside risks to GDP growth and a higher probability of banking crises and banking sector stress, over and above the previously documented signals provided by credit growth. Thus, a riskier allocation of corporate credit is an independent source of financial vulnerability.

The results highlight the importance of monitoring the riskiness of credit allocation as an integral part of macro-financial surveillance. The new measures constructed in this chapter are simple to compute, rely mostly on firm-level financial statement data that are available in many countries, and can be readily replicated for use in macro-financial surveillance. For this purpose, policymakers would benefit from collecting these data in a timely manner.

The chapter shows that various policy and institutional settings may help policymakers mitigate the increase in the riskiness of credit allocation that takes place during relatively fast credit expansions. A tightening of the macro-prudential policy stance, greater independence of the supervisory authority from banks, a smaller government footprint in the corporate sector, and greater minority shareholder protection are all related to a smaller increase in the riskiness of corporate credit allocation during these episodes.