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‘Rethinking Priority Sector Lending for Banks in India’

Final Report

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CONTENTS

		Page Number
Executive Summary		4-5
Acknowledgements		6

Chapter One

Motivation, Objectives and Scope of the Study **7-10**

1.1	Introduction	7
1.2	Motivation of the Study	8
1.3	Objectives of the Study	8
1.4	Data and Methodology	8-10
1.5	Organization of the Thesis	10

Chapter Two

Priority Sector Lending in India: Historical Overview & Literature Survey **11-33**

2.1	Introduction	11
2.2	Priority Sector Lending in India: Historical Overview	11-24
2.3	The Current Status of Targets /Sub-targets for Priority Sector Lending	24-25
2.4	Review of Relevant Past Studies	25-33
2.5	Concluding Remarks	25-33

Chapter Three

International Experience on Directed Lending **34-40**

3.1	Introduction	34
3.2	Forms of Directed Lending	34-35
3.3	International Experiences on Directed Lending	35-38
3.4	Few Research Studies and Evidences	38-40

Chapter Four

Priority Sector Lending in India: Bankers' Views through Primary Survey **41-51**

4.1	Introduction	41

4.2 Sample Selection for the Survey: "Quota Sampling" 41-42
4.3 Survey Results & Discussions 43-47
4.4 Computation of PSL Targets: Path to ANBC 47-48

Annexure

Sample Questionnaire 49-51

Chapter Five

Banking without Priority Sector Lending: A Hypothetical Scenario 52-56

5.1 Introduction 52
5.2 Approach to Create a Hypothetical Scenario 52-53
5.3 Estimated Model 53
5.4 Empirical Results & Discussions 54-55
5.5 Primary Survey Results on 'Not having PSL Targets' 55

Annexure

Bank credit to various sectors: Existing and Hypothetical 56

Chapter Six

Impact of Priority Sector Lending in India: A Cost-Benefit Analysis 57-78

6.1 Introduction 57
6.2 Sectoral Analysis of PSL Lending 57-67
6.3 Costs of Priority Sector Lending In India 67-78

Chapter Seven

Conclusion and Major Recommendations 79-86

7.1 Recommendations 79-85
7.2 Limitations of the Study and Scope for Future Research 85
7.3 Concluding Remarks 85-86

References ***87-91***

Executive Summary

Revisiting or rethinking about priority sector lending (PSL) is a daunting task given the fact that plethora of committees and researchers have already pondered over it. Still we endeavour to take-up this mammoth task in order to provide bankers' point of view. A practitioner's view is always more reliable and authentic than regulators' or researchers' view as he/she knows the ground realities in wider set of information. In this study, our objective is quite different from the others as we revisit PSL norms from the Bankers' Perspective. Since the advent of PSL norms, two things have not changed so far, one is the overall PSL target of 40% of ANBC and second is sub-target fixed for agriculture (18% of ANBC), although some the committees set up by Government/RBI has pitched for their reduction as well. Since the inception of PSL norms, a substantial literature is available by many researchers/academicians and industry experts but most of the findings are generalised observations, without any statistical or mathematical evidences. On the one hand, the studies, which are based on secondary data are focused on trend analysis and achievement of targeted number, while the primary survey studies mostly focuses on 4/5 branches or 2/3 villages or a single district, to figure out the impact of priority sector lending. To the best of our knowledge, we did not find any single comprehensive and schematic effort has been made to analyse the subject based on the experience of bank managers and borrowers.

So, this study is conducted to fill the desired gap in literature. In this study, first, we made an attempt to explore the mind-set of bankers regarding various aspects of PSL with the help of a primary survey. Further, we made a statistical analysis to see the impact of PSL on economy as general and banking as particular. The primary survey is conducted with 100 bank branches (85 branches of public sector banks and 15 branches of private sector banks) and the survey results indicate that most of the bankers are in favours of PSL targets in India but some of the respondents also indicate to change the 40% target. Lending to housing is the easiest and darling to most bankers, while lending to new sectors like social infrastructure and renewable energy is challenging.

The most interesting fact is that 64% of the respondents are not happy with the calculation of 40% target on ANBC. They want that since lending is proportional to Net Lendable Resources (Aggregate Deposits minus CRR minus SLR), the 40% target should be calculated on NLR only. We did one exercise on it and found very interesting results. Also there is a dire need to link PSL targets with the changing contours of the economy in the form of reduction in

agriculture target and inclusion of new sectors like, start-up industries, cold storage, etc. in the PSL portfolio. The issue of non-performing assets in priority sector is primarily due to unclear laws regarding sale of stressed assets.

Most of the bankers indicated that high cost in managing priority sector accounts is the most crucial factor that obstruct banks to lend to priority sectors. Even international experience shows that directed credit programs proved very costly, with the highest costs borne by the banking industry. Hence we did sector-wise and on consolidated basis a cost analysis. The results indicate that the 1% increase in agriculture, exports and MSME lending leads to 0.61%, 0.43% and 1.11% increase in agriculture GDP, exports GDP and MSME GDP, respectively.

International experiences indicated that directed credit programmes although benefit industrial sectors, generate spill-over effects, and contribute to general economic growth yet they might not always be efficient in making financing available to certain sectors. Furthermore, in most of the countries, low repayment rates led to high NPAs that locked up bank assets, affecting the banks' profitability and efficiency.

At last, as an anecdote, we have hypothetically recreated a banking scenario devoid of PSL norms and surprisingly found that sectoral GDP growth would have been more if credit flow to them without any PSL target or limit.

Based on our research, analysis and survey we have proposed the following recommendations:

- *The overall target for PSL needs to be reduce to 35% from 40% in a phased manner by March 2020.*
- *The target for agriculture needs to reduce to 15% from 18% with no distinction like direct and indirect agriculture.*
- *Need to add more sectors (like start-up industries) under MSME target.*
- *Need to rationalize home loan limits.*
- *Ceiling of export credit needs to increase from 2% to 5% of ANBC.*
- *The PSL targets need to be calculate on 'Net Lendable Resource' instead of ANBC.*

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Chapter I
Motivation, Objectives and Scope of the Study

1.1 Introduction

The policies towards priority sector lending (PSL) were introduced in the 1970s accorded significant priority to agriculture, exports and micro and small enterprises. The Government of India has taken a number of initiatives like two rounds of nationalisation of major commercial banks in 1969 and 1980, lead bank scheme, co-operative banks etc., to provide the desired credit in continued manner to the needy sectors of the economy. In consequent to that, priority sector lending, social inclusion etc. become an integral part of monetary policy of Reserve Bank of India (RBI). As monetary policy in India has the twin objectives of *growth and price stability,* the growth objective in a way is embodied in the credit targets. Even as the interest rate channel has gained more prominence in the recent past, the credit channel remains active, with credit targets being stipulated from year to year. There are two dimensions to credit - quantum and direction. First, we argue here that given the current growth prospects, there must be an added thrust to credit flow to agriculture and export sectors in a pro-cyclical way. Second, given the role played by micro, small and medium enterprises (MSME) in promoting both employment and exports, MSME will be the other sector that will require special attention. In fact, when the policies for priority sector lending were evolved, these three sectors were rightly accorded significant priority.

Over the years, the scope and extent of priority sector lending (PSL) has undergone changes with several new areas and sectors being brought within the purview. There is a view that enlargement of areas has resulted in loss of focus. It is also held that credit growth in housing and infrastructure has been strong while it has been sluggish in agriculture and in small industries. Further, it is argued that only sectors that impact large population, weaker sections and employment-intensive such as agriculture, tiny and small industry should be eligible for priority sector. Since, several issues began to gain importance. Third, therefore we argue that there is a need for revisiting the priority sector guidelines and reprioritising such targets in conjunction with the parallel policy developments under financial inclusion. In this study, we made an attempt to examine the priority sector prescriptions for Indian public and private commercial banks.

1.2 Motivation of the Study

In the last several years, PSL has been widened to include more and more sectors. For instance, since the 1970s there have been several additions to the sectors covered under directed bank credit - infrastructure, retail traders, small businesses and education and weaker sections. These additions have been frequently modified and even repealed in the subsequent years. This apparent lack of any particular pattern strongly suggests that there is a need to closely examine the fundamental design of the PSL guidelines and its designated sub-targets for different sectors in order to ensure that indeed the limited resources are being put to the best possible use and serving the purpose for which they were originally intended.

Further, the banking and economic environment has changed considerably in the past few years and with the emergence of new players (like small and payment banks) and regulations. So, there is a need to rethink the PSL norms so as to align them with the current dynamics and also to derive the maximum mileage towards the objective for which PSL was put in place.

1.3 Objectives of the Study

With the above motivation, the main objectives of the study are outlined below:

- ***Objective #1*:** To review the relevance of existing framework, including overall PSL targets, sector specific sub-targets and also in/exclusion of sub sectors like, Agriculture, MSME, Education, Housing, and Export Credit etc. Accordingly, a new framework to be propose, based on the changing macro-environment.
- ***Objective #2*:** To find out the reasons for the reluctance of banks (through survey) for PSL, despite the fact that less proportion of aggregate gross NPAs lies in the priority sector (36% of total gross NPAs as on Mar'14) as compared to non-priority sector.
- ***Objective #3*:** To evaluate the impact of priority sector lending vis-à-vis non-priority sector lending on banking industry in particular and Indian economy in general, the costs (both direct and indirect) and benefits of engaging in PSL must also be analysed.

1.4 Data and Methodology

a. Data & Sources

The study is based on both primary and secondary data sources. The secondary data sources includes, both national (RBI, Various committee reports, Ministry of Finance, NABARD) and international level (IMF, ADB, World Bank, and various research reports, etc.) data sources.

The primary data is being collected from the branch managers through primary surveys, which is conducted through proper questionnaire to understand the problem for the bankers in lending related to priority sector. On the basis of availability of data, the study is being conducted for the period 1981-82 to 2013-14. However, for the literature survey section, we have updated till the date (October 2015) but not able to do the same in the analysis section, as the sector specific, bank specific data was not available for 2014-15 at the time of the study.

b. Methodology

The study is conducted in the following manner, with objective specific.

Objective # 1

- A detailed analysis of Government/RBI policy documents to understand how the policy initiatives has moved towards priority sector lending in India. In addition to this, we also reviewed relevant literature in relation to PSL available since 1970's. International practices on directed lending are summarized with key takeaways.
- The sectoral analysis of secondary data on different parameters of PSL over the years is analysed.
- To suggest the new framework, we analyse the sector specific data based on the importance in the economy and growing demand needs of the sectors.

Objective # 2

- A primary survey of branch managers/front-line officers is conducted to know the problems they are facing to lend the priority sectors. This aim is to find out the reasons that the bankers are reluctant to give credit to PSL, whether it is due to deteriorating asset quality or strict regulatory framework.
- In addition to that, we also prepared a hypothetical scenario of *not-having PSL* in India and its impact on credit flows to the sectors and subsequently on GDP.

Objective # 3

- The calculations of costs include direct and indirect costs. Direct costs is the sum of funding, transaction, and credit costs. Funding cost is the marginal or average cost at which banks are able to raise money. Transaction cost is the cost of delivering credit to the borrower (e.g., wages, salaries, printing, rent, electricity, connectivity,

transportation of cash, insurance, overhead, and depreciation). Credit cost is the sum of the risk (hurdle rate) and capital cost of a loan (unexpected loss). *Capital Cost = Hurdle Rate * Unexpected Loss.*

- Indirect cost of PSL loans impose a higher cost on the economy (in terms of priority sector NPAs) compared to the non PSL loans. This is estimated by two models, using PSL loans and NPAs from PSL as the independent and the dependent variables in the first regression and non PSL loans and non PSL NPAs in the second regression, respectively.
- We analyse the costs incurred by public, private and foreign banks in channelling small amounts of credit to priority sectors like agriculture (domestic banks) and MSEs (foreign banks) and compare these costs with the returns on such loans to determine the net cost/return of PSL by bank type.

1.5 Organisation of the Study

The rest of the Report contains six chapters. Chapter II & III deals with the *Objective 1* and provide a comprehensive review of priority sector lending since its advent in India with key international experiences. Chapter IV & V deals with the *Objective 2*. While Chapter IV gives insight on the primary survey results with discussion on an alternate method of calculating PSL targets, i.e., from net lendable resources (NLR) rather than ANBC, the Chapter V discusses a hypothetical case of not having PSL in India and its impact on economy. The Chapter VI takes into account the *Objective 3* and analyse the cost-benefit analysis of PSL in India with the help of econometric tools. The Chapter VII summarizes the major findings and recommended a new structure of PSL. In addition to that, it also offers some concluding remarks with limitations and scope for further research in PSL in India.

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Chapter II
Priority Sector Lending in India:
Historical Overview & Literature Survey

2.1 Introduction

Adequate and cheap credit is a boon for the economic development of a country. Economic progress can easily be achieved by providing credit to farmers, industries, traders and business. The banks play a very crucial role in the process of economic development of any country that is why the availability of banking infrastructure is considered as pre condition for rapid and balanced development of the country. The impact of banking system on economic growth can be seen by enhancing resources to those sectors which are employment intensive and have greater contribution to GDP (Gross Domestic Product) of the country. The Government of India through Reserve Bank of India (RBI) mandates certain type of lending on the banks operating in India to those sectors which are neglected by the banks and cannot afford to pay high rate of interest due to their weak position. This type of sectors fall under the category of priority sectors and lending to those sectors are called priority sector lending. Financing of small scale industry, small business, agricultural activities, export activities & small transport operators fall under this category. In course of time, other priority sectors were also included such as retail trade, professional and self-employed persons, education, housing loans for weaker sections and consumption loans.

2.2 Priority Sector Lending in India: Historical Overview

The genesis of the existing framework of the Priority Sector Lending (PSL) is way back to 1967. Morarji Desai, the then Deputy Prime Minister and Minister of Finance, Government of India made a statement in the Lok Sabha on December 14, 1967 that there have been persistent complaints that several priority sectors such as agriculture, small-scale industries and exports have not been receiving their due share of bank credit. This appears to be the first occasion that the term priority sector was used. Thus, the concept of priority sector lending was introduced. Social control on banks was instituted through Banking Laws (Amendment) Bill 1967, which was introduced in the Lok Sabha on December 23, 1967. Through social control, banks were directed to align their operations in line with the national objectives. At a meeting of the National Credit Council held in July 1968, it was emphasised that commercial banks should increase their involvement in the financing of priority sectors, viz., agriculture and small scale industries.

In February 1968, before the nationalisation of banks, **National Credit Council (NCC)** was set up to look into the priorities of the bank's credit among various sectors of the economy. There was a need to support the farmers in the rural areas and later All India Rural credit review committee, (**Venkatappiah Committee, 1969)** endorsed the view that the Central Bank should increasingly come forward to finance activities in rural areas.

A study group (**Gadgil Committee, 1969)** was set up which recommended the adoption of Area Approach for bridging the spatial and structural credit gaps. Based on the recommendations 'Lead Bank Scheme' was adopted. The Banker's committee, headed by **F.S Nariman** concluded that districts would be the units for area approach. As per Lead Bank Scheme, each district was placed with one of the commercial banks and the role of these lead banks were to identify credit gaps, locating growth centres, assessing deposit potential, etc.

Formalisation of the Priority sector lending took place in 1972 with the recommendations of the **Informal Study Group** on Statistics relating to the advances to the priority sectors.

The sectors that were identified as priority sectors were-

- Small scale industries
- Industrial estates
- Road and water transport operators
- Professional and self-employed persons
- Retail traders
- Education

At that time, NO targets were imposed on banks for giving loans to priority sectors. These sectors got priority in sanctioning of credit and concessions in terms and conditions including rate of interest.

The DRI (Differential Rate of Interest) Scheme was initiated in 1972. It was especially designed to aid the weaker sectors and advances are granted at a concessional rate of interest under this scheme.

The *targets* for Priority Sector Lending were first set in 1974 at 33.3% by March 1979. Private sector banks were also advised to achieve the same target. RBI directed all the Commercial Banks to ensure the flow of 40% of the net bank credit to priority sector by March 1985.

Though priority sector lending norms initially focused on increasing commercial finance to sectors deemed as 'national priority' since 1980, the scope of the priority sector has largely

evolved to give greater prominence to segments of the population that have traditionally been denied credit, thus making it a tool to address financial inclusion. The issue of revision of PSL targets was raised in a meeting of the Union Finance Minister with Chief Executive Officers of the Public Sector Banks in March 1980. RBI acted to it by appointing a working group (lead by **Krishnanswamy, 1980**). The revised targets were:

- All commercial banks (public and private sector banks) should raise the priority sector advances to 40% by March 1985.
- 16% of credit to agriculture by March 1985.
- At least 50% of direct agriculture advances should go to weaker sections by 1983. Small scale industrial advances granted to units with credit limits not exceeding Rs 25,000 have been considered as advances to weaker sections.

New sectors included in the Priority Sector Lending groups were: 1) Housing loans, and 2) consumption credit. Housing loans up to Rs 5000 for construction of houses for SC/ST and weaker sections and pure consumption loans granted under the Consumption Credit Scheme. Further RBI advised public sector banks (PSBs) that they should achieve a credit deposit ratio of at least 60% by March 1979 in rural and semi-urban branches.

By the recommendations given by the committee (C**hairman: B. Sivaram**), NABARD (National Bank For Agriculture and Rural Development) was set up in 1982 to look after all the major works related to rural credit.

The Reserve Bank of India issued following guidelines as per the recommendation given by the working group (**Ghosh Committee, 1982**):

- A new 20 point programme introduced as an extension of the earlier programme with greater emphasis on improving the standard of living of the rural poor and other weaker sections of the society.
- The working group suggests that the overall target remains the same at 40% but it has suggested a separate target for direct advances to agriculture with a view to supporting the poor. It also recommended that the banks should aim at increasing advances to the weaker sections to not less than 25% of the total priority sector advances by March 1985.
- The revised classification of various segments of priority sector was: Agriculture (both direct and indirect), Small Scale Industries, Small Road and Water Transport Operators,

Retail Trade, Small Business, Professional and Self Employed Persons, State sponsored schemes for Scheduled Castes/Scheduled Tribes, Education, Housing and Consumption loans.

- Banks to achieve direct agriculture lending of 15% of total bank credit by March 1985, 16% by March 1987, 17% by March 1989 and 18% by March 1990 respectively. The sub target was further bifurcated in October 1993 to a minimum of 13.5% for direct loans and a maximum of 4.5% on indirect loans.
- The revised definition of weaker sections under priority sector would include:
  a) Small and marginal farmers with land holdings of five acres and less, landless labourers, tenant farmers and also share croppers,
  b) Artisans irrespective of location or small industrial activity viz., manufacturing, processing, preservation and servicing in villages and small towns with a population of not exceeding 50,000 involving utilization of locality available resources and/or human skills, where individual credit requirements does not exceed Rs 25,000,
  c) IRDP beneficiaries,
  d) Scheduled Castes and Scheduled Tribes, and
  e) DRI beneficiaries

The **First Narasimham Committee** on financial sector reform in 1991, acknowledged the role of the Priority Sector Lending programmes in extending the reach of banking system to the neglected sectors of the economy and therefore it recommended that the priority sector should be redefined to include the marginal farmers, tiny sector, small business and transport sector, village and cottage industries etc. The committee had drawn attention to the problem of low and declining profitability and stated that there is need for gradual phasing out of the directed credit programme. The committee had recommended reducing the 40% directed credit target to 10%, while simultaneously narrowing the definition of the priority sector to focus on small farmers and other low income target groups. This recommendation was not accepted by the government and the directed credit requirement continues unchanged.

Rajagopal Committee (1994) suggested that concessional credit or low rate of interest should be restricted only to the poorest of the poor and to the underprivileged sections of the society and recommended that commercial rate of interest should be charged from those who can afford it. The **Gupta Committee (1996)** had analysed that the target of 18% for lending to agriculture was fixed when the reserve requirements were 63% but the total lendable resources

of banks have increased due to progressive reduction of the reserve requirements over the years. The committee suggested that to maintain the same share, the banks have to double their lending to agriculture because the base on which the target of 18% was calculated had doubled. The committee suggested that banks should set targets for themselves for agricultural lending based on the flow of credit. They needed to prepare Special Agricultural Credit Plans (SACPs), with RBI indicating every year the expected increase in the flow of credit over the previous year.

RBI issued instructions to banks to show SHG lending as a separate segment under priority sector as **Kalia Committee** viewed that the SHG-bank linkage programme is cost effective, transparent and flexible to improve the accessibility of credit from formal banking system to the rural poor.

The **Second Narasimham Committee (1998)** observed that directed credit had led to an increase in non- performing loans and had adversely the efficiency and profitability of banks. It was observed that 47% of all non-performing assets have come from the priority sector. At the same time, the committee also accepted that a sudden reduction of priority sector targets could have the danger of a disruption in the flow of credit to these sectors. The committee recognized that the small and marginal farmers and the tiny sector of industry and small businesses have problems with regard to obtaining credit and some earmarking may be necessary for this sector. Under the present dispensation, within the priority sector, 10% of net bank credit is earmarked for lending to weaker sections. The Committee recommended that given the special needs of this sector, the current practice may continue. The Committee also proposed that given the importance and needs of employment oriented sectors (like food processing and related service activities in agriculture, fisheries, poultry and dairying), these sectors should also be covered under the scope of priority sector lending. It, however, recommended for the removal of concessional rates of interest on loans up to Rs 2 lakh and a phased moving away from overall priority sector targets and sub-sector targets. Debt securitisation concept was suggested within the priority sector. This would enable banks, which are not able to reach the priority sector target, to purchase the debt from other institutions.

Technical Group on Computation of Priority Sector Lending Targets, (**Verma Committee, 2000)** recommended withdrawal in a phased manner of the facility of exclusion of FCNR(B)/ NR deposits from NBC for computation of priority sector lending targets. The Group also recommended that the priority sector lending targets could be linked to the previous year’s Net Bank Credit (NBC) and upscaled by the estimated growth in credit during the year.

Vyas committee (2001) observed that commercial banks seem to have less interested in extending rural credit as they are dealing vast number of small accounts. The committee recommended that the mandated rates of 18% of credit outstanding for agricultural loans and 40% for priority sector loans should be reviewed after every five years. It also recommended a substantial reduction in RIDF interest rates to cover the interest cost of deposits. The committee suggested retaining the upper limit of 4.5% on indirect credit while reckoning the achievement of 18% target for agricultural lending.

The Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System, **Vyas Committee (2004)**, recommended that all public and private sector banks should increase their direct lending to agriculture to 12% of NBC in the next two years and to 13.5% in the two years thereafter. Banks that have already reached this level may at least continue to maintain the position; it would be best if they would further improve their direct lending. Indirect lending to agriculture may be reckoned to the extent of 6% in the first two years for assessing banks' performance against the 18% target. Thereafter, the ceiling of 4.5% should apply. Small and marginal farmers, who account for 80% of the total number of holdings and 36% of the total area, have only a 27% share in disbursements under Special Agricultural Credit Plan (SACP). This should be progressively raised to 40% by the end of the Tenth Plan period. Loans for storage facilities even outside producing or rural areas should be treated as indirect advances to agriculture, if they are used mainly for handling and storing agricultural commodities. Banks' investments in securitised assets comprising wholly direct advances to agriculture may be treated as part of their direct lending to agriculture. Similarly, if the securitised assets comprise wholly indirect advances to agriculture, the banks' investments in such securitised assets may be treated as their indirect lending to agriculture.

The committee felt that the entire issue of fixation of targets for lending to priority sector including agriculture needed a comprehensive review. Pending such a review, the existing target of 18% of net bank credit for lending to agriculture should continue.

Following the recommendations of the committee, RBI issued the revised guidelines on agricultural credit:

a) Waiver of margin requirements for agricultural loans up to Rs 50,000 and in the case of agri-business and agri-clinics for loans up to Rs 5 lakh.

b) Modified the NPA norms for agricultural advances aligning the repayment dates with the harvesting of crops.

c) Loans to storage units and cold storage units which are designed to store agricultural produce/products, irrespective of their location, would be treated as indirect agricultural finance under the priority sector.

d) Investments by banks in securitized assets representing direct (indirect) lending to agriculture may be treated as their direct lending to agriculture under the priority sector.

The **C.S. Murthy Committee (2005)** further redefined the priority sector to include those sectors that affect large sections of society, benefit small borrowers and involve small loans, and lead to substantial employment generation. The bulk of lending in that category appears to be in the form of large ticket loans to farmers with larger landholdings. While marginal farmer households comprise over 66% of all farmer households, the share of credit accounts among this section of farmers barely increased between 1991 and 2005, while the share of credit accounts for medium and large farmers increased by 41% over the same period. Similarly, credit access among the tiny enterprises under the small and medium enterprise category fell post-2000.

Based on the recommendations of the committee and feedback received from Government, the priority sector lending norms were changed from 30 April 2007. Major changes made in the guidelines were:

- Loans above Rs 1 crore sanctioned to big Corporates will get only one-third weightage for being counted under direct agriculture advances.
- Investment in bonds of financial institutions shall not be treated as priority sector loans. Priority sector lending is linked to the credit equivalent to the off balance sheet exposure as some banks are showing nil Net Bank Credit in their balance sheets.
- The overall target of 40% and 32% for the domestic and foreign banks has remained unchanged. Nevertheless, instead of Net Bank Credit (NBC), this was calculated as a percentage of adjusted net bank credit (ANBC). (New targets are linked to ANBC or the credit equivalent amount to off-balance sheet exposures, whichever is higher as on March 31 of the previous year)
- The outstanding FCNR (B) and NRNR deposits balances are withdrawn from computation of ANBC for priority sector lending purposes.
- Revised definition of MSMED Act, 2006 will be considered for SSI units.

RBI constituted a Working Group (**Chairman: Professor S.S. Joshi**) to suggest measures for assisting distressed farmers and the committee recommended that financial and livelihood

counselling is important for increasing the viability of credit. Further, the Working Group constituted to examine procedures and processes for agricultural loans (**Chairman: Shri C.P. Swarnkar**) had also recommended that banks should open counselling centres, either individually or with pooled resources, for credit and technical counselling with a view to give special thrust for credit delivery in the relatively underdeveloped regions. In the light of the recommendations of these two Groups, in May 2007, RBI advised the convener banks of State Level Bankers' Committee (SLBC) to set up a financial literacy-cum-counselling centre in any one district on a pilot basis and extend it to all other districts in due course. Another recommendation, all SCBs (including RRBs) were advised to dispense with the requirement of submitting 'Nil Dues' Certificate (NDC) for small loans up to Rs 50,000 to small and marginal farmers, share-croppers and the like and, instead, obtain self-declaration from the borrower. Furthermore, in order to overcome the problem of producing identification/status documents, banks were advised to accept certificates provided by local administration/panchayati raj institutions regarding the cultivation of crops in case of loans to landless labourers, share-croppers and oral lessees.

The **Raghuram Rajan Committee (2009)** on Financial Sector Reforms had, inter alia, recommended introduction of "priority sector lending certificates (PSLCs)" to implement the priority sector lending in the country. The committee believed that the process by which the priority sector mandates are implemented should be reformed to emphasize efficiency and ease of compliance, and once the new process is in place, the mandate should be strictly enforced. The focus should be on actually increasing access to services for the poor regardless of the channel or institution that does this - large banks may or may not be the best way to reach the poor, and while the mandate may initially force them to pay. Hence, the PSLC scheme was recommended by the committee to allow a more efficient implementation of the priority sector lending mandate. The committee also recommended selling of small underperforming public sector banks, possibly to another bank or to a strategic investor, to gain experience with the process and gauge outcomes. It was proposed to create stronger boards for large public sector banks, with more power to outside shareholders (including possibly a private sector strategic investor), devolving the power to appoint and compensate top executives to the board.

n 2009, RBI had set up a High Level Committee on Lead Bank Scheme under the Chairmanship of **Smt. Usha Thorat** to examine the status of lead bank scheme in the country. The committee was of the view that Lead Bank Scheme is useful and it should continue. The committee

recommended enhancing the scope of the scheme and suggested a sharper focus on facilitating financial inclusion rather than a mere review of the government sponsored credit schemes. The committee said that most forums to monitor the implementation of LBS are being used for routine review of the government-sponsored schemes, credit deposit ratio, and recovery performance among others. Lending under such schemes constitute 0.4% of the total priority sector lending. As such, the State Level Bankers' Committee (SLBC) / District Consultative Committee (DCC) could utilize its time to discuss specific issues inhibiting and enabling financial inclusion rather than those concerning government-sponsored schemes. Private sector banks should be given a greater role in LBS action plans, particularly in areas of their presence. The committee also stated to enhance the business correspondent model, making banking services available in all villages having a population of above 2,000, and relaxation in KYC (know your customer) norms for small value accounts.

The **Malegam Committee (2011)** report should be strongly appreciated because it seeks to legitimize microfinance as an integral part of the Indian financial sector. By recommending creation of a new category called Non-Banking Finance Companies (NFBC) Micro Finance Institutions (MFIs) (with associated conditions which are perhaps open for discussion) - the report has clearly positioned and mainstreamed micro-finance within the framework of the larger financial sector in India. This ensures that micro-finance will come under the purview of the RBI and no longer can microfinance be treated as a fringe activity or as an orphaned child in the larger Indian financial sector. The report has recognized and stressed the importance of off-site and on-site supervision of NBFC MFIs (including systemically important ones) while also alluding to the need for significantly enhancing the supervisory capacity of RBI with regard to micro-finance. A second aspect is that while the report has recommended continuation of priority sector funds for MFIs, it was however made it conditional, especially after recognizing some of the key problems like ghost lending, multiple lending, over lending and attempting to outline some measure to tackle them as well.

The RBI in August 2011 set up a Committee to re-examine the existing classification and suggest revised guidelines with regard to PSL classification and related issues **(Chairman: Shri M V Nair)**. The recommendations were as follows:

- Target under PSL for domestic scheduled commercial banks retained at 40% of Adjusted Net Bank Credit (ANBC) or credit equivalent of Off Balance sheet exposure (CEOBE), whichever is higher. However, a target of 40% for Foreign Banks was proposed.

- Distinction of Direct and Indirect agriculture within the overall target of 18% for Agriculture credit was proposed to be discontinued. A sub-target of 9% of ANBC is proposed for loans extended by banks to small and marginal farmers, to be achieved in stages latest by 2015-16. Similarly, a sub-target of 7% of ANBC for loans extended to micro enterprises, to be achieved in stages latest by 2013-14, proposed.
- Establishment of Agriculture Credit Risk Guarantee Fund for Small and Marginal Farmers, similar to Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), proposed. Scope of weaker sections proposed to be widened by including priority sector loans to individual women and housing loans to economically weaker sections & low income group segments.
- The *Investment Credit Sector* was added by the committee in the list of priority sectors responding to the concern that declining investment credit in agriculture in the recent years has been a major cause of concern for agrarian economy.
- To encourage usage of clean energy for households, loans given to individuals for setting up off-grid solar and other renewable energy solutions for households may be allowed as part of priority sector.
- Like Agriculture sector, comprehensive approach for *Micro and Small Enterprises (MSE)* was envisaged by doing away with the distinction between 'direct' and 'indirect' finance to MSE sector.
- *Micro credit:* Loans provide by banks directly and through SHG/Joint Liability Group (JLG) mechanisms would be eligible to be classified as priority sector advances subject to the conditions given below:
    - Income limit of individual beneficiary is Rs 60,000 per annum in rural areas and Rs 120,000 per annum in non-rural.
    - Loan does not exceed Rs 50,000 per beneficiary
    - Loan is without collateral
- Loans granted by banks to their own employees for the purchase of house will be termed as priority sector lending up to Rs 25 lakhs. Loans given for repairs of damaged dwelling units, loans up to Rs 2 lakh in rural areas an up to Rs 5 lakh in urban and metropolitan areas may be considered as priority sector against the earlier ceiling of 1 lakh and 2 lakh respectively.

- *Education loans* to individuals including for vocational courses up to Rs 10 Lakhs in India and Rs 20 lakhs abroad.
- Foreign Banks having 20 or more branches in the country have been brought on par with the domestic banks for priority sector targets in a phased manner over a maximum period of 5 years, April 2013 to March 2018. They will be required to submit an action plan. Foreign banks with less than 20 branches have no sub-targets within the overall priority sector lending target of 32%.

The recommendation of **Nachiket Mor Committee (2014)** on Comprehensive Financial Services for Small Business and Low Income Households were as follow:

- The RBI should remove the stipulation that the all-inclusive interest charged to the ultimate borrower by the originating entity should not exceed the Base Rate of the purchasing bank plus 8% per annum.
- In order to enable greater regional and sectoral specialisation among banks, the committee recommended that the RBI revise the PSL targets and require banks to meet an Adjusted PSL target of 50% against the current requirement of 40%. Districts and sectors are weighted based on the difficulty in lending to them, and a bank lending to a difficult sector in a difficult to reach district can benefit from a multiplier value based on the specific sector and district. Every sector-district combination has a weight associated with it and the bank will have to reach an adjusted PSL value of 50% taking these weightages into account.
- The Committee suggested that investment by banks in bonds and equities and provision of guarantees to PSL beneficiaries be counted towards meeting the banks' PSL targets.
- All loans given to landless labourers and small and marginal farmers should be counted as a part of Direct Agriculture and not merely the wages component of a loan given to a farmer for financing her agricultural production.
- Investment by banks in bonds of institutions must qualify for PSL where wholesale lending to the same institutions already qualifies under PSL.
- Credit facilities documented as bonds or Pass-Through Certificates (PTC), whether originated directly or purchased in the secondary markets should be permitted to be held in the ―banking book of a bank based on declared intent and not merely based on source or legal documentation.

- Investment by banks in RIDF must not qualify for PSL.
- As an added category, within the overall equity investment limits of banks, RBI could permit equity investments by banks in complementary infrastructure within the purview of PSL guidelines, such as rural warehouses, market yards, godowns, silos, and NBFCs in low financial depth districts.
- The current PSL targets be applicable on the last reporting Friday of the last month of each quarter in exactly the same manner as it is currently applicable in the month of March, so as to ensure more timely and continuous credit flow into priority sectors.
- In order to guard against large scale defaults resulting from catastrophic events, banks would allow to purchase bank-wide portfolio level insurance with insurance companies.
- Universal reporting of information with credit bureaus should be mandatory for all loans, especially kisan credit cards and general credit cards.
- Banks should price farm loans based on risk and that any waivers be provided by the government through direct benefit transfer and not through interest subsidies or loan waivers.
- A State Finance Regulatory Commission need be set up into which all state level financial regulators will be merged.
- The Non-Performing Asset reporting provisions and other regulations for Non-Banking Finance Companies (NBFCs) be aligned with those of banks. It also suggested measures to ease funding constraints of NBFCs including relaxation of External Commercial Borrowings and equity investment rules. Further, it proposed the removal of barriers to the transition of NBFCs into banks by including more sectors in the Priority Sector Lending (PSL) classification.

In 2015, RBI appointed **Internal Working Group (Chair: Lily Vadera)** revisit the existing priority sector lending guidelines and recommended the following:

- The Working Group (WG) recommended that the target for lending to the priority sector may be retained at 40% of ANBC or Credit Equivalent of Off-Balance Sheet Exposure (CEOBE), whichever is higher, for all scheduled commercial banks uniformly. All foreign banks (irrespective of number of branches they have) may be brought on par with domestic banks and the same target/sub-targets may be made applicable to them.

- The WG has attempted to focus on 'credit for agriculture' rather than 'credit in agriculture'. While the WG recommended retaining the agriculture target of 18%, the approach and thrust has been re-defined to include (i) Farm Credit (which will include short-term crop loans and medium/long-term investment credit to farmers) (ii) Agriculture Infrastructure and (iii) Ancillary Activities and on-lending
- Considering the significant share of landholdings of small and marginal farmers and their contribution to the agriculture sector, the WG recommended a sub-target of 8% of ANBC for lending to them. The remaining 10% may be given to other farmers, agri-infrastructure and ancillary activities.
- Presently, credit extended to micro and small enterprises counts for priority sector. The WG recommended extending PSL status to Medium Enterprises (MEs) in addition to the Micro and Small Enterprises (MSEs). While all MEs (Manufacturing) may be included under PSL, MEs (Service) with credit limit up to Rs 10 crore may be eligible to qualify for PSL. (To ensure that the smallest segment within the MSME sector i.e. micro enterprises, is not crowded out with the inclusion of the medium enterprises, the WG recommended a target of 7.5% of ANBC for lending to micro enterprises to be achieved in stages)
- To ensure that MSMEs do not remain small and medium units merely to be eligible for priority sector status, the WG recommended that the priority sector lending status may stay with them for up to three years after they grow out of the category of MSMEs.
- The WG recommended that bank loans up to Rs 10 crore to borrowers other than households, for purposes like solar-based power generators, biomass-based power generators, wind mills and micro-hide plants and for purposes like non-conventional energy-based public utilities viz., street lighting systems, remote village electrification, etc. be included under priority sector. For household sector, the loan limit may be Rs 5 lakh.
- The WG recommended carving out a separate category of export credit under priority sector. The export credit under priority sector may have a ceiling of 2% of ANBC in order to ensure that other segments are not crowded out.
- The WG recommended introduction of Priority Sector Lending Certificates (PSLCs) to enable banks to meet their PSL requirements and allow leveraging of their comparative advantage. The model on PSLCs envisages that banks will issue PSLCs that can be

purchased at a market determined fee on an electronic platform. This purchase will give the buyer a right to undershoot his PSL achievement for the stated amount of PSLC. The model on PSLCs envisages that banks will issue PSLCs that can be purchased at a market determined fee on an electronic platform. This purchase will give the buyer a right to undershoot his PSL achievement for the stated amount of PSLC.

- The WG recommended that to be eligible for PSL status, any borrowal account, including that to individual members of SHGs and JLGs, should be reported to one of the credit bureaus. The information should also capture the borrower's Aadhaar number which will help in identification of the borrower. The deadline for this may be linked to that of UIDAI deadline for completion of Aadhaar enrolment. A system of information sharing may be put in place between the credit bureaus.

2.3 The Current Status of Targets /Sub-targets for Priority Sector Lending

The present classification of targets and sub-targets for PSL are outlined in the following table.

Table 1: Current Status of Targets/Sub Targets of PSL		
Categories	**Domestic SCBs & Foreign banks 20 Branches and above**	**Foreign banks with less than 20 branches**
Overall Priority Sector	**40% of ANBC** Foreign banks with 20 branches and above have to achieve the Total Priority Sector Target within a maximum period of five years starting from April 1, 2013 and ending on March 31, 2018 as per the action plans submitted by them and approved by RBI.	40% of ANBC to be achieved in a phased manner by 2020: FY16: 32% FY17: 34% FY18: 36% FY19: 38% FY20: 40%
Agriculture	**18% of ANBC** Within the 18% target (Direct: 13.5% and Indirect: up to 4.5%), a target of 8% is prescribed for Small and Marginal Farmers, to be achieved in a phased manner i.e., 7% by March 2016 and 8% by March 2017. Foreign banks with 20 branches and above have to achieve the Agriculture Target within a maximum period of five years starting from April 1, 2013 and ending on March 31, 2018 as per the action plans submitted by them and approved by RBI. The sub-target for Small and Marginal farmers would be made applicable post 2018 after a review in 2017.	Not Applicable
Micro Enterprises	**7.5% of ANBC to be achieved in a phased manner i.e. 7.0% by March 2016 and 7.5% by March 2017.** The sub-target for Micro Enterprises for foreign banks with 20 branches and above would be made applicable post 2018 after a review in 2017.	Not Applicable
Weaker Sections	**10% of ANBC** Foreign banks with 20 branches and above have to achieve the Weaker Sections Target within a maximum period of five years starting from April 1, 2013 and ending on March 31, 2018 as per the action plans submitted by them and approved by RBI.	Not Applicable
Source: RBI		

2.4 Review of Relevant Past Studies

In 1969, nationalisation of banks was made to ensure a better alignment of the commercial banking system to meet the needs of the economy. So, the banks need to perceive that credit flows into the most productive sector of the economy, which will contribute more to our growth and development. Further, to promote the welfare of the people who are socially and economically backward, the concept of priority sector lending (PSL) was evolved in 1970's.

Under the PSL, quantitative targets were set for lending to priority sector and separate sub-targets were also set for lending to agriculture and weaker sections of the society. As a result, lending to the borrowers in priority sectors have increased substantially. Increased flow of credit to the different sectors assisted the developmental activities and thereby expanded the income as well as the standard of living of the people.

To find out the impacts of PSL loans on economic growth, standard of living of the different stake holders, a number of studies have been conducted. However, all the studies are restricted to a particular bank/group of banks, individuals and organisations. In the following, we have summarized some of the relevant studies on priority sector lending in India.

Joshi (1972) requested the RBI to give clear and specific definition of the different components of priority sectors. Some of the bankers are not clear about the precise scope of agricultural lending. Guidance from the RBI would help them to increase their involvement in farm credit on right lines.

Oommen (1972) found that among the institutional sources of finance to SSI in Kerala, commercial banks provided the lion’s share. The assistance of commercial banks in Kerala stands at par with some advanced countries.

Dagli (1975) is of the opinion that the aim of the banking policy should be to uplift the under privileged class of the society in rural India from subsistence existence to surplus existence. The concept of priority sector should include only the real poor of the country and by providing them necessary financial assistance; they can be lifted from the pitches of animal existence to the heights of human existence.

Hazari (1976) made it clear that institutional financing does not mean replacing individual moneylenders with institutionalised moneylenders. Institutional financing should enable the agriculturists to move on to a level of new technology that will increase agricultural output and employment. This means productivity of both land and human beings. Data relating to finance must be able to provide a basis for assessing how much financing has really contributed to additional output and employment.

P. C. D. Nambiar (1977) pointed out that the role of commercial banks in the priority sectors is not confined merely to the provision of finance. They have to evaluate the feasibility of the project and assist the entrepreneurs to select the right type of project. He also emphasised the need for proper co-ordination between government agencies and banks for better results in the development of priority sectors.

S. L. Shetty (1978) in his study on the achievement of commercial banks since nationalisation has found that the banks, which have relatively low priority sector lending have been the ones with higher than the average credit deposit ratios. Another finding noticed among the banks is that in regard to the priority sectors, a few branches of banks achieved impressive ratios, to the neglect of the rest of the areas. Again there is considerable concentration of priority sector advances in a few a States.

I. G. Patel (1979) reminded the banks about their socio-economic responsibility in the up-liftment of the poorest strata of the society. A substantial portion of the people live in abject poverty and the first priority should be to provide productive employment opportunities to the very poor- whether they are in rural or urban areas. Banks should equip themselves fully to serve as instruments of development for the poorer sections of people.

L. D'Mello (1980) is very much doubtful about the capacity and suitability of commercial banks to provide large amount of credit to the priority sectors. Since banks are high cost organisations, existing developmental agencies can be used by commercial banks to reduce the cost and to improve efficiency in the use of credit.

C. L. Khemani and K. V. Balakrishnan (1981) are of the opinion that if the borrower selected under IRDP is made to approach the money lender for his very genuine consumption needs, then the very objective of institutional finance for priority sector will be defeated. Consumption credit granted on the basis of specific needs of the target groups are not going to cause problems. The actual consumption loans will have to be related to their minimum needs and their capacity to repay.

Angadi (1983) observed the consideration of Priority sector lending in general and agriculture advances in particulars in some states because of repaid branch expansion, deposit mobilization, privileged cropped area, adoption of high yielding variety etc.

V. B. Angadi (1983) observed the concentration of priority sector advances in general and agricultural advances in particular in a few States. The reasons for such concentration are number of bank offices, deposit mobilisation, total cropped area, land under certain food and cash crops, extent of irrigated land in respective States, adoption of high yielding varieties, the availability of cooperative credit and the level of political awareness in these States.

Senior Executive Seminar on Priority Sector Financing (1983) organized by NIBM advised the banks to remember the philosophy behind the policy towards priority sector and to develop

faith in this philosophy. Priority sectors should be looked upon as opportunities of developing the banks' business.

A. R. Patel (1984) conducted a survey on public sector banks to assess their performance under DRI scheme. The study revealed that the banks had positively responded to the increasing needs of SC/ST borrowers in respect of DRI loans and had been able to increase their share of SC/ST borrowers, both in terms of number of borrower accounts and the amount outstanding. At the same time, banks are finding it extremely difficult to finance all those eligible identified beneficiaries who approach them in view of the limited loanable funds available under the scheme. Thus, demand and supply forces in respect of this scheme have created problems at the branch level as well as the beneficiary level. While large numbers of deserving eligible beneficiaries have so far remained out of the fold of this scheme, a good number of influential and well to do persons have taken advantage of this scheme.

K. V. Patel and N. B. Shete (1984) analysed the priority sector lending by commercial banks in India from 1969 to 1980 and concluded that quantitatively a very impressive coverage is achieved during the period of twelve years. The total priority sector advances have gone up by more than fourteen times. But the credit absorption capacities of the weaker sections are constrained by a variety of factors, which may not be under the direct control of the banking industry. Therefore, the co-coordinated efforts of executives and developmental agencies require special care and attention in this matter.

B. S. Viswanathan (1985) stated that the overdues to a large extent were on account of wilful default, which was either due to ineffective recovery machinery or because of unfavourable recovery climate.

S. B. Dangat, S. R. Radkar and M. P. Dhongade (1986) conducted a micro level study into the borrowings and utilisation of medium and long term loans in Ahmednagar district and reported that the medium and long term loans were diverted for conduct of marriages, for consumption and for construction of residential buildings in all the size group of holdings in both developing and underdeveloped regions. Proper appraisal of loan proposals, follow-up and supervision after the disbursement of loans were suggested for effective financing of agriculture.

B. Ramachandra Rao (1987) strongly proposed for the redefinition of priority sector. Priority sector advances at low rates of interest should be given only to the weaker sections and not to the affluent under the label of priority sector. This will help the banks to improve monitoring

and supervision of these advances, the impact of these advances on the weaker sections and their own profitability.

Economic Research Department of the State Bank of India, Central Office, Bombay (1987) conducted a study to observe the impact of bank credit on weaker sections in Kerala. The study revealed that bank loans enabled the borrowers to become self-employed businessmen or artisans whereas previously they were mere wage earners. The utilisation of bank loans generally raised the income and employment of the borrowers and thereby improved the quality of life.

C. Rangarajan (1988) focused the developmental role of the RBI on deepening and widening the financial system. In view of the imperfections and rigidities present in the credit market, special measures have to be taken to ensure the flow of credit to the needy and priority sectors.

Muhammad Yunus (1988) strongly commented that credit without strict discipline is nothing but charity. And charity in the name of credit will only destroy the poor, instead of helping them. Thus credit institutions must make sure that every loan gets paid back in full and in due time. If that does not happen, one should not blame the people of the recipient country for failure, rather one should blame the designer of the credit institution that failed to do the job.

K. V. Rao (1989) opined that the scheme of service area could assure success only if the banking staff live among the villagers, easily mixing with them and acting as real extension workers.

V. K. Bhaskara Rao (1989) opined that writing off the farm loans by Government would not serve the real purpose and would severely hinder the future bank lending in the country. It is suggested that neither the State Government should write-off the loans nor create an atmosphere for non-repayment of dues to the banks.

Jacob Kurien (1990) found that delinquency and default occur due to inadequate market support and lack of proper follow-up. Fungibility of credit is largely attributable to the low cost of borrowing and to it being targeted and rationed. So he concluded that what is essentially needed is wider perspective of circumstances and factors which influence the borrowers in their use of credit as well as their attitude towards formal credit institutions.

Yercaud R. Devaprakash (1990) criticised loan write-offs that encourages credit delinquency. Any welfare measures to farm sector should increase growth in investment for which credit discipline is a must.

Brinda Jagirdar (1991) urged the need for redefining the priority sector components into two groups. One group covering advances to weaker sections and also advances which may further technological up-gradation and resource augmentation, saving and improvement of agriculture, small industry etc., even though the borrowers do not belong to the weaker sections and the remaining advances under priority sector comes under the second group. Only the former group needs to be offered the benefit of concessionary finance and the others may be charged commercial rate of interest.

D. Rajasekhar and Vinod Vyasulu (1991) stressed the guideline of 40% of loans to the priority sectors and opined that with more professional functioning the banks can maintain a recovery rate of at least 90 per cent through better lending, with reference to quality of credit. Also the proportion of nonperforming assets in a bank's portfolio can be reduced if political interference in the functioning of the banks is reduced.

S. N. Bansal and V. K. Agarwal (1991) requested the Government to strictly refrain from declaring any policy of waiving of loans just for the purpose of political expediency or use it as a vote catching device. The loan waiver scheme will only aggravate the problem of loan recovery causing serious problem for the Government.

D. N. Ghosh (1992) opined that the curtailment of the target of priority sector lending, as urged by the Committee on the Financial System, will send an unfortunate signal to the dispensers of credit that the basic objective for which priority was developed. Policy makers in the developing countries, from time to time had found that they have to reconcile with the conflicting objectives, but they cannot afford to let the crucial economic agents such as banks and financial institutions, choose the easy way out of such situations.

N. B. Shete (1992) brings out some lessons for Indian commercial banks based on the experience of agricultural loan recoveries of some developing countries. Intensive education campaign for proper use of funds by borrowers in Sri Lanka, commodity oriented programmes in Philippines, provision of infrastructure, farm supportive prices and extreme penalty for wilful defaulters in China are some of the examples which facilitate prompt recovery of agricultural loans.

S. C. Anand (1992) calculated the economics of priority sector lending after analysing the cost and benefits resulting therefrom and concluded that priority sector advances have not been and are not a drag on profitability.

C. Rangarajan (1996) pointed out that the main thrust of the Indian public policy towards rural credit has been to ensure that sufficient and timely credit is made available to the rural population. The strategy of developing rural financial services consists of expansion of institutional structure, directed lending and concessional or subsidised credit.

K. Kaladhar (1997) suggested that priority sector should be changed to micro finance and targeting is to be done in terms of growth in number of accounts instead of the present stipulation of 40% of the credit outstanding. With the realisation that the poor are bankable and banking with the poor is profitable, there will be no hesitation on the part of the commercial banks to actively pursue micro financing. In other words the present priority sector may be given up in favour of targeting micro finance particularly in the rural and semi urban areas.

Renu Kohli (1997) after examining the existing evidence on the costs and benefits of priority sector lending in India argued that the credit policy in this regard re-appraised and geared towards more specific objectives. These objectives could be defined locally on the basis of a bank industry exchange that could guide the banks as to which firms or industries are to be financed.

N. A. Mujumdar (1998) strongly advocated that since priority sector are critical to high and sustained growth of GDP, it should be the business of public sector banks to support these sectors irrespective of whether there are credit targets or not. While the ninth plan recognises the critical role of this sector, the credit policy needs to be re-oriented so as to reverse the neglect of this sector in the recent past.

K. V. Patel and V. S. Kaveri (1998) conducted a study of nonperforming advances in priority sector and found that uncertainty of income generation is one of the most important reasons for NPAs. The experiences of branches covered in the study suggest that recovery from NPAs is possible provided proper care is taken. With careful approach, sincerity and involvement of staff recovery problems can be effectively solved.

K. M. Shajahan (1998) in his study on priority sector lending has observed that the banking sector reforms initiated as a part of the liberalisation policies since the beginning of 1990’s have almost brought the priority sector lending to a halt. Moreover, the position of the poorer States with regard to the priority sector bank credit seems to have worsened because of the manner in which priority sector targeting has been done. The study recommended linking of the priority sector target to bank deposits rather than to total bank credit.

P. Ganesan (1998), in his study on public sector banks and priority sector advances, has found that the priority sector advances did not actually reach to the so-called neglected sections within the priority sector. Without growth and development in these neglected sectors, a further reduction in advances would adversely affect these sectors. Therefore, the study opined that there is an urgent need to redefine the concept of priority sector.

Department of Banking Supervision, RBI (1999) studied the impact of priority sector advances on NPAs and found that the proportion of NPAs in priority sector to total NPAs were 48.27% as on 31st March 1996 which has gradually declined to 46.40% as on 31st March 1998. The proportion though lesser than the NPAs in non-priority sectors, reveals that the incidence of NPAs in priority sector is much higher in view of the fact that the priority sector advances constitute only 30-32% of the gross bank credit during the period. However, the gradual increase in the proportion of NPAs in non-priority sectors could indicate that NPAs are increasingly occurring on borrower accounts of industrial sector during the recent years.

Namasivayam and Ganesan (2008) used Friedman's test to analyse the performance of different classified commercial banks in financing SSI, Madurai district, Tamil Nadu. The study found that higher range of performance has been shown by state bank groups as compared to national commercial banks and private sector banks.

Uppal (2009) concludes that public sector banks have not achieved the target of 40% while private sector banks have achieved the overall target. No private sector bank could achieve the 10% target by lending to weaker section. On the other hand, foreign banks have achieved the small scale industries' export credit and overall target. NPAs of public sector banks have increased because of high priority sector advances.

Ahmed (2010) considered different factors that may affect the scheme of bank financing to priority sectors. The study found that 97% variation in bank financing of agriculture in the three districts of Barak valley Assam was explained by independent variable. The study suggested that proper recovery of loan schemes should be used otherwise banks will have to face liquidity crisis for recycling the fund.

Raman (2013) analyzes the performance of the commercial bank in the area of priority sector lending for a period of 10 years (2000–2001 to 2009–2010) in Tamil Nadu. It has been identified that the performance of the commercial bank in the area of priority sector advances are in increasing trend, that too it has increased by 13.9 times for public sector banks, 35.6 times for private sector banks and 69.1 times for foreign banks. Apart from quantum-wise

analysis the NPA created through the priority sector advances for the period 2005–06 to 2009–10 was examined. The share of outstanding priority sector (NPAs as a proportion of total NPAs has steadily risen from 46% in 2008-09 to 52% at the end of 2010-11.

Deokar and Shetty (2013), argued that the revised RBI guidelines on priority sector lending discriminate against small and marginal farmers and favour corporates involved in agriculture. The guidelines seem to have been drawn up under pressure from banks.

2.5 Concluding Remarks

A critical perusal and review of the studies reveal that most of these studies are not scientifically designed and the opinion surveys were not properly structured. Also most of the findings are in the form of generalised observations without testing the statistical significance. Despite the availability of sufficient literature on priority sector lending and rural credit, no comprehensive and schematic effort has been made to analyse the subject based on the experience of bank managers and borrowers. The available literature on the subject is only descriptive, partial and often biased. It covers only some micro aspects of priority sector lending.

Priority sector lending is done through District Credit Plans. An analysis of priority sector lending in the State through District Credit Plans is not attempted by any scholar so far. This study is also an attempt in this direction. It is designed to analyse the working of District Credit Plans, the weakness in the lending procedures, methods of making priority sector lending profitable and beneficial and the difficulties experienced by the bankers and borrowers in the implementation of the scheme. Hence in this study, different aspects of lending to priority sector together with its systematic impact are analysed.

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Chapter III
International Experience on Directed Lending

3.1 Introduction

In most of the countries, directed credit (or priority sector lending in India) is meant for specific purposes. The rationale for directed credit programs is that lending by the financial sector is not only a function of credit quality, risk of tolerance and pricing of loans but also its influence and impact on social, geographic and economic structures in the economy. Choice of sectors and financing options deployed to directed lending to specific sectors/groups varies from country to country. Since the Second World War, several countries (emerging economies as well as advanced economies) have experimented with its Directed Credit Lending programmes (DCLPs). The design and construction of these programmes varied across different economies but the essence of it and the purpose of it remained the same to provide credit-based support for the development of the deserving sectors/sections that had been under-served by the mainstream banking institutions by way of public intervention in the financial markets.

3.2 Forms of Directed Lending

The international thinking about directed lending has also influenced the perception about these programmes. While the economic theory after the 1950s bore the influence of Keynesian economics, the period after 1980s was a period of economic liberalism. During the 2000s, the concept of "financial inclusion" gained global attention through its link with the achievement of the Millennium Development Goals (MDGs) set by the United Nations (UN). In addition, the global financial crisis of 2008 brought to the fore the informational asymmetries, credit rationing, prevalence of complex products in financial markets requiring regulatory intervention to protect the interests of small customers. In response to many of these developments, some countries either liberalised or even discontinued their DCLPs, while some others have continued/redefined and even strengthened them in order to deal with a financial/economic crisis.

The table 1 represent the various forms of DCLPs that the countries are undertaking over the years:

Table 1: Various Forms of Directed Lending	
Form	**Remarks**
Sectoral lending programmes	These are public programmes designed to lend to a particular sector/section of the population. These programmes can be implemented through a governmental agency or in collaboration with public/private banking institutions. These may involve sectoral targets, as is the case with the priority sector lending programme in India.
Administered interest rate programmes	These programmes carry an element of interest subsidy while lending to the targeted sectors/sections.
Refinance programmes	These programmes involve refinance from apex financing institutions towards lending to the targeted sectors/sections.
Development financial institutions (DFI)/Public sector banks	Certain institutions are created in the public sector or private banks are nationalised to lend to either exclusively or primarily to the targeted sectors/sections.
Credit guarantee programmes	These programmes involve credit guarantee with respect to loans advanced to the targeted sectors/sections.
Source: RBI	

3.3 International Experiences on Directed Lending

The experiences of Japan, Korea, China, Brazil, and Thailand suggest that directed credit lending might *not always be efficient* in making financing available to certain sectors. The experiences of Korea and Japan show how directed credit can benefit industrial sectors, generate spill-over effects, and contribute to general economic growth. The experience of Brazil, where funds earmarked for small farmers went to large and wealthy borrowers, reveals a weakness in directed credit programs. A study conducted by the World Bank on the effectiveness of directed credit in the United States suggests that directed credit policy had a limited impact and it might also be negative when cross program effects are considered. The study shows that in US, the directed credit programs have generally been successful in increasing credit to targeted sectors, but not necessarily in increasing investment by such targeted groups (Schwarz, 1992).

In most countries, directed credit programs proved very costly, with the highest costs borne by the banking industry. Furthermore, in most of the countries, low repayment rates led to high

NPAs that locked up bank assets, affecting the banks' profitability and efficiency. Non-priority sectors also felt the impact of NPAs as funds available for lending dried up. Interest rate ceilings under preferential credit policies led to an increase in borrowing in general, contributing to inflation and price instability that, in turn, harmed the intended beneficiaries of directed credit. In Korea and Japan, where directed credit was relatively successful, the government closely monitored the programs, thus adding to the costs of administering such programs.

Table 2: Characteristics and Impact of Directed Credit Programs in Various Countries

Characteristic/ Impact Area	Japan	Korea	China	Brazil	Thailand
Priority sectors	Export, large-scale industry, small-scale industry and agriculture	Export, heavy and chemical industries	Large state-owned enterprises	Rural areas, agriculture, infrastructure and housing finance	Exports, small-scale industry, agriculture
Implementing institutions	Bank of Japan, government-owned financial institutions, commercial banks	Bank of Korea, government-owned financial institutions, commercial banks	Bank of China, Policy banks	Public sector banks, commercial banks	Bank of Thailand, specialized government institutions
Main source of funds	Postal savings, commercial bank credit	Central Bank credit, foreign debt capital	Central Bank credit, foreign capital (mainly from Chinese diaspora)	Government credit, demand deposits of commercial banks	Commercial bank credit
Monitoring and supervision	High level of supervision	High level of supervision	Relatively little supervision	Very little supervision	Little supervision
Costs and loan losses	Low costs because government absorbed loan losses	High loan losses	High loan losses	High loan losses	Inefficiency in banking sector because of interest rate ceilings
Impact	Beneficial for industrialization but costly to implement	High NPAs. Costs borne by banks	High NPAs, high inflation	High NPAs, interest rates for non-priority sectors, and inflation	Positive impact on access to finance in priority sectors only after deregulation

Source: Re-Prioritizing Priority Sector Lending, Economic Impact Analysis, December 2013

Table 3: Existing DCLPs in Select Advanced and Emerging Economies		
Country	Sectors/activities under focus	Implementing agency
US	Small businesses, students/education, Low income groups in rural areas/for creation of electricity, waste disposal facilities Low income groups, elderly and handicapped/housing *(involves credit guarantee in lending to some of these sectors)*	US Government Departments (either independently, or in collaboration with private investment companies)
EU (Denmark and Ireland)	Micro enterprises, Small and Medium Enterprises *(involves sectoral targets, credit guarantee)*	Private banking institutions
Pakistan	Agriculture, Exports *(involves indicative targets and interest rate subsidy)*	Public and private banking institutions
Russia	Agriculture and agro-based industries, Rural infrastructure *(involves interest subsidies)*	Public banking institutions
Philippines	Agriculture *(involves credit guarantee)*	Public and private banking institutions/cooperatives
Source: RBI		

3.3.1 Asia's Experience with Priority Sector Lending

Historically, the countries in Asia have used priority sector lending as a policy tool to improve access to credit for underserved sectors. Today, India, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam implement some form of PSL, whether through lending quotas or interest rate caps. Among priority sectors, small and medium sized enterprises (SMEs) and agriculture frequently receive preference across the geographies considered in this sample, creating an opportunity to assess common implications of current priority sector lending programs. The Japanese and Korean governments both relied heavily on priority lending to industrial firms during their rapid economic development in the latter half of the 20th century. China has also had extensive experience with state-directed priority lending, though the government no longer maintains major priority lending programs. Governments typically implement priority sector lending programs based on the theory that the financial sector might otherwise underserve socially beneficial projects because of under-priced risks, information asymmetries, or high transaction costs that the private sector is unwilling to bear.

Currently, the most common form of priority sector lending in Asia is the use of lending quotas by banking regulatory authorities. India, Indonesia, Thailand, and the Philippines implement such quotas. In the case of India, 40% of all bank loans must go to priority sectors, which include agriculture, SMEs, and export-oriented industries. Indonesia and the Philippines both direct priority sector lending to SMEs, with quotas of 20% and 8%, respectively, while Thailand directs 20% of bank deposits to agriculture (14%) and SMEs (6%).

In an alternative approach, Malaysia and Vietnam mandate interest rate discounts for lending to priority sectors. In Vietnam, loans to agriculture, SMEs, export-oriented industry, and technology are capped at 200 basis points above the deposit rate ceiling. As of March 2014, this meant priority sector interest rates of 8%; by contrast, loans to other sectors are not capped. In Malaysia, loans to SMEs are capped at 200 basis points above the base lending rate.

Table 4: Priority Sector Lending Quotas

Country	Quotas/Caps	Priority Sectors
India	40%	Agriculture (18%), SMEs, export, microfinance
Indonesia	20%	SMEs
Philippines	8%	SMEs (6% small; 2% medium)
Thailand	20% of deposits	Agriculture (14%) and small-scale industries (6%)
Vietnam	200 basis points above deposit ceiling	Agriculture, SMEs, export, technology
Malaysia	200 basis points above base lending rate	SMEs

3.4 Few Research Studies and Evidences

Various studies have attempted to ascertain the impact of some of the past and present DCLPs on income, private savings, employment, production, productivity and other social outcomes across countries. The evidence from these studies on the impact of DCLPs is mixed:

Evidence # 1: *Directed credit had a desired impact on the access to formal finance, growth of a given sector, private investment and income poverty in many countries.* The most notable success stories were of Japan, South Korea and Taiwan between the 1950s and 1980s. Studies also found a positive correlation between government credit and private credit as also with

reinvestment by firms themselves in Japan and South Korea. Turkey, through directed production credit towards priority sectors in the 1970s and early 1980s, was able to raise its economic growth rates in an otherwise challenging global environment. China's reliance on directed credit to finance investment was regarded as a means of raising its exports and economic growth. Studies noted the impact of subsidised credit on the purchase of inputs and thereby influencing growth in the agricultural sector in Pakistan. The evaluation of one of the largest public sector driven micro finance programmes in Thailand showed a positive impact of the programme on private consumption and income. There were also spill-over effects on non-beneficiaries through an increased labour demand leading to higher wage rates.

Evidence # 2: *However, there were problems of targeting the beneficiaries under many of these programmes leading to a misallocation of resources to non-priority sectors.* For example, the subsidised credit intended for small farmers in Costa Rica showed high degree of concentration benefiting primarily the large farmers. In Brazil too, studies showed that the distribution of agricultural credit was highly skewed in favour of large borrowers.

Evidence # 3: *There were signs of financial stress resulting from directed lending in some of the countries. This stress was on account of either the usage of directed funds by beneficiaries for less productive purposes or deliberate defaults by beneficiaries exploiting the priority sector status.* The targeted sectors in China and Indonesia reported persistently high default rates. Financial stress was most evident in the case of development financial institutions created by the government to fund the various priority sectors

However, there were also notable exceptions among the development financial institutions that showed a consistently sound financial performance. For example, the performance of the development financial institution for industrial finance in Botswana.

Evidence # 4: *Governments in many countries could not scale down or discontinue the DCLPs in order to avoid further misuse of these programmes given the pressures exerted by a given constituency that benefitted from these programmes.*

However, there were also cases where the government discontinued these programmes, particularly the longstanding ones, leading to a serious contraction in credit availability, growth and employment. Like in the case of Turkey.

Further, many such regimes were immensely complicated. At one point of time Korea had 221 formal directed credit programs. In 1986 the Philippines had 49 schemes for agriculture and 12 for industry. Turkey in 1983 had about 30 categories of rediscount rates. Indonesia's central

bank operates 32 different schemes. In Peru in 1980-82 the average differential between general and preferential real rates was 32 percentage points; the corresponding figure in Turkey was 36 percentage points. In Brazil in 1987, government credit programs accounted for more than 70% of the credit outstanding to the public and private sectors.

DCLPs have often been used not to correct the inadequacies of financial markets but to channel funds to priority sectors regardless of whether these were the most productive investments. Policies aimed more directly at goods markets or at the distribution of income-price reform in agriculture, grants for the poor, and so on might have been more successful and would have avoided many of the drawbacks of directed credit.

In sum, the available evidence on DCLPs from various countries suggests positive social and economic outcomes from these programmes. In certain cases, however, it raised concerns about the benefits from these programmes, not reaching the targeted sections and resulting in financial stress for the lenders.

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Chapter IV
Priority Sector Lending in India:
Bankers' Views through Primary Survey

4.1 Introduction

In order to comprehend the reluctance of bankers in providing credit to priority sector lending, despite the fact that less proportion of aggregate gross NPAs lies in the priority sector (36% of total gross NPAs as on Mar'14) as compared to non-priority sector, we have been conducting a primary survey, through a structured questionnaire. A questionnaire or primary survey method is simply a 'tool' for collecting and recording information about a particular issue of interest. The questionnaire consists of 15 questions, which are simple and the respondent (bank manager) can answer them within 10-15 minutes of time, without referring any documents/files etc. The survey basically aims to study the motives of the respondents, rather figuring out any figures/numbers on PSL. The list of questions is presented at the end of this Chapter (annexure). Due to the short time period of the project, the sample of the survey is fixed at 100 branches around the country.

4.2 Sample Selection for the Survey: "Quota Sampling"

The results of survey mostly depends on the quality and appropriate sampling distribution, which may be characterized by the number and selection of subjects or observations. Obtaining a sample size that is appropriate in both regards is critical for many reasons. When the sample size is pre-determined by the researchers, along with appropriate proportions of sub-samples, the sampling technique predominantly using is "**Quota Sampling**". As the sample size is fixed at 100 branches, we followed the Quota Sampling for the selection of sample branches.

The **rationale for choosing the 100 branches** is as follow:

a) In India, as of Mar'15 there were 125,863 bank branches and even to capture 1% of that for primary survey is a mammoth task. Additionally, the project time period is very short to cover more branches in the sample.

b) The sample size depends largely on how accurate we want our survey data to be. In other words, how closely we want our results to match those of the entire population. In data empirical literature, there are two measures that affect the accurateness of the data:

   - **Margin of Error:** The margin of error expresses the maximum expected difference between the true population parameter and a sample estimate of that parameter. To be

meaningful, the margin of error should be qualified by a probability statement (often expressed in the form of a ***confidence level***).

- **Confidence Level:** The confidence level describes the uncertainty associated with a sampling method. Suppose we used the same sampling method to select different samples and to compute a different interval estimate for each sample. Some interval estimates would include the true population parameter and some would not. A 90% confidence level means that we would expect 90% of the interval estimates to include the population parameter; A 95% confidence level means that 95% of the intervals would include the parameter; and so on.

The table 1 indicates the appropriate sample size at 95% confidence level with different margin of errors. If the population size is more than 1 lakh and we choose margin of error at 5% then sample size would be 384. However, it is not possible for us to conduct the survey in 384 branches in such a short span of time. Hence we increase our margin of error at 10%, which leads us to our sample size of 100.

Table 1: Sample Size at 95% Confidence Level

Population Size	Sample Size		
	Margin of Error		
	10%	5%	1%
100	49	80	99
500	81	217	475
1000	88	278	906
10000	95	370	4899
100000	96	383	8762
500000	96	384	9423

In order to choose sub-sample from our sample of 100 branches, we have followed a very logical and appropriate methodology. As of March 2015, we have calculated the share of branches as per population group wise, viz. Rural, Urban, Semi-Urban and Metropolitan. We divide our sample of 100 branches in that share only. Hence, the table 2 provides our sub-sample according to population-group wise and bank-group wise. Since 15% of branch network covered by private sector banks, we have also taken in our analysis 15 branches of private sector banks. However, the sample not considered any foreign bank branch, due to their negligible market share.

Table 2: Sample Distribution

Population Group	Number of Branches	*of which*	
		Public Sector Banks	Private Sector Banks
Rural	38	32	6
Semi-Urban	27	23	4
Urban	19	16	3
Metropolitan	16	14	2
Total Sample	**100**	**85**	**15**

4.3 Primary Survey Results & Discussions

As indicated above (and also as this is one of our objective) we had conducted one primary survey to appreciate the mind-set of bankers regarding PSL. The consolidated results of our survey are as follow:

The very first question that we have asked in the survey*: 'Is there should be any target for PSL in India?'.* Out of the 100 sample, 84 respondents said YES to PSL norms. Only 16 respondent thought that there should be NO need for any PSL target for India. This results indicate that banking fraternity is in the favour of PSL targets.

Questions		YES (No. of Respondents)		NO (No. of Respondents)
Q1	Do you think there should be a target for Priority Sector Lending in India?	84		16
Q2	If YES, is 40% target an appropriate one?	YES	NO	-
		47	37	

However, 56% of the respondents i.e. 47 respondents out of 84, thought that 40% is an appropriate target. 44% respondents (37 out of 84) are in the favour of change in the target and out of that, 24 are in favour of reduction in target to either 30% or 35% and rest of the 13 respondent were in favour of increase in target to 45 or more than 50%.

Q3	If not, then what should be the appropriate target?	30%	35%	45%	50% or Above
		23	1	7	6

In Q4 to Q6, we asked about the exposure of braches to various sectors and list of sectors that were difficult or easy to lend.

While 60 respondents indicated that they have exposure of 'Housing' in their banking books, only 7 respondents have exposure to 'Social infrastructure' and 'Renewable energy'. 48 respondents have exposure to 'Education' and 47 have 'Agriculture'. The worrying fact is that despite the largest chunk of PSL is mandated to agriculture (18%), still 27 respondent thought that this was one of the most difficult sector to lend. On the other hand housing being the easiest one. Bankers have also facing difficulty in lending to MSME and weaker sections. The two new areas like 'social infrastructure' and 'renewable energy' are not so popular and also difficult to lend. These results indicated that there is a need for the removal of structural bottlenecks in providing credit to various sectors instead of giving mandate to that sectors.

No. of Respondents	Q4	Q5	Q6
Sectors	Which sectors of your branch has exposure in priority sector lending?	Which sectors are most difficult and vulnerable to lend?	Which sectors are most easy
Agriculture	47	27	35
MSME	39	22	13
Export Credit	12	8	7
Education	48	17	28
Housing	60	3	60
Social Infrastructure	7	16	1
Weaker Sections	23	29	8
Renewable Energy	7	11	0

The next two questions (Q7 and Q8) have posed in order to understand the mentality of bankers regarding the mandatory nature and business potential of PSL. There are 56 respondents told that they lend to PSL only to meet the targets set by RBI. Only 42 respondents marked that there is business potential in PSL.

<table>
<tr><th colspan="2">Questions</th><th>YES</th><th colspan="2">NO</th></tr>
<tr><td>Q7</td><td>Do you think that banks are giving loan to the priority sector, only to meet the target set by RBI?</td><td>56</td><td colspan="2">44</td></tr>
<tr><td rowspan="2">Q8</td><td rowspan="2">If NO, do you think that there is business potential for the banks?</td><td rowspan="2">-</td><td>YES</td><td>NO</td></tr>
<tr><td>42</td><td>2</td></tr>
</table>

In Q9, we want to know the bankers' view on 'new or emerging' sectors that need to be included in PSL norms. The survey results indicate that 'start-up industries' is the favourite emerging sectors among bankers. Very few (only 19 respondents), indicate that 'Agriculture Tourism' is a good sector to lend. 'Cold storage' and 'Rural roads' may also include in PSL classifications.

No. of Respondents	Q9
Areas	Which "New or Emerging" sectors that you think should be part of Priority Sector Lending?
Cold Storage and Godown in rural & semi-urban areas	39
Rural Roads	41
Agricultural Tourism	19
Start-up Industries	49

It is a tie regarding the question that the current sub-target classification of PSL is correct or not.

Q10	At present banks need to give 18% of PSL to Agriculture, 7.5% to Micro Enterprises and 10% to Weaker Sections. Do you this targets and classification is perfect?	YES	NO	Do Not Respond
		48	47	5

In Q10 those who has an opinion that the present classification of PSL targets is not correct, we asked them (Q11) in which sectors they want change in sub-targets. In agriculture most of the respondents want to change the 18% target, followed by MSME and Housing.

No. of Respondents	Q11
Sectors	In which sectors you want to change the targets?
Agriculture	26
MSME	18
Export Credit	5
Education	8
Housing	13
Social Infrastructure	4
Weaker Sections	9
Renewable Energy	12

To include the unbanked households into the banking system, banks have opened of 18.86 crore (14 Oct'15) of PMJDY accounts, of which 85.0% (16.02 crore) A/cs were seeded with RuPay Debit Cards. Further, a total of Rs 230.65 lakh of Overdraft Draft facility has been sanctioned to 15,790 PMJDY accounts. On the positive side, the percentage of zero balance accounts are declining and people are started doing operations in these accounts.

To have banker's view regarding the OD facility, we asked the respondents their view on the same in Q12. There are 64 respondents indicate that inclusion of OD amount sanctioned to PMJDY accounts in PSL is a welcome move from banks' point of view.

Q12	Recently, RBI added the OD amount sanctioned to PMJDY accounts in Priority Sector Lending. Do you think, it is a welcome move from a banker's perspective?	YES	NO
		64	36

The RBI data indicate that compared to non-priority sector, the priority sector's contribution to NPA level is low. With the help of Q13, we endeavour to find out the reason for banks reluctance to PSL. The survey results indicate that high cost in managing priority sector accounts is the most crucial factor (47 respondent) that obstruct banks to lend to priority sectors. The high NPA in priority advances and lack of employees in the branch are other two factors.

No. of Respondents	**Q13**
	The RBI data shows that compared to non-priority sector, the priority sector's contribution to NPA level is low. Then, what obstruct the banks to giving loans to priority sector?
Higher NPA	39
High Cost in managing these accounts	47
Not having proper KYC	16
Not Profitable	22
Lack of Employee at branch	37

In the case of high NPAs in PSL, the problem that maximum bankers faced is the unclear law regarding recovery or sale of stressed assets (Q14). The legal framework in India is not so conducive for bankers.

No. of Respondents	**Q14**
	If the issue is 'higher NPA', what are the problems banks are facing in recovery of these loans?
Lack of Identification of the borrower	17
Unable to sale the assets due to unclear law	43
Any other	40

The final question (Q15) is regarding the computation of PSL. Currently banks are required to lend 40% of Adjusted Net Bank Credit (ANBC) to priority sectors. However, lending as proportion of ANBC always raise serious questions among banking fraternity. In order to address this issue we pose this questions to our respondents. Interestingly only 23 respondents are happy with the current methodology. A larger chunk (i.e. 64 respondents) want that PSL

should be calculated as % to Net lendable Resources (after deducting the regulatory pre-emptions like SLR and CRR).

No. of Respondents	**Q15**
Type	Do you think any change is needed in structure of PSL loans to Adjusted Net Bank Credit (ANBC)?
as % to Aggregate Deposits	13
as % to Net lendable Resources (after deducting the regulatory pre-emptions like SLR,CRR)	64
No need to Change	23

4.4 Computation of PSL Targets: Path to 'Net Lendable Resources' from 'ANBC'

As per the current practise, the computation of priority sector targets/sub-targets achievement will be based on the Adjusted Net Bank Credit (ANBC) or Credit Equivalent Amount of Off-Balance Sheet Exposures (OBSE), whichever is higher, as on the corresponding date of the preceding year. So, as per RBI ANBC for PSL (refer table 3) denotes the outstanding Bank Credit in India minus bills rediscounted with RBI and other approved Financial Institutions plus permitted non SLR bonds/debentures under Held to Maturity (HTM) category plus other investments eligible to be treated as part of priority sector lending (e.g. investments in securitised assets). The outstanding deposits under RIDF and other funds with NABARD, NHB, SIDBI and MUDRA Ltd. in lieu of non-achievement of priority sector lending targets/sub-targets will form part of ANBC. Advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for exemption from CRR/SLR requirements, will be excluded from the ANBC for computation of priority sector lending targets, till their repayment. The eligible amount for exemption on account of issuance of long-term bonds for infrastructure and affordable housing will also be excluded from the ANBC for computation of priority sector lending targets.

As evident from our survey results also, the computation of PSL should be based on percentage of net lendable resources and not on ANBC. Also note that lending is proportional to the lendable resources (or in other words, deposits) available to the banks. But banks are not allowed to lend all the deposits they have. In order to secure banking system and depositors

money from any crisis, banks are required to maintain some money with RBI in the form of CRR and SLR.

Table 3: Computation of ANBC	
Bank Credit in India	A
Bills Rediscounted with RBI and other approved Financial Institutions	B
Net Bank Credit (NBC)	C= (A-B)
Bonds/debentures in Non-SLR categories under HTM category+ other investments eligible to be treated as priority sector +Outstanding Deposits under RIDF and other eligible funds with NABARD, NHB, SIDBI and MUDRA Ltd. on account of priority sector shortfall + outstanding PSLCs	D
Eligible amount for exemptions on issuance of long-term bonds for infrastructure and affordable housing	E
Eligible advances extended in India against the incremental FCNR (B)/NRE deposits, qualifying for exemption from CRR/SLR requirements	F
ANBC	**G= C+D-E-F**

PSL Calculations Based on NLR, not on ANBC

We here endeavour one exercise to make out that what would be the results if PSL computation is based on net lendable resources not on ANBC. And the results are quite interesting. Net Lendable Resources (NLR) are the effective money available with banks after adjusting for CRR and SLR. We have a view that instead of calculating targets and sub-targets of priority sector on ANBC, RBI should use NLR. Since NLR pie is greater than ANBC, a 40% target will provide greater sum of money for both priority sector lending and subsequently for non-priority sector lending. Our calculation suggests that, shifting of calculation from ANBC to NLR releases additional Rs 613 billion for priority sector lending and Rs 919 billion for non-priority sector lending during year FY14.

Table 4: Priority Sector Lending: Calculation based on ANBC and Net Lendable Resources

Year (Rs Bn)	CRR+SLR (%)	Total Credit	Total Deposits	ANBC	Net Lendable Resources (NLR)	40% PSL of ANBC	40% PSL of NLR	Credit to Non-PSL (@ANBC)	Credit to Non-PSL (@NLR)	Increase in PS Lending	Increase in Non-PS Lending
1	2	3	4	5	(6 = 4-2*4)	7	8	(9 = 5-7)	(10 = 6-8)	(12 = 8-7)	(13 = 10-9)
FY11	30	39421	52080	31929	36456	12772	14582	19157	21873	**1811**	**2716**
FY12	28.75	46119	59091	39453	42102	15781	16841	23672	25261	**1060**	**1590**
FY13	27	52605	67505	46569	49278	18628	19711	27941	29567	**1084**	**1626**
FY14	27	59941	77056	54206	56251	21682	22500	32524	33750	**818**	**1227**
FY15	25.5	65364.2	85333	62041.2	63573	24816	25429	37225	38144	**613**	**919**

Source: Author's Calculations

Annexure
Sample Questionnaire

1. Do you think there should be a target for Priority Sector Lending in India?

☐ Yes ☐ No

2. If Yes, is 40% target an appropriate one?

☐ Yes ☐ No

3. If not, then what should be the appropriate target?

a. 20% b. 30% c. 35% d. 45% e. above 50%

4. Out of the following schemes, which sector of your branch has exposure in priority sector lending?

a. Agriculture
b. MSME
c. Export Credit
d. Education
e. Housing
f. Social Infrastructure and
g. Renewable Energy
h. Weaker Sections

5. Among the priority sector lending sectors, which sector is most difficult and vulnerable?

a. Agriculture
b. MSME
c. Export Credit
d. Education
e. Housing
f. Social Infrastructure and
g. Renewable Energy
h. Weaker Sections

6. Among all the categories, lending in which category is most easy?

a. Agriculture

b. MSME
c. Export Credit
d. Education
e. Housing
f. Social Infrastructure and
g. Renewable Energy
h. Weaker Sections

7. Do you think that banks are giving loan to the priority sector, only to meet the target set by RBI?

☐ Yes ☐ No

8. If No, do you think that there is business potential for the banks?

☐ Yes ☐ No

9. Which "New or Emerging" sectors that you think should be part of Priority Sector Lending?

a. Cold storage and Godown in rural & semi-urban areas
b. Rural Roads
c. Agricultural Tourism
d. Start-up Industries

10. At present banks need to give 18% of PSL to Agriculture, 7.5% to Micro Enterprises and 10% to Weaker Sections. Do you this targets and classification is perfect?

☐ Yes ☐ No

11. If 'No', in which sector you want to change the targets?

a. Agriculture
b. MSME
c. Export Credit
d. Education
e. Housing

f. Social Infrastructure and
g. Renewable Energy
h. Weaker Sections

12. **Recently, RBI added the OD amount sanctioned to PMJDY accounts in Priority Sector Lending. Do you think, it is a welcome move from a banker's perspective?**

☐ Yes ☐ No

13. **The RBI data shows that compared to non-priority sector, the priority sector's contribution to NPA level is low. Then, what obstruct the banks to giving loans to priority sector?**
    a. Higher NPA
    b. High cost in managing these accounts
    c. Not having proper KYC documents
    d. Not profitable
    e. Lack of Employee at Branch

14. **If the issue is 'higher NPA', what are the problems banks are facing in recovery of these loans?**
    a. Lack of Identification of the borrower
    b. Unable to sale the assets due to unclear law
    c. Any other; if any

15. **Do you think any change is needed in structure of PSL loans to Adjusted Net Bank Credit (ANBC)?**
    a. as % to Aggregate Deposits
    b. as % to Net Lendable Resources (after deducting the regulatory pre-emptions like SLR, CRR)
    c. Do not know

*****

Chapter V
Banking without Priority Sector Lending: A Hypothetical Scenario

5.1 Introduction

Initially to discuss how the banking sector look, if there were no priority sector lending (PSL) targets for banks in India was not the part of our study. However, one of the comments received from the experts on our Mid-term Report, suggest that the authors should (if possible) explore the possibility of creating a situation where there is no PSL targets for banks. Although, it is difficult for us to appreciate a situation like that but we made an attempt to create a hypothetical example and its impact on the sectors of the economy. Further, to have the 'banker's view', we have incorporated a new question in the primary survey questionnaire, whether banker's really need any target for PSL lending. The results both from the primary and secondary study are interesting.

5.2 Approach to Create a Hypothetical Scenario

After working on how to create a hypothetical example on various fronts, we have arrived at the conclusion that to *link bank credit with GDP value chain* is the best possible way to do this. In this approach our bank credit would be deployed at the best possible way in the entire value chain.

In this context, we followed a simple but powerful technique and assume that banks are going to lend in the coming fiscal according to the share (5-year moving average) of Agriculture, Industry and Services (obviously with sub-sectors) in economic growth i.e. GDP. For example, for year FY16, banks will plan to lend in various sectors according to their share in GDP in last 5 year (say 15% for agriculture, 35% for industry and 50% for services). In this way banks are actively participate in dynamic changes that happened in the economy without adhering to any targets for any sector.

To empirically validate this hypothesis, we have approached in the following manner:

Step 1: We have derived the 5-year moving average of share of agriculture, industry and services in GDP for the period 1981-82 to 2013-14 (33 years). For example, for 1981-82, we took the average of last 5 years (1976-77 to 1980-81), and so on for the subsequent years. The 5-year average dispel the any inconsistency in the data either due to domestic or external disturbances. Further we have added construction in Industry as prescribed by CSO not in

Services.

Step 2: In the next step, we multiplied the Non-food credit of the all scheduled commercial banks (ASCBs) to the sectors' share and arrived at the credit available to all 3 sectors (hypothetical distribution of credit). In annexure to this chapter, we have provided the entire hypothetical and actual sector-wise credit data from 1981-82 to 2013-14.

Step 3: In order to empirically compare the hypothetical distribution of credit vis-à-vis the actual credit to that sector, we estimated the model by using Ordinary Least Square (OLS) regression on sector GDP as dependent variable and sector credit (both hypothetical and actual) as independent variable. So, we estimated six models.

The estimated regression analysis helped us to understand *the impact of sectors Credit on Growth of the respective sectors*. The regression coefficient indicate the impact of 1% increase in sector credit on sector GDP.

5.3 Estimated Model

To do the regression, we propose the following model:

$$Y = \alpha + \beta X + \mu \ldots\ldots\ldots\ldots(5.1)$$

or GDP (Sectors) = Constant + NF Credit (Sectors) + μ ……..(5.2)

Where,

α : Constant

β: Slope Coefficient (indicate the impact of 1% increase in sector credit on sector GDP)

Y: Sectoral GDP at Current Price (e.g. Agriculture, Industry & Services)

X: Credit deployment to Sectors (e.g. Agriculture, Industry & Services)

The estimated models are:

Model I: $Ln\ (GDP_{Agriculture}) = \alpha_1 + \beta_1\ Ln\ (Credit_{Agriculture}) + \mu_1$

Model II: $Ln\ (GDP_{Agriculture}) = \alpha_2 + \beta_2\ Ln\ (Hypothetical\ Credit_{Agriculture}) + \mu_2$

Model III: $Ln\ (GDP_{Industry}) = \alpha_3 + \beta_3\ Ln\ (Credit_{industry}) + \mu_3$

Model IV: $Ln\ (GDP_{Industry}) = \alpha_4 + \beta_4\ Ln\ (Hypothetical\ Credit_{Industry}) + \mu_4$

Model V: $Ln\ (GDP_{Services}) = \alpha_5 + \beta_5\ Ln\ (Credit_{Services}) + \mu_5$

Model VI: $Ln\ (GDP_{Services}) = \alpha_6 + \beta_6\ Ln\ (Credit_{Services}) + \mu_6$

5.4 Empirical Results & Discussions

The estimated above 6 models are mentioned in the following table:

Table 1: Empirical Results: Existing vis-à-vis Hypothetical Models

Variables	Agriculture		Industry		Services	
	(Y=Agriculture GDP, X=Agriculture Credit)		(Y=Industry GDP, X=Industry Credit)		(Y=Services GDP, X=Services Credit)	
	Model I	Model II	Model III	Model IV	Model V	Model VI
	Existing	Hypothetical	Existing	Hypothetical	Existing	Hypothetical
Constant	3.95*** (22.390)	3.03*** (20.770)	2.35*** (17.350)	2.84*** (23.100)	2.80*** (21.490)	2.40*** (22.79)
X Variable	0.67*** (23.930)	0.73*** (35.300)	0.75*** (41.630)	0.73*** (41.960)	0.81*** (47.540)	0.88*** (62.49)
No. of Observations	33					
Adjusted R^2	0.94	0.97	0.98	0.98	0.98	0.99
Figures in parentheses are t-statistics; *** indicates significance at 1%; ** at 5% and * at 10%						

Some of the *stylized facts* emanating from the above regression results are as follow:

- ❖ The estimated coefficient in all the 6-models are highly significant and the Adjusted R^2 is also at very comfort level.
- ❖ The impact of hypothetical agriculture credit on agriculture GDP is more than the actual credit to agriculture. The 1% increase in hypothetical agriculture lending leads to 0.73% (Model II) on agriculture GDP compared to impact of 0.67% (Model I) in actual credit. This is very interesting though disturbing trend. This indicates that agriculture sector needs more credit to contribute more to the agricultural GDP of the country. So, it indicate that credit to Agri. & Allied sector is needed to revive growth in the economy.
- ❖ The results of the Model III & IV indicate that the actual credit available to the 'industry' is approximately at the same level. The actual industry credit contribution (0.73) to industry GDP is a tad lower than for the hypothetical industry credit.
- ❖ Finally, the actual services credit contribution to services GDP is 0.81 (model V), however, the hypothetical services credit to Services GDP is 0.88 (model VI). So, the

estimated Model VI, indicates that there is a more need of credit to the services sector, which will contribute more to Services GDP of the economy.

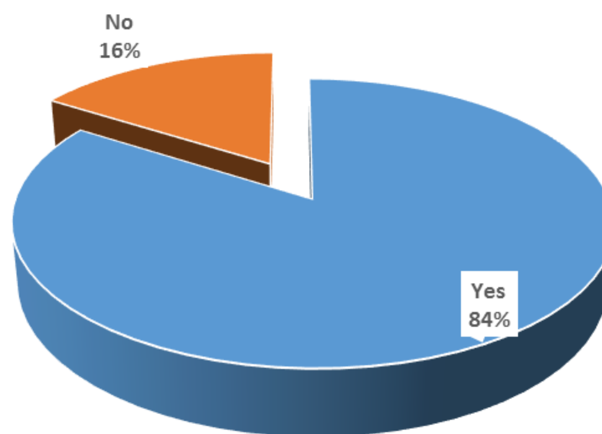
Interestingly, hypothetical credit to the sectors surprisingly found that sectoral GDP growths would be more if credit flow to them without any PSL target or limit.

In annexure, we have provided the existing bank credit to agriculture, industry and services along-with the hypothetical credit amount based on GDP value chain.

5.5 Primary Survey Results on 'Not having PSL Targets'

The survey questionnaire has started with the first question on, whether the bankers/managers need PSL or not. The survey results are very interesting as 84% of the respondents reply that there should be a target for priority sector lending. Only, 16% of the respondents don't want any target as PSL, as banks are giving loans to all the sector.

Chart 1: Q: Do you think there should be a target for Priority Sector Lending in India?



Source: Survey Results

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Annexure

Bank credit to various sectors: Existing and Hypothetical

Year (Rs Bn)	Agriculture Credit		Industry Credit		Services Credit	
	Existing	Hypothetical	Existing	Hypothetical	Existing	Hypothetical
1981-82	46	105	133	71	118	117
1982-83	53	125	146	87	156	141
1983-84	61	142	159	102	193	167
1984-85	77	166	184	122	229	200
1985-86	91	188	214	141	256	228
1986-87	106	207	252	161	275	265
1987-88	120	225	322	180	263	301
1988-89	140	264	383	217	324	366
1989-90	165	309	445	261	405	444
1990-91	168	347	471	302	524	514
1991-92	182	370	586	328	488	558
1992-93	200	426	579	378	673	648
1993-94	212	449	747	399	576	687
1994-95	240	577	931	517	822	899
1995-96	270	704	1026	633	1146	1106
1996-97	314	765	1175	707	1219	1236
1997-98	349	867	1305	821	1462	1429
1998-99	396	959	1473	932	1651	1630
1999-00	444	1094	1628	1088	2031	1921
2000-01	519	1222	1723	1239	2472	2254
2001-02	608	1354	2352	1393	2397	2611
2002-03	735	1660	2472	1746	3590	3391
2003-04	905	1882	3523	2064	3620	4102
2004-05	1253	2370	4592	2722	4748	5501
2005-06	1740	3121	5794	3847	7130	6977
2006-07	2304	3852	7256	5025	9287	8105
2007-08	2753	4522	8854	6354	11568	8836
2008-09	3387	5193	11051	7639	12855	9013
2009-10	4161	5892	13944	9092	13858	9019
2010-11	4806	7048	17011	11017	16961	11073
2011-12	5484	8180	19458	12783	20363	13119
2012-13	5899	9279	22301	14403	23440	15222
2013-14	6694	10507	25164	16110	27098	17838

Chapter VI
Impact of Priority Sector Lending in India: A Cost-Benefit Analysis

6.1 Introduction

Impact of any policy can be judged in two ways: first, the benefits derives from the policy and second, the cost associate to it. If the benefits are more than the costs then the policy is consider as a successful one. However, every time we cannot assess policy on economic terms, there are certain social objectives that are crucial in nature and will bear fruits in long-term. This is an un-denying fact that PSL has impacted the social and economic strata of the country. Here, to assess the impact of PSL on Indian Economy, we analyse the benefits that are accrued to the lending of three major sub-sectors, namely agriculture, exports and micro and small enterprises, with the costs borne by lending to them.

6.2 Sectoral Analysis of PSL Lending

Before we do the empirical analysis to evaluate the impact of PSL, here we made an attempt to find out the impact of priority sector lending on the sub-segments through numbers and graphs.

6.2.1 Agriculture

Since a large part of population in India depends directly or indirectly on agriculture it will get the top-most priority in most of the India's economic and social policies. Even under PSL norms, agriculture has received the largest chunk of the 40% pie, i.e. the 18% share in ANBC. But it is interesting to note that even though the share of agriculture in total GDP has reduced significantly from 30% to 13% its share in PSL has remain intact at 18% (Direct: 13.5% and Indirect: up to 4.5%).

However, the RBI circular dated 23 April 2015 has removed the sub-sector lending targets for direct and indirect agricultural lending, but kept the overall 'Agricultural Advances' target of 18%. Keeping in view that the direct lending to the most disadvantaged farmers, the small and marginal farmers, has been around 6% of ANBC, under the revised PSL norms, RBI fixed the sub-sector target of 7% for 2015-16 and 8% for 2016-17 for direct lending to 'small and marginal farmers'. Furthermore, a variety of corporate loans have been precluded from getting direct lending status.

Further on 16 July 2015, RBI directed the banks, to ensure that their overall direct lending to non-corporate farmers does not fall below the system-wide average of the last 3 years achievement. The targets for direct lending by banks to agriculture under PSL norms are aimed to increase the flow of credit directly to non-corporate farmers. Additionally, it also asked banks to maintain all efforts to reach the level of 13.5% direct lending to the beneficiaries who earlier constituted the direct agriculture sector.

Shift from Non- Institutional to Institutional Credit

The mandatory 18% lending by commercial banks leads to an increase in institutional credit (including commercial banks, cooperative banks and societies) to agriculture sector compared to non-institutional credit (like money-lenders, etc.). At the time of 1971 (possibly at the time of advent of PSL norms), while institutional credit comprises of 31.7% of total credit, non-institutional has larger chunk of 68.3%. However, in 2002 the pattern has reversed and institutional credit held 61.1% share. But, the concern is that even after hugely promoted directed lending to agriculture, still around 40% of agriculture credit comes from non-institutional sources. So, what are the reasons for this, let us analyse a few of them.

Table 1: Share in Total Debt of Cultivator Households (%)

	1951	1961	1971	1981	1991	2002
Institutional	7.3	18.7	31.7	63.2	66.3	61.1
Non-Institutional	92.7	81.3	68.3	36.8	33.7	38.9
Money Lenders	69.7	49.2	36.1	16.1	17.5	26.8
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: All India Debt and Investment Survey

Opening a bank is costly, and the more sparsely populated the area, the larger the costs per loan. Moreover, banks operating in towns or cities can finance a wide variety of enterprises, while banks in agricultural areas are forced to specialize in undiversified portfolios of loans, making them extremely vulnerable to the effects of adverse prices and weather. Both problems can be alleviated somewhat by allowing banks to open branches, which have lower overhead and thus are less expensive to operate.

The allocation of capital in agricultural areas is also hampered by the difficulties farmers face in establishing and maintaining creditworthiness. This follows from two intrinsic problems. First, agricultural production requires large amounts of advance credit and entails long delays in repayment. Second, because farmers hold their wealth in the form of the land they cultivate, they find it difficult to diversify their asset risk.

Farmers may want to diversify even more than the typical consumer because their ability to invest hinges on continuing access to credit. But the benefits of reduced borrowing costs may outweigh those from diversification. It is an unfortunate irony that some of the riskiest assets in the economy are held as the sole form of wealth by some of the most risk-averse investors. Risk-averse farmers may even choose not to diversify their crop mix.

Banks take account of the extent and riskiness of borrowers' collateral when deciding whether to enter new locales or to make new loans. In areas with volatile land prices, banks place lower limits on loans, charge higher interest rates, and are more reluctant to invest in information about new borrowers or to enter rural markets with little pre-existing wealth accumulation.

The risk of undiversified assets in agriculture cannot be solved by combining corporate ownership of land with rentals to farmers. Although renting or sharecropping land would eliminate the risk to the farmer of a decline in the value of the land, the fact that farmers who can own their land almost always choose to do so is prima facie evidence for the relative efficiency of land ownership.

Increase in Credit Supply

Credit to agriculture grew in double digits during 1980-2012, thanks to PSL norms, before it came down to 7.9% in 2012-13. Even during the period between 2000 and 2010, credit to agriculture grew by whopping 25.3%.

Table 2: Trends in Agriculture Credit

	Share of Agri credit in total NF credit (% Average)	YoY growth in Agri credit (% Average)	YoY growth in NF credit (% Average)
1980-81 to 1989-90	17.2	19.7	18.1
1990-91 to 1999-00	13.2	10.5	14.2
2000-01 to 2009-10	12.6	25.3	23.6
2010-11 to 2014-15	12.6	13.0	14.6
Source: RBI			

In order to promote agricultural advance at low-interest rates, the Government introduced the interest subvention scheme in 2006-07 for short-term crop loans up to Rs 3 lakh, which has been continuing ever since with minor variations. Currently, it is providing interest subvention to banks, RRBs and cooperative banks with respect to short term production credit up to Rs 3 lakh provided they make available the credit at the ground level at 7% per annum. Besides, an additional interest subvention of 3% per annum is also provided for farmers who repay the loans in time making the effective rate of interest for such farmers at 4%. From 2013-14, the

subvention is available to private sector banks with respect to loans given by their rural and semi-urban branches.

We have a view that interest subvention has significant implications for the financing banks. On the one hand, it has enabled the banks to expand their loan portfolio considerably, but on the other hand, the profitability of such lending is dependent on the ability of the banks to mobilise funds at rates lower than the effective lending rate or Base rate (which is different for different banks).

Besides, the release of interest subvention/rebate from Government through NABARD, is on reimbursement basis. Thus, there is a time lag between the date on which the amount is due to the banks under the scheme and the date on which the same is actually received by them. The time lag may vary depending on several factors such as periodicity of submission of claims at various levels, time taken in processing the claims, sanction and release from Government or NABARD. For prompt repayment incentive also, it will depend on the time lag between the dates of actual repayment and the due date for lodgement of claims, actual lodgement of claims, processing for sanction and actual release at various levels.

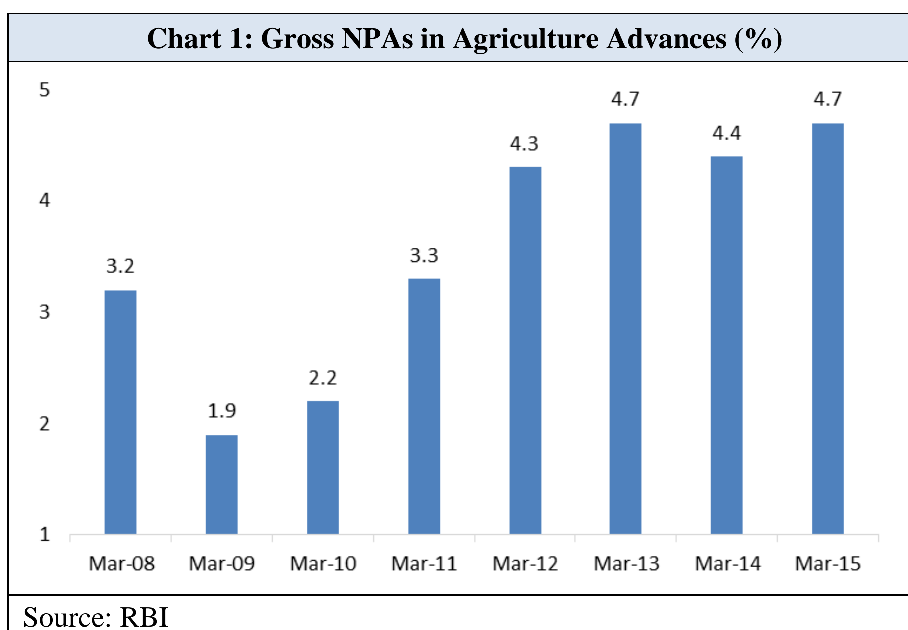
Recently, the finance ministry has decided to revamp the interest subvention scheme by channelising it through direct benefit transfer (DBT) or changing the character of the scheme in the wake of complaints about its misuse and distortion in the pricing of credit.

As part of its revamp plan, the finance ministry has asked public sector banks to come up with suitable alternatives to extend loans at reduced rate to small and marginal farmers. The three proposals made by the department of financial services (DFS) to PSBs include, (i) only 2% subvention upfront/ the need for 3% additional subvention for prompt repayment, (ii) scheme in its existing form or only for small and marginal farmers, and (iii) DBT either to all farmers or only to small and marginal farmers.

The DFS report said there have been demands that the benefit of subvention should also be extended to long-term agricultural loans, as the share of long-term loans in agriculture credit is gradually going down to the detriment of capital formation and asset creation.

Banks non-performing assets (NPAs) in the agriculture sector have been rising steadily since 2010, reflecting, inter alia, a decline in the recovery of agriculture advances, which has been almost stagnant at around 75%. The NPAs ratio in agriculture loans have been rising and stood at 4.7% (provisional) as of Mar’15 from merely 1.9% as of Mar’09.

Chart 1: Gross NPAs in Agriculture Advances (%)



Source: RBI

Table 3: Recovery of Direct Agriculture Advances (Rs Billion)

Year ended June	Demand	Recovery	Per cent of recovery to demand
2008	951	717	75.4
2009	1,190	907	76.1
2010	1,244	922	74.1
2011	1,822	1,383	75.9
2012	1,918	1,429	74.5
2013	2,596	1,976	76.1
2014	2,815	2,066	73.4

Source: RBI Annual Reports

Table 4: Target and Achievement for Agricultural Credit (Rs Billion)

Year	Target	Achievement	Achievement as % of Target
2004-05	1,050	1,253	119%
2005-06	1,410	1,805	128%
2006-07	1,750	2,294	131%
2007-08	2,250	2,547	113%
2008-09	2,800	2,871	103%
2009-10	3,250	3,845	118%
2010-11	3,750	4,683	125%
2011-12	4,750	5,110	108%
2012-13	5,750	6,074	106%
2013-14	7,000	7,116	102%
2014-15	8,000	8,406	105%
2015-16	8,500	-	-

Source: NABARD, RBI

Further the productivity in agriculture has also not been increasing in tandem with credit growth. Yield rates in wheat have grown at a compounded annual growth rate of 1.8% from 1983 to 2013 and in rice by 1.71% over the same period, whereas credit to agriculture has increased with a CAGR of 15% during the same period.

A decision was taken by the Government in June, 2004 to double the flow of agriculture credit in three years with reference to base year 2003-04. The flow of agriculture credit since 2003-04 has consistently exceeded the target. Against the agriculture credit flow target of Rs 8,000 billion during 2014-15, the achievement as on Mar'15 was Rs 8,406 billion forming 105% of target.

6.2.2 Exports

India is primarily a current account deficit country and as a measure to remedy this imbalance, exports are encouraged by both the Government of India and RBI. Interest subvention and refinance have been the twin tools that have used for this purpose. They promote exports by reducing the cost and augmenting the quantity of funds available to the exporters. In this regard export credit played a crucial role.

Prior to 2012 PSL guidelines, only foreign banks are required to lend 12% of their ANBC to exports sector. For domestic banks, export credit to eligible activities under agriculture and MSE is reckoned for priority sector lending under respective categories. In 2012 guidelines, only foreign banks with less than 20 branches need to follow the mandate, the foreign banks with more than 20 branches are treated as domestic banks.

Public Sector Banks always demand for the inclusion of export credit under PSL norms. Even the RBI appointed panel under G. Padmanabhan (Report of the Technical Committee on Services/Facilities to Exporters, April 2013), also recommended inclusion of exports in the priority sector list. Panel recommended that inclusion would not only increase the availability of credit, but also help reduce the cost of such credit for exporters. According to the Panel Report:

To provide required thrust to exports, the Committee recommended, export credit to be included under the priority sector lending for all commercial banks for a period of 3 to 5 years subject to periodic review. Further the committee suggested:

- *Introduction of a sub-target of 8% of Aggregate Net Bank Credit (ANBC) or credit equivalent amount of Off-balance Sheet Exposure, whichever is higher for exports. To encourage flow of credit to MSME sector, RBI to look into the feasibility of fixing a suitable sub-target.*
- *Alternatively, the Committee suggested inclusion of 'export credit' as an eligible sector for deployment of 50% of the respective bank's shortfall in priority sector, automatically allocated to export credit in the subsequent year, with the balance shortfall continue to be deployed in RIDF.*

However, RBI decline the said recommendation with the argument that if export credit is included in the priority sector list, then it could crowd out loans under this window to sectors like agriculture and micro, small and medium enterprises (MSMEs).

However, RBI's Internal Working Group (IWG) to revisit the existing PSL guidelines (Chairman: Lily Vadera) recommended inclusion of export credit under PSL with a ceiling of 2% of ANBC provided that other segments are not crowded out. The Working Group also recommended that incremental export credit from a base date (i.e. the outstanding export credit as on the date of reckoning minus outstanding export credit as on the base date) to units having turnover of upto Rs 100 crore having sanctioned credit limit of upto Rs 25 crore from the banking system may be included in priority sector.

Impact of Exclusion of Export Credit

An analysis of past 15 years data suggests that exclusion of export credit was unwarranted and would have serious repercussion on the economy going forward. There is a high positive correlation between growth in export credit and GDP growth (0.56). And also it is evident from the data that the year when export credit grew by more than 20%, GDP grew around 9%. For the last 3 years, export credit is on decline, so the GDP.

Export credit by banks as percentage of Non-food (NF) credit also fell sharply to 4.2% in 2013-14 from 8.9% in 2000-01. This indicates that due to exclusion of export credit under PSL norms, exports sector did not received its required amount of credit, which subsequently impact exports growth in the past 3-4 years.

Table 5: Export Credit								
Year	Export Credit (ASCB)		Bank Credit		Total Exports		Export Credit as % of Bank Credit	GDP Growth (%)
	Rs Bn	YoY Gth (%)	Rs Bn	YoY Gth (%)	$ Billion	YoY Gth (%)		
2000-01	454	-	5114	-	44.6	-	8.87	4.1
2001-02	431	-5.0	5897	15.3	43.8	-1.6	7.31	5.4
2002-03	502	16.5	7292	23.7	52.7	20.3	6.89	3.9
2003-04	597	18.9	8408	15.3	63.8	21.1	7.11	8.0
2004-05	691	15.6	11004	30.9	83.5	30.8	6.28	7.1
2005-06	862	24.8	15071	37.0	103.1	23.4	5.72	9.5
2006-07	1049	21.7	19312	28.1	126.4	22.6	5.43	9.6
2007-08	1300	23.9	23619	22.3	162.9	28.9	5.50	9.3
2008-09	1289	-0.8	27755	17.5	185.3	13.7	4.65	6.7
2009-10	1381	7.1	32448	16.9	178.8	-3.5	4.26	8.6
2010-11	1690	22.3	39421	21.5	251.1	40.5	4.29	8.9
2011-12	2048	21.2	46119	17.0	306.0	21.8	4.44	6.7
2012-13	2228	8.8	52605	14.1	300.6	-1.8	4.24	5.1*
2013-14	2523	13.2	59941	13.9	314.4	4.6	4.21	6.9*
2014-15	-	-	65364	9.0	310.5	-1.2	-	7.3*
Source: RBI; SBI Research, * Based on New Base Year								

6.2.3 Micro, Small and Medium Enterprises (MSME)

The micro, small and medium enterprises (MSMEs) has been accepted as the engine of economic growth and for promoting equitable development around the world. The major advantage of the sector is its employment potential and low capital cost. The labour intensity of the MSME sector is much higher than that of the large enterprises. The MSMEs constitute over 90% of total enterprises in most of the economies and are credited with generating the highest rates of employment and account for a major share of industrial production and exports.

In India, the MSMEs play a pivotal role in the overall industrial economy of the country. In recent years the MSME sector has consistently registered higher growth rate compared to the overall industrial sector. With its agility and dynamism, the sector has shown admirable innovativeness and adaptability to survive during the global financial crisis.

- ❖ As per the latest available statistics, MSME sector employs an estimated 59.7 million persons spread over 26.1 million enterprises.
- ❖ It is estimated that in terms of value, MSME sector accounts for about 45% of the manufacturing output and around 40% of the total export of the country, which is next only to the agricultural sector. It is, therefore, only appropriate that public policy has accorded high priority to this sector in order to achieve balanced, sustainable, more equitable and inclusive growth in the country.

- ❖ MSMEs constitute nearly 94% of the industrial enterprises in the economy. The sector contributes 36% of the total value of exports of the country and employs over 80 million people.
- ❖ The contribution of the MSME sector to the output of the country is 40% and to the GDP is over 8%.

The MSMEs primarily rely on bank finance for their operations and as such ensuring timely and adequate flow of credit to the sector has been an overriding public policy objective. Advances extended to the micro and small enterprises sector are treated as priority sector advances. However, despite the increase in outstanding credit to the sector, the MSME borrowers feel that banks are not doing enough for the MSMEs and are catering more to the needs of the large corporates. This gap in perception needs to be bridged.

Till recently, credit extended to Micro and Small Enterprises (MSEs) counts for priority sector. The Working Group (2015) recommended extending PSL status to Medium Enterprises (MEs) in addition to the MSEs. While all MEs (Manufacturing) may be included under PSL, MEs (Service) with credit limit up to Rs 10 crore may be eligible to qualify for PSL.

To ensure that micro enterprises is not crowded out with the inclusion of the medium enterprises, the Working Group recommended a target of 7.5% of ANBC for lending to micro enterprises to be achieved in stages i.e. achieve 7% by March 2016 and 7.5% by March 2017.

Table 6: Bank Credit to Micro and Small Enterprises (Rs Billion)

Mar-end	Public Sector Banks	Private Sector Banks	Foreign Banks	ASCBs
2005	678	86	69	835
2006	824	104	84	1013
2007	1026	131	116	1273
2008	1511	469	155	2135
2009	1914	467	181	2561
2010	2784	645	211	3640
2011	3766	879	215	4859
2012	3963	1105	218	5286
2013	5025	1547	300	6872
2014	6160	2001	300	8641

Source: MSME Annual Report 2014-15

As at the end of March 2015, the total outstanding credit provided by ASCB to the MSEs sector stood at Rs 9665 billion as against Rs 8461 billion in March 2013 registering an increase of 13.6%, while the non-food credit increased by merely 9.0% during the same period. Although public sector banks are market leader in providing credit to MSE (around 71% share), their share has declined from the Mar-05 level (around 81% share).

Despite the increase in financing to the sector there is still a considerable credit gap which needs to be bridged. In terms of the Report of the Private Sector Investment for MSME Sub Group under Working Group for the 12th Five Year Plan (2012-2017) the credit gap as a percentage to total demand is estimated at 56% in 2013-14 for the MSME sector as may be seen from the table below:

Table 7: Estimated Outstanding Credit Demand and Supply of MSMEs (Rs Crore)

Year	Total Demand	Total Supply	Credit Gap in absolute terms	Credit gap as % of total demand
2010-11	2092500	737161	1355339	65
2011-12	2308384	874482	1433902	62
2012-13	2541574	1038948	1502626	59
2013-14	2803628	1237539	1566089	56
2014-15	3089863	1477928	1611935	52
2015-16	3405845	1769659	1636186	48
2016-17	3757755	2124644	1633111	43

Source: Report of the Private Sector Investment for MSME Sub Group under Working Group for the 12th Five Year Plan (2012-2017)

The reason for this huge credit gap, despite the fact that banks provide credit worth Rs 9665 billion to micro and small enterprises during FY15 (17.8% of ANBC), is that banks regards lending to MSMEs sector as high risk segment for different reasons like low capitalization, lack of appropriate accounting records, and unavailability of complete financial statements and business plans. Further, loaning to MSMEs is a costly affair for bankers because the processing of each application calls for intensive fieldwork and high levels of scrutiny. Nearly 50% of the total application processing time is taken up in collecting the required documents.

Further, banks have to take upon themselves to understand the MSME sector better, design relevant products & processes and reach out to target MSMEs and fulfil their responsibility of an efficient financial intermediary towards nation building. Banks, in order to bridge the credit gap need to adopt a two pronged approach i.e. a) sectoral & cluster based approach and b)

product design approach. A sectoral & geographic cluster based approach will keep the required focus in order to understand the value chain and cash flow dynamics. Product design approach will allow the banks to design a product suited to value chain analysis and role debt can play in growth of small businesses in the value chain. This should include design of products like consumer loans and distribution strategies amenable for reaching out to small business owners on mass scale.

Towards this, borrowers have to equally understand their responsibility in providing all the information in a transparent manner so as to enable the financier make their decisions. There are established methodologies used by niche NBFCs such as sectoral value chain & cash flow scenarios, small business & household cash flow, sensitivity analysis, small business owners network profiling and psychometric assessment tools to understand the willingness of small business owners to repay the loan.

As per a study by the International Finance Corporation (IFC), in 2010, the MSME sector in India, had a credit demand of about Rs 32.5 trillion. According to estimates, about 78% of the credit demand in this sector is met from informal sources (e.g., family, friends, and moneylenders) and the remaining 22% from banks and other formal institutions. The large share of the informal credit market in the sector is accountable to timely disbursal of credit, no requirement of immovable collateral and shorter turnaround times that attract in particular, the micro enterprises operating in the sector.

Out of the total formal credit to the sector, banks accounted for 92% of the formal credit supply to the MSME sector. This shows that though they are reluctant to lend to small businesses because of size-related risks and limited collateral, banks are central to formal financing in the MSE sector.

6.3 Costs of Priority Sector Lending In India

It is an un-denying fact that priority sector lending impart crucial benefits on Indian economy. However, it is pertinent to look at the costs associated with these benefits. In this section we endeavour to calculate the direct and indirect costs borne by the banking industry and the general economy.

6.3.1 Indirect Costs

Non-performing assets (NPAs) are often referred as the indirect cost. Since money getting blocked in NPAs the ability of bank's lending decreases not only by the amount of NPAs but NPAs lead to opportunity cost also as that much of profit invested in some return earning project/asset. So NPAs doesn't only affect current profit but also future stream of profit, which may lead to loss of some long-term beneficial opportunity.

(i) Impact according to Bank Type

In order to calculate the indirect costs, we have used regression analysis to test the hypothesis whether PSL loans impose a higher cost on the economy (in terms of priority sector NPAs) compared to the non PSL loans. We performed two separate regressions, using PSL loans and NPAs from PSL as the independent and the dependent variables in the first regression and non PSL loans and non PSL NPAs in the second regression, respectively. In other words, we tested the following two hypotheses:

$$Log\ (NPA_{PSL}) = f\ (Log(LOANS_{PSL}\ ))$$

$$Log\ (NPA_{Non-PSL}) = f\ (Log(LOANS_{Non-PSL}))$$

The above regression analysis allow us to assess the relationship between dependent variable and independent variable (positive or negative) and also the quantitative impact of that. We have run separate regression for public, private and foreign banks to assess the impact on bank group wise. The results of the regression analysis is as follow:

Table 8: Impact of PSL Lending on PSL NPAs

$\boldsymbol{Y = NPA_{PSL}}$	Constant	Intercept ($LOANS_{PSL}$)	No. of Observations	Adjusted R^2
Public Sector Banks	2.11** (2.428)	0.43*** (4.201)	14	0.56
Private Sector Banks	0.99** (2.780)	0.36*** (7.144)	14	0.79
Foreign Banks	-11.60*** (-6.585)	2.14*** (7.857)	8	0.89
Figures in parentheses are t-statistics; *** indicates significance at 1%; ** at 5% and * at 10%				

Table 9: Impact of Non-PSL Lending on Non-PSL NPAs				
$Y = NPA_{Non-PSL}$	Constant	Intercept ($LOANS_{Non-PSL}$)	No. of Observations	Adjusted R^2
Public Sector Banks	2.14 (1.435)	0.40*** (2.430)	14	0.27
Private Sector Banks	2.52*** (2.428)	0.28*** (7.144)	14	0.48
Foreign Banks	-5.29* (-2.312)	1.30*** (3.978)	8	0.68
Figures in parentheses are t-statistics; *** indicates significance at 1%; ** at 5% and * at 10%				

The regression results indicates that,

- ***In public sector banks***, a 1% increase in PSL lending leads to a 0.43% increase in NPAs in priority sectors. However, a 1% increase in the non-PSL loans, leads to a 0.40% increase in NPAs in the non-PSL category. The difference in the magnitude of impact indicates the greater cost that PSL loans impose on public sector banks in the form of NPAs vis-à-vis the non-priority sectors.
- ***In private sector banks***, a 1% increase in PSL lending leads to a 0.36% increase in NPAs in priority sectors and a 1% increase in the non-PSL loans, leads to a 0.28% increase in NPAs in the non-PSL category.
- ***In foreign banks***, a 1% increase in PSL lending leads to a 2.14% increase in NPAs in priority sectors and a 1% increase in the non-PSL loans, leads to a 1.30% increase in NPAs in the non-PSL category.

Thus, the results indicate that for private and foreign banks, the difference in magnitude is quite big, this explains why these banks are so reluctant in providing credit to priority sectors vis-à-vis non-priority sectors.

(ii) Impact according to Sector-wise

To quantify the impact of priority sector lending on various sector's growth (namely agriculture, exports and MSME) and vice-versa, we have conducted ***Simultaneous Equation Model (SEM).*** SEM is a system of equations representing a set of relationships among variables or describing the joint dependence of variables. In such models there are more than one equation one of the mutually or jointly dependent or endogenous variables. SEM is useful tool in order to assess the two-way impact of both variables (like agriculture priority lending and agriculture GDP growth).

a) Impact on Agriculture

Since agriculture GDP growth and PSL to agriculture are impacting each other we have constructed a SEM for that. As agriculture GDP growth is also depend upon area under cultivation and rainfall, we also add these variables as independent variables in first regression equation. As real interest rate prevailing in the economy, affect borrowing of funds and also PSL (because lending rates on PSL loans are also linked to the base rate), we include it as an independent variable in the second regression equation.

$$Log\ (Agriculture\ GDP) = f\left(Log\ \left(PSL_{Agriculture}\right), Log\ (Area\ under\ Cultivation), Log\ (Rainfall)\right)$$

$$Log\ \left(PSL_{Agriculture}\right) = f\left(Log\ (Agriculture\ GDP), Log\ (Real\ Interest\ Rate)\right)$$

The results of the above regression analysis is as follow:

Table 10: Simultaneous Equation – Agriculture Sector		
	Model 1 Dependent Variable: Agriculture GDP	**Model 2** Dependent Variable: PSL to Agriculture
Intercept	-9.53 (-1.169)	-4.21*** (-4.756)
Log PSL to Agriculture	0.61*** (10.980)	-
Log Area Under Cultivation	2.71 (1.310)	-
Log Rainfall	-0.03 (-0.055)	-
Log Agricultural GDP	-	1.35*** (13.332)
Real Interest Rate	-	-0.21*** (-4.756)
No of Observations	33	33
Adjusted R^2	0.95	0.86
Figures in parentheses are t-statistics; *** indicates significance at 1%; ** at 5% and * at 10%		

The results of model 1 indicates that a 1% increase in Agriculture lending leads to only 0.61% increase in Agriculture GDP. This indicates that credit to agriculture impacts agriculture GDP in a lesser way due to the structural bottlenecks persists in agriculture sector like land fragmentation, dependence on monsoon, etc. The sign of area under cultivation and rainfall are as per hypotheses although both the variables comes out to be insignificant. However, the contribution of these variables in promoting agriculture growth is undisputable.

The results of model 2 indicates that a 1% increase in Agriculture GDP demands 1.35% increase in Agriculture lending. As expected, an increase in real interest rates leads to decline in PSL lending due to costlier loans.

b) Impact on Exports Sector

Similarly, exports GDP growth and PSL to exports are impacting each other we have prepared a SEM for that. It is well known fact that exports growth largely depend upon exchange rate, hence we put exchange rate as one of the independent variable in our first regression equation. We also include real interest rate as an independent variable in the second regression equation.

$$Log\ (Exports\ GDP) = f\left(Log\ (PSL_{Exports}), Log\ (Exchange\ Rate)\right)$$

$$Log\ (PSL_{Exports}) = f(Log\ (Exports\ GDP), Log\ (Real\ Interest\ Rate))$$

The results of the above regression analysis is as follow:

Table 10: Simultaneous Equation – Exports Sector		
	Model 1 Dependent Variable: Export to GDP	**Model 2** Dependent Variable: PSL to Exports
Intercept	1.04*** (3.488)	-2.12*** (-7.675)
Log PSL to Exports	0.43*** (4.782)	-
Log Exchange Rae	-0.38* (-1.644)	-
Log Exports to GDP	-	3.52*** (28.969)
Real Interest Rate	-	0.04** (1.997)
No of Observations	33	33
Adjusted R^2	0.95	0.97
Figures in parentheses are t-statistics; *** indicates significance at 1%; ** at 5% and * at 10%		

The results of model 1 indicates that a 1% increase in exports credit leads to only 0.43% increase in exports GDP. The reasons for such a low increase in exports GDP due to credit are as follow:

- Exports growth are primarily depend upon external situation. A conducive external environment is very favourable for exports.

- Exporters have options of other forms of credit also (like ECB/FCCB, etc.). They are depend upon banks very rarely.

Although exchange rate is one of the most important factor that affects exports GDP in our regression it comes out to be significant at 10% confidence level.

The results of model 2 indicates that a 1% increase in exports GDP demands 3.52% increase in exports lending. This is quite interesting that banks (particularly PSBs) always demand from RBI that export credit should be included in priority sector list (finally in 2015 RBI added it with a cap of 2% of ANBC). Our result confirms the said demand.

c) Impact on MSME Sector

The same logic applies here also. Employment is an important determinant of the output generated in MSME sector. Hence we include it as an independent variable in first equation. Total number of MSMEs and the real interest rate were used as the independent variables in the second regression.

$$Log\ (Manufacturing\ GDP) = f\big(Log\ (PSL_{MSEs}), Log\ (Employment)\big)$$

$$Log\ (PSL_{MSEs}) = f(Log\ (Manufacturing\ GDP), Log\ (Real\ Interest\ Rate), Log\ (Total\ number\ of\ MSMEs))$$

The results of the above regression analysis is as follow:

Table 10: Simultaneous Equation – MSME Sector		
	Model 1 Dependent Variable: Manufacturing GDP	**Model 2** Dependent Variable: PSL to Manufacturing
Intercept	1.76*** (11.808)	-3.46*** (-3.427)
Log PSL to MSME	1.11*** (11.798)	-
Log Employment	-0.22 (-1.639)	-
Log Manufacturing GDP	-	1.31*** (-0.055)
Log Total Number	-	-0.25 (-1.471)
Real Interest Rate	-	-0.01 (-1.234)
No of Observations	33	33
Adjusted R^2	0.99	0.99
Figures in parentheses are t-statistics; *** indicates significance at 1%; ** at 5% and * at 10%		

The result of MSME sector is quite different from the other two above sectors. According to model a 1% increase in MSME lending leads to 1.11% increase in Manufacturing GDP. This result indicates that MSME sector is the most beneficial sector from priority credit, due to the fact that there is no such structural bottleneck in this sector. An input of credit leads to output of material instantly.

The results of model 2 indicates that a 1% increase in manufacturing GDP demands 1.31% increase in MSME lending. As expected, an increase in real interest rates leads to decline in PSL lending due to costlier loans.

In the nutshell,

- *The 1% increase in Agriculture lending leads to 0.61% increase in Agriculture GDP.*
- *The 1% increase in Exports lending leads to 0.43% increase in Exports GDP.*
- *The 1% increase in MSME lending leads to 1.11% increase in MSME GDP.*

6.3.2 Direct Costs

Direct costs include *funding costs, transaction costs, and credit costs*. **Funding cost** is the marginal or average cost at which banks are able to raise money from the depositors or market. **Transaction cost** is the cost of delivering credit to the borrower (e.g., wages, salaries, printing, rent, electricity, connectivity, transportation of cash, insurance, overhead, and depreciation). **Credit cost** is the sum of the risk cost and capital cost of a loan.

Let us explain how we quantify each of the direct costs.

Funding Cost: In some of the research papers the interest rate offered on savings accounts is considered as funding cost as it is the lowest possible rate at which banks can raise their money. But since only 25% of total deposits raise through savings it is unappropriated to take only savings rate as funding rate. We have taken cost of funds as the funding cost as it will represent the exact cost that bear by banks in raising money.

The cost of fund for bank-group wise for last five year is as follow:

Table 10: Cost of Funds (%)				
Year	**Public Sector Banks**	**Private Sector Banks**	**Foreign Banks**	**All SCBs**
FY14	6.14	5.86	4.00	5.97
FY13	6.27	6.12	4.05	6.12
FY12	6.06	5.84	3.88	5.90
FY11	4.89	4.56	3.11	4.73
FY10	5.35	4.83	2.83	5.10
Source: RBI's Statistical Tables Relating to Banks in India				

Transaction Cost: As discussed above transaction cost is the cost of delivering credit to the borrower which includes all type of expenses. This cost is the most difficult to calculate since no such measure is readily available in literature and data regarding this. If we have to calculate the transaction cost for the entire loan book than it is an easy one and can be calculated by dividing total operating expenses by total advances.

However, in our case we want to calculate the transaction cost of providing Rs 100 for priority sector lending. Some of the studies (like Nathan, 2013) take into account the transaction cost as given in Rangarajan Committee Report (Report of the Committee on Financial Inclusion, January 2008). According to the Rangarajan Committee Report, the transaction cost for providing Rs 10,000 and Rs 25,000 to priority sector for public and private sector banks is as follow:

Table 11: Transaction Cost (according to Rangarajan Committee Report 2008)		
	Public Sector Bank	Private Sector Bank
Rs 10,000	32.37%	21.56%
Rs 25,000	12.95%	8.62%
Source: Report of the Committee on Financial Inclusion, January 2008		

The above results as presented in Rangarajan Committee Report have been estimated by Central Bank of India (as a proxy for public sector banks) and ICICI Bank (as a proxy for private sector banks) in September 2006 for the YC Nanda Working Group on Outreach of Institutional Finance and Cooperative Reforms constituted for Eleventh Five Year Plan.

We have two choices in calculating transaction costs, (i) we could use the above estimates, or (ii) we could estimate the fresh numbers. However, it is quite impossible to calculate the transaction cost at branch level, we have used operating expenses and PSL advances. Hence the formula for calculating transaction cost per Rs 10,000 is as follow:

$$Transaction\ Cost = \frac{Operating\ Expenses}{Total\ PSL\ Advances}$$

The results of transaction cost based on above formula, bank group wise is as follow:

Table 12: Transaction Cost per Rs 10,000			
	2013-14	2012-13	2011-12
Public Sector Bank	8.30%	8.13%	8.07%
Private Sector Bank	12.36%	12.98%	12.11%
Foreign Banks	18.14%	18.47%	18.39%
Source: RBI; Authors' Calculations			

There are several *stylized facts* that need to understand with respect to above results:

- ❖ The transaction cost has declined sharply in last 5-10 years due to digitisation of most of the banking services for almost all the bank-group.
- ❖ The transaction cost for private and foreign banks was more than the public sector banks due to the fact that they both have huge operating expenses (due to high salary packages and large number of hi-tech metro and urban branches) and low PSL advances (due to their not so robust rural and semi-urban presence).
- ❖ It is inappropriate to take transaction cost for foreign banks as calculated above since they are mandated only 32% of their advances for PSL and also they hardly have any branch in rural and semi-urban area. Hence we have taken transaction cost for private banks as foreign banks.

Credit Cost: It is calculated as the sum of risk cost (expected loss) and capital cost (unexpected loss) of providing a loan. Risk and capital losses arise from the probability of borrower default on loan repayment.

<u>(i) Calculation of Risk Cost or Expected Loss:</u> The expected loss for the bank is a function of the following variables:

(a) Probability of default (PD): It is the likelihood that the borrower will fail to make full and timely repayment of its financial obligations. In this study, we have computed PD as the five year average (2011-2014) of total PSL NPAs as a percentage of the total PSL advances.

(b) Loss given default (LGD): The LGD of a transaction is more or less determined by "1 minus recovery rate", i.e., the LGD quantifies the portion of loss the bank will really suffer in case of default. The estimation of such loss quotes is far from being straightforward, because recovery rates depend on many driving factors, for example on the quality of collateral (securities, mortgages, guarantees, etc.) and on the seniority of the bank's claim on the borrower's assets.

(c) Exposure at default (EAD): This is basically the expected value of the loan at the time of the default. In this study, it is computed as the average of PSL advances over the total advances of the bank from 2011 to 2014.

Banks are expected to hold reserves against expected credit losses which are considered a cost of doing business. The most basic model of expected loss considers two outcomes: default and non-default.

Event	***Loss***	***Probability***
Non-Default	0	(1-PD)
Default	LGD*EAD	PD

Thus, Expected loss (or risk cost in our case) would be

$$Expected\ Loss\ (Risk\ Cost) = (1 - PD) * 0 + PD * LGD * EAD$$

or

$$Expected\ Loss\ (Risk\ Cost) = PD * LGD * EAD$$

<u>(ii) Calculation of Capital Cost:</u> In addition to expected loss due to default based on borrower history is the possibility of unexpected losses that might exceed the average or expected losses. The standard deviation of the credit loss function is thus used to compute these unexpected losses. To establish the appropriate amount of capital to cover unexpected losses, the bank must establish an adequate confidence level. Confidence level indicates the probability that a bank will not fail in some business line because of extreme losses. Confidence levels used in risk management usually range from 95% to 99%. Thus,

$$Unexpected\ Loss: \alpha * Standard\ Deviation\ (PD)$$

Where α signifies the confidence level = 2.575 for 99% confidence interval.

To bear this unexpected loss, the bank and its shareholders must be assured of a minimum threshold return known as the hurdle rate. The hurdle rate is computed in compliance with the Basel II accords.

$$Hurdle\ Rate = \frac{Expected\ Return\ on\ Equity}{(1 - Tax\ Rate)} - Risk\ Free\ Rate$$

Here, we took yield of 10-year Government Bond as Risk-free rate (at 8%) and effective corporate tax rate as 34.61%.

Finally,

$$Capital\ Cost = Unexpected\ Loss * Hurdle\ Rate$$

Hence the credit cost equals to:

$$Credit\ Cost = Risk\ Cost + Capital\ Cost$$

The estimation of direct cost using above analysis is as follow:

Table 13: Cost of Delivering Credit (Direct Cost)			
Variables	**Public Sector Bank**	**Private Sector Bank**	**Foreign Bank**
Funding Cost (A)	6.14%	5.86%	4.00%
Transaction Cost (B)	8.30%	12.36%	12.36%
Credit Cost (C = D+E)	1.43%	0.69%	0.63%
Risk Cost (D)	1.33%	0.52%	0.60%
PD	4.53%	1.77%	1.92%
LGD	1	1	1
EAD	29.35%	29.33%	31.32%
Capital Cost (E)	0.10%	0.17%	0.03%
Standard Deviation of Default due to PSL	0.70%	0.34%	0.19%
Hurdle Rate	4.95%	16.81%	5.79%
Total Cost of Credit (A+B+C)	**15.87%**	**18.91%**	**16.99%**

The below table indicated the total cost incurred and the returns obtained by different bank group in delivering credit to borrowers in the priority sectors. The table clearly reflects that engaging in PSL generates high costs for the banks compared to the resulting returns, which are low on account of interest rate ceilings imposed on these small loans. To exemplify, for a loan of Rs 10,000 offered by a public sector bank at 9.69%, the bank makes a loss of Rs 618. ((Return - Cost)* Loan size). The costs for private and foreign banks are Rs 767 and Rs 761 respectively, thus indicating that irrespective of the bank type, extending small size loans through branch networks is costly for the banking industry.

Table 14: Bank Group wise Cost and Return of Priority Sector Lending			
Bank Group	**Cost of Credit**	**Return on Advances**	**Difference (Return - Cost)**
Public Sector Bank	15.87%	9.69%	-6.18%
Private Sector Bank	18.91%	11.24%	-7.67%
Foreign Banks	16.99%	9.38%	-7.61%

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Chapter VII
Conclusion and Major Recommendations

Though the philosophy of priority sector remains intact, the framework has undergone transformational changes since its introduction in the early 1970s. Since then, both RBI and Government of India has taken a number of initiatives recommended by various expert committees to meet the credit requirements of the sectors due to changing needs of the economy.

Following the internal group (Chair: Lily Vadera) recommendations, RBI has enhanced the scope of PSL sectors in 2015 by including a number of some new sectors like social infrastructure, over draft (OD) facility to PMJDY etc. By including new sectors, the priority sector appears as nothing more than several diverse items clubbed together. The original thrust was given to agriculture, small industries and exports, which seems to be diluted as the share of PSL to agriculture and small-scale industrial sector has come down from 43% and 38% respectively in 1980-81 to 35% and 17% in 2014-15.

7.1.1 Recommendations

Priority Sector Lending has been a mainstay of monetary and banking policies in India ever since nationalisation of major commercial banks. It also keeps alive the operation of the credit channel of monetary policy along with increasing prominence of the interest rate channel. But the priority sector guidelines which form the basis of exercising this policy have lost their initial thrust. A reprioritisation is expedient from the angle of minimising the adverse shocks emanating from monetary and external shocks. The sacrifice of growth for containing inflation and the cost of correcting adverse redistributive effects of inflation need not be that large, if reprioritisation of directed credit is strategically attempted.

7.1.1 Regarding Overall Target

In the last 40 years, RBI and Government had appointed several committees to assess the impact and need of priority sector lending and the committees has recommended a number of suggestions for better funds flows to the desired sectors of the economy. However, except Narasimham committee, not a single committee has recommended to change the overall PSL target of 40% (interestingly Narasimham committee recommended to reduce target from 40% to 10%). However, among researchers there is no equanimity regarding the 40% target. Interestingly, our primary survey results indicate that a majority (47%) of respondents (branch

managers) desired that PSL target should kept at 40%, while 24% wants reduction and 13% wants that it should increase.

On 16 Sep'15, RBI granted 'in-principle' approval to 10 applicants to set up small finance banks (SFB). The SFBs are similar to regular commercial banks except that their scale of services will be much smaller. These new type of banks should generate at least 75% of their business from the priority sector (largely agriculture) and mainly from areas where large banks are not present. Besides, 50% of their loans should be of ticket sizes under Rs 25 lakh. In other words, SFBs will cater the needs of small borrowers in Agriculture, MSME etc., which will help the Universal Banks (ASCBs) to reduce their stress in these sectors.

Going forward, as these banks presence will increase in the system, We have a view that now the time has come to think of reduction in overall target in a phased manner from 40% to 35% in the next 5 years.

Present PSL Norms	Our Recommendation
▪ 40% of ANBC	▪ 39% of ANBC by Mar'16 ▪ 38% of ANBC by Mar'17 ▪ 37% of ANBC by Mar'18 ▪ 36% of ANBC by Mar'19 ▪ 35% of ANBC by Mar'20

7.1.2 Regarding Sub-targets

Though, RBI has kept overall target fixed at 40%, the apex bank has added a number of new sectors to PSL. In our view, by adding more sectors in to PSL and keeping the target and sub-targets fixed, the focus of priority sector lending gets misplaced. Hence there is a need to change the sub-sectors targets in terms of their importance in the GDP value chain.

a) ***Agriculture:*** This is the most critical and contentious member of priority sector family. It is interesting to note that even though the share of agriculture in total GDP has been reduced significantly from 30% to 13% its share in PSL is remain intact at 18% (Direct: 13.5% and Indirect: up to 4.5%). We also appreciate the fact that although agriculture is a capital-starved sector what it urgently needs are the crucial structural reforms regarding land, irrigation, fertilizers, and more. So that one rupee investment in agriculture give more returns. Currently due to various structural bottlenecks and high NPAs, lending to this sectors become '*Achilles Heel*' for the bankers. *We recommend that target for agriculture*

need to be reduced from 18% to 15% without any distinction between direct and indirect agriculture.

Present PSL Norms	Our Recommendation
▪ Agriculture: 18% of ANBC ▪ Direct (13.5%) and indirect (up to 4.5%)	▪ Agriculture: 15% of ANBC with no such distinction

b) ***MSME:*** The importance of MSME sector has emerged as a highly vibrant and dynamic sector of the Indian economy over the last five decades. The major advantage of the sector is its employment potential and low capital cost. As per the latest available statistics, MSME sector employs an estimated 59.7 million persons spread over 26.1 million enterprises. It is estimated that in terms of value, MSME sector accounts for about 45% of the manufacturing output and around 40% of the total export of the country, which is next only to the agricultural sector. However, the sector persists of a very high exclusion, as around 93% of units had no finance or depended on self-finance (As per the 4th Round Census 2009, Ministry of MSME, Government of India).

Due to the importance of the sector, RBI included the medium enterprises under PSL and fixed the sub-target of 7.5%. As of now, banks are providing a substantial portion of credit to MSME sector but they are facing the issue of mounting NPAs in the sector. In our view, the sector is struggling due to the growing incidence of sickness of the sector. It is, therefore, only appropriate that public policy has accorded high priority to this sector in order to achieve balanced, sustainable, more equitable and inclusive growth in the country. Further, Government may include the medium enterprises under the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTME).

Further, it is estimated that the contribution of MSME sector to India's GDP would touch 15% by 2020 and increase the sector's share of employment to over 50% of total employment across the agricultural, manufacturing and services sectors. Additionally, India has also the potential to build 2,500 scalable businesses over the next 10 years, it would require more than 10,000 start-ups to achieve that number. *Thus, we recommend to keep the sub-target fixed at 7.5%, however, RBI may include some sectors like start-up industries under MSME segment. Further, we recommend Government should include the medium enterprises under the CGTMSE scheme, which will help the banks to manage their assets, in case of economy slow-down.*

Present PSL Norms	Our Recommendation
▪ MSME: 7.5% of ANBC	▪ MSME: 7.5% of ANBC ▪ Include sectors like start-up industries ▪ Include the medium enterprises under the CGTMSE scheme

c) ***Housing*****:** The share of housing in priority sector is increasing over the years owing to fact that it is the most secured loan in entire priority sector basket. Even our primary survey results also indicate that 67% of the bankers agree that it is easy to give loans to housing sector. Currently, loans to individuals up to Rs 28 lakh in metropolitan centres (cost: Rs 35 lakh) and up to Rs 20 lakh in other centres (cost: Rs 25 lakh) for purchase/construction of a house is including under definition of PSL. Given the rising cost of houses due to inflation, the Rs 28 lakh limit in metro and Rs 20 lakh in other areas are very less. According to research agency Knight Frank, during H1 2015, in Bengaluru and Hyderabad only 2% and 4% of new launches were under Rs 25 lakh category, respectively. Recently, in order to boost demand for low-cost housing for economically weaker sections and low income groups RBI has recently reduced the risk weight from 50% to 35% for individual housing loans of select category. Further, RBI has also increased the amount banks can advance for a property purchase (LTV ratio) to 90% in a move that will likely make more credit available to borrowers. In connection to this there is a dire need to increase the housing loan limit under PSL norms.

Even given the fact that our per-capita income stand at Rs 87,748 (FY15), a housing loan of Rs 35 lakh for 30 years @ 10% rate of interest bring EMI of only Rs 30,000, which is only one-third of nominal per-capita income. Considering all these factors *we recommended that RBI should increase housing loan limit up to Rs 35 lakh in metro areas and up to Rs 30 lakh in non-metro areas.*

Present PSL Norms	Our Recommendation
▪ Housing loan to individuals up to Rs 28 lakh in metropolitan centres (cost: Rs 35 lakh)	▪ Housing loan to individuals up to Rs 35 lakh in metropolitan centres (cost: Rs 45 lakh)
▪ Housing loan to individuals up to Rs 20 lakh in non-metropolitan centres (cost: Rs 25 lakh)	▪ Housing loan to individuals up to Rs 30 lakh in non-metropolitan centres (cost: Rs 35 lakh)

d) ***Export Credit:*** Being neglected till now, exports credit becomes the part of priority sector family after RBI's Internal Working Group (IWG) recommended that export credit should be included under PSL with a ceiling of 2% of ANBC. However, we belief that this treatment is still unfair given the fact that exports comprises of 15.4% of GDP (FY15) and being a current-account deficient country, we need to promote exports in vigorous manner and for this banks need to incentivise to give export credit to exporters. The current ceiling of 2% of ANBC is very low and *we recommended that ceiling of exports credit under PSL should increase to 5% of ANBC*.

Present PSL Norms	Our Recommendation
▪ Export credit: Ceiling of 2% of ANBC	▪ Export credit: Ceiling of 5% of ANBC

7.1.3 Computation of ANBC

The achievement of PSL targets by banks are being calculated on the basis of Adjusted Net Bank Credit (ANBC) by banks. However, some literature suggests to consider deposits in place of ANBC to assess the banks' performance regarding PSL. So, we made an attempt to make out that what would be the results if PSL computed on Net Lendable Resources (NLR) and not on ANBC. And the results are quite interesting. The Net Lendable Resources are the effective money available with banks after adjusting for CRR and SLR. We have a view that instead of calculating targets and sub-targets of priority sector on ANBC, RBI should use NLR. Since NLR pie is greater than ANBC, a 40% target will provide greater sum of money for both priority sector lending and subsequently for non-priority sector lending. Our calculation suggests that, shifting of calculation from ANBC to NLR releases additional Rs 613 billion for priority sector lending and Rs 919 billion for non-priority sector lending during year FY15.

The extra money available to lend due to shift in calculation from ANBC to NLR also compensate the effect of lower lending due to our proposed reduction in overall target.

7.1.4 Addition and Subtraction of Sectors in PSL

- By adding more sectors into PSL, it is easy for the banks to meet the target of 40%. The survey results also indicate that a number of respondents wants to add more sector like start-up industries, cold storage etc., into the PSL targets.

7.1.5 Other Recommendations

- Earlier, term loans were disbursed by term-lending institutions (ICICI, IDBI) and cash-credit facility by Banks. At such time, term loans were out of the preview of PSL guidelines. At present, term-lending institutions have disappeared and banks provide both term loans (TLs) and cash credit. Interestingly, under the current dispensation, term-lending of banks is still under PSL guidelines. Further, TLs to the identified sectors are not covered under PSL. As banks have become the sole provider of institutional term credit, there is no need a distinction between TLs or Cash Credit (CC) in so far as meeting PSL targets are concerned.

- One of the objective of our primary survey is to find out the problems faced by the front line managers while sanctioning priority sector loans. So, in the survey questionnaire, we asked a question related to that and the results are interesting. Around 37% of managers are facing the problem of inadequate and quality staff at branch level to understand and process the priority sector loans. Further, some of the respondents also raised the issue of KYC, higher NPA and profitability. In our view, knowledge gap, lack of staff at the branch is a critical issue in a service led industry like banking. So, the banks need to place right person at the desired place, by which the officer can contribute more to the organisation. If required, banks may recruit officers/assistants specifically for rural areas.

- Further, due to unclear law for recovery, the sectors are facing huge amount of bad loans. The Government should made laws more stringent by amending the SARFAESI Act and DRT laws to effectively deal with the issue of bad loans, especially those created by suspected wilful defaults. It had planned to amend the laws during the recently-concluded winter session of Parliament, but it could not. Further, it is time that the Government should move swiftly to bring about the changes which will bring some relief to the banks that are faced with continuous rise in non-performing assets.

- In the last one and half year, banks have opened around 18 crore of PMJDY accounts by putting a huge efforts and made the programme success. In our view, Government should fix a target for each bank to open and service PMJDY accounts in a year. If any bank opened more number of accounts, that can be convert into Priority Sector Lending Certificates (PSLC). This move will incentivise to open and maintain more number of PMJDY accounts.

Sector	Present PSL Norms	Our Recommendation
Overall	▪ 40% of ANBC	▪ 39% of ANBC by Mar'16 ▪ 38% of ANBC by Mar'17 ▪ 37% of ANBC by Mar'18 ▪ 36% of ANBC by Mar'19 ▪ 35% of ANBC by Mar'20
Agriculture	▪ 18% of ANBC ▪ Direct (13.5%) and indirect (up to 4.5%)	▪ 15% of ANBC with no such distinction
MSME	▪ 7.5% of ANBC	▪ 7.5% of ANBC ▪ Include sectors like start-up industries ▪ Include the medium enterprises under the CGTMSE scheme
Housing	▪ Housing loan to individuals up to Rs 28 lakh in metropolitan centres (cost: Rs 35 lakh) ▪ Housing loan to individuals up to Rs 20 lakh in non-metropolitan centres (cost: Rs 25 lakh)	▪ Housing loan to individuals up to Rs 35 lakh in metropolitan centres (cost: Rs 45 lakh) ▪ Housing loan to individuals up to Rs 30 lakh in non-metropolitan centres (cost: Rs 35 lakh)
Export Credit	▪ Ceiling of 2% of ANBC	▪ Ceiling of 5% of ANBC

7.2 Limitations of the Study and Scope for Future Research

All studies have limitations and scope for future research and our study is also not an exception of that. Though, the study captured the mind-set of selected bankers towards PSL (through our primary survey), however, unable to cover other stakeholders like farmers, small entrepreneur, etc, due to time and resource limitation. A study on customers' point of view, their experiences and expectations, regarding PSL may be thought provoking for bankers and policy-makers.

7.3 Concluding Remarks

The problem with the present priority sector guidelines suffer from multiple and complex categorisations incorporating several objectives, viz., growth, employment, and equity. There are sectoral classifications combined with beneficiary-oriented categorisation. The added complexity also comes from the bifurcation of direct and indirect financing under major

categories. A strategic reprioritisation of directed credit to agriculture, exports and micro, small and medium enterprise sectors can moderate the costs of correcting the adverse redistributive effects of inflation.

The master circular updated to June 2010 are an amalgamation of about 22 circulars issued from 1977 onwards. Despite the avowed intention of banking outreach to the vulnerable groups in the population, priority sector targeting as per the present framework has left a major part of this population untouched. This has led to the parallel development of new policy initiatives in the arena of financial inclusion. It is imperative that the priority sector be redefined more from the objectives of growth and employment and the equity angle be left to be best served through the policy of financial inclusion. One suggestion could be to include sectoral classification and leave the beneficiary-oriented groupings to be served by the financial inclusion strategy.

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