Chapter-II

EVOLUTION AND IMPLEMENTATION OF PRIORITY SECTOR LENDING BY BANKS

The discussion in this chapter of the research study is focused on the evolution and implementation of priority sector lendings by banks in India. The discussion provides a broad historical and economic background that compelled the Government of India and the Reserve Bank of India in stipulating special credit deployment of the banking institutions in favour of the ‘priority sectors’ in the country with the broad economic objective of channeling directed credit towards these sectors. The major aspects discussed in this chapter relate to,

2.1 General Steps Initiated in the Process of Evolving the Priority Sector Lending by Banks in India

2.2 Monitoring and Reporting Priority Sector Lending by Banks

2.3 Viability of Priority Sector Lending by Banks

2.4 Impact of Concessional Interest Rates, Subsidy Rate and Credit Outstanding to Priority Sector

2.5 The Approach and Recommendation of the Committee on Financial Subsystem Headed by Narasimhan

2.6 Target Fixing for Priority Sector Lending

The evolution of priority sector advances is traced to the regime of ‘Social Control on Banking’ during later part of sixties. Social control on banks was imposed as a measure to employ prudently and purposefully the deposits along productive and socially desirable
channels with the objective of achieving economic growth, combined with stability and social justice as envisaged in the national plan. The following steps were initiated in the process of evolution of the priority sector lending by banks.

2.1 General Steps Initiated in the Process of Evolving the Priority Sector Lending by Banks in India

1. The national credit council in its second meeting held at New Delhi on July 24, 1968 emphasized that commercial banks should increase their involvement in the financing of two priority sectors, namely agriculture and small scale industries as a matter of urgency. RBI forwarded a list including the type of agricultural advances which would qualify for the purpose of compliance with the targets set by the NCC.

2. In July 1969 the Government of India, nationalized 14 commercial banks with the main objective of providing among other things, assured financial support to ‘Priority Sector’ and neglected sections of the community.

3. In 1972 the RBI formulated the description of priority sectors on the basis of the report submitted by the Informal Study Group on statistics in 1971 and some additional sectors were brought under priority sector, i.e., retail trade, small business, professionals and self employed and education. Advances to transport operators and for establishment of industrial estates which were considered as part of advances to small scale industries till then were considered as separate sectors under the priority sectors. The Reserve Bank of
India also prescribed a detailed return for the lending by Banks conforms to the national priorities and planning.

4. There was specific target fixed initially for priority sector lending. In 1974 the banks were advised to increase the share of priority sector advances to 33.3 percent of total advances by March 1979.

5. On the 1st July 1975 the 20 point programme was announced by the Prime Minister with the twin objectives of ensuring efficient production and distribution of essential goods and services to the community and to ensure that the income and the standard of living of the weaker sections of the community were raised so as to secure better distributive justice. The banking sector had a vital role to play in fulfilling these objectives. The RBI issued instructions to banks in 1976 regarding implementation of 20 point programme. The banks were expected to bridge the gap created in rural structure following.

- An imposition of moratorium on debt recovery.
- In assisting the farmers who had been newly allotted lands for cultivation including those who had been conferred occupancy rights.
- In providing assistance to those released from bounded labour for taking subsidiary and allied activities under agriculture.
- In promoting handloom sector and
- In enlarging employment opportunities especially for the weaker sections.
6. Regarding the credit by commercial banks to agriculture the subgroup under the working group on Rural Credit and Cooperatives and the sub-group on private saving and Investment under Planning Commission constituted by the Government of India had indicated that the banks should step up the rationing of their credit to agriculture to 60 percent by 1983.

7. The RBI guidelines in the early years of nationalization did not specify the ceilings on limits and the advances granted to the affluent sections within priority sector were also included for target purpose. Hence in order to ensure adequate flow of credit to the weaker sections particularly small and marginal farmers, agricultural labourers, tenant farmers and share croppers, etc., it was stipulated that the share of small and marginal farmers, landless labourers, etc., in direct agricultural advances should reach a level of 50 percent by March 1983.

8. At the meeting held on 6th March 1980 the Finance Minister and chief executives of public sector banks decided to increase the share of priority sector advances in the total advances to 40 percent by March 1985. Further within this target to allocate significant proportion of credit to the beneficiaries under the 20 point programme.

9. A working group was constituted by the RBI under the chairmanship of Dr. K.S. Krishnaswamy the Deputy Governor of RBI to

• Identify the eligible beneficiaries under the 20 point programme.
• Examine the definition of various priority sector in order to support the beneficiaries under the programme.
• Define the ‘Weaker Section’ under the priority sectors and
• Fix sub targets to achieve the overall objectives besides
• Suggest modalities of implementing the programme and ways to monitor the implementation of the programme.

10. In the light of the recommendation of the working group of RBI informed the banks in October 1980 to ensure that credit assistance under priority sector is given increasingly to the comparatively weaker and under privileged sections who are the real beneficiaries identified by the group under 20 point programme. The weakness of these may be either financial or social and they have covered Scheduled Castes (SC) and Scheduled Tribes (ST). In this context the concept of weaker sections within the two main segments of priority sectors namely agriculture and small scale industries were introduced.

2.2 Monitoring and Reporting of Priority Sector Lending

i. Budgeting and Reviewing

ii. Returns

iii. On the Spot Studies and

iv. Reporting to Various Forums and the Board

At the grass level it is branch monitors the level, percentage quantum, quantity, schemes, coverage and recovery. The divisions / Regions / Zones monitor the branch level, monitoring of priority sector
advances from all these angles. The zones which are close to the head offices report the progress to the head offices.

Monthly monitoring of targets for various sectors and sub-sectors under the priority sector is done inadequately. Reasons for inadequate flow of credit to any sectors are ascertained and steps are taken to step up the flow. If the flow is more the real need for it is examined and further flow is allowed very cautiously as it affects the profitability, if the target is already fulfilled. The quantity of the flow of credit and level of credit to each sector and scheme of priority sector advances. Monitoring also takes into consideration the extent of rural areas covered by loaning under the priority sector schemes.

The performance of priority sector lending by banks is placed before the top management at monthly intervals. A detailed note covering the progress made by the bank in lending to priority sectors and all aspects of implementation is placed before the special committees of Board of Directors and the Board once in quarter for their review and information. A copy of the notes placed before the board of directions is sent to RBI. A detailed statement of the advances is also sent to the RBI and the Government of India once in a half year. The RBI reviews the progress made by the banks from time to time and issues necessary instructions to banks for their implementation.

2.3 Viability of Priority Lending by Banks

It is rightly observed that the efficiency of any financial system given a supportive policy regime depends largely on the competence
and integrity of the institutions comprising it. As any reform programme has to be undertaken by the banks and financial institutions as continuing entities, what become crucial for its sustainability are their viability and the effectiveness of the regulators agencies.

The viability of the public sector banks has been eroded due to two factors viz. directed investment in terms of minimum statutory liquidity ratio and directed lending to priority sectors. The committee on financial reforms has indicated that the reduction in SLRM progressive basis would enable the bank to have more maneuverability in planning their portfolio of advances and would certainly help to activate the government bond market. The same committee has mentioned that the macro economic policy which has affected seriously the validity of the banking system is the directed credit programme (Erstwhile priority sector lending)

**The Declining Profitability of Public Sector Bank**

Bank authorities are concerned about the declining profitability of the public sector banks. Economists and researchers have argued that the various credit and developmental policies of the Reserve Bank of India and the Government of India have led to the erosion of bank profitability. The policies relate to priority sector lending too viz.

- Increasing the quantum of interest subsidized loans causing heavy interest income losses.
- Causing highest establishment expenditure to supervise small amounts without matching productivity.
• Raising the level of credit outstanding of sick limits resulting in the poor recovery of small loans.

• Expanding the volume of non-performing assets (NPAS).

The guidelines of the Reserve Bank of India and the Government of India relating to credit to priority sectors are responsible for the low profitability of public sector banks according to bankers and economists.

2.4 Impact of Concessional Interest Rates, Subsidy Rate and Credit Outstanding to Priority Sector

Studies on the impact of concessional interest rate, subsidy rate and credit outstanding to priority sector have largely indicated the erosion of the bank profitability. The following studies have positively confirmed this generalization.

1. The study by P. Ganeshan has revealed the following facts relating to priority sector lending by Public sector Banks.

• Credit outstanding to priority sector showed a tremendous increase over the period from 1974 to 1999.

• The total amount of income loss in 1974 was Rs. 34.16 crores which went up to the maximum of Rs. 973.60 crores in 1990-91 with export credit. The estimated income loss declined to Rs.527.58 crores in 1997-98 but reached an amount of Rs. 108.24 crores in 1998-99.

• During the pre-reform period the loss due to priority sector credit outstanding was Rs. 5259.05 crores which was not much higher than the loss of Rs. 4258.45 crores during the post
reform period of just 8 years. This sizeable loss of income was attributed to higher volume during the post reform period.

- The total quantum of loss during the period under review was Rs. 9517.51 crores in which agriculture accounted for the major portion of Rs. 6549.20 crores (67.87%) followed by small scale Industries (Rs. 1476.27 crores) and export (Rs. 937.07 crores). In other words agriculture, small scale sector and export collectively accounted for loss during the period from 1974 to 1999.

- During the post-reform period the income loss ratios were substantially lower than the profitability ratios in all the years and the differences between them increased. The higher interest income loss ratios significantly affected the profitability ratios consequent to the introduction of liberalization measures and reforms in financial sector. The banks began to step down the target for priority sector credit and thus there was decline in the income loss ratios which subsequently increased the profitability ratios.

P.G. Ganeshan’s study has confirmed that pumping of credit to priority sector at subsidized rate of interest have had a negative impact on the profits and profitability of public sector banks during pre and post reform periods. The author has however observed that more reduction in target and sub-target of priority sector credit outstanding or raising of interest rates is not the only way to achieve
profitability. He has suggested the following measures for making the banks viable in relation to their priority sector lending.

- There is need to review the concept of sub-sectors of priority sector.
- Strong and immediate policy consideration on recovery of overdues without political intervention.
- Promoting the productivity of bank employees for effective recycling of funds.

2. T.R. Bishnoi has examined the impact of priority sector credit. The author has observed in his study that achievement of the priority sector credit target implied deployment of bank funds at concessional rates to the sectors, thus causing income losses to banks. He has further mentioned that interest subsidy rates varied across the priority sector and increased over the period. The absolute interest income loss to public sector banks increased from Rs. 33.44 crores in 1974 to Rs. 607.39 crores in 1986 due to the combined effect of increase interest subsidy rates and rise in the income loss ratios are substantially higher than the profitability ratios in all these years and difference between them has increased. Mr. Bishnoi’s other findings relating to the priority sector lendings by PSBS are

- The ratio of income loss to total working funds increased from 0.27 percent in 1974 to 0.62 percent in 1892 and then decreased to 0.48 percent in 1986.
• The ratio of income loss to operating income increased from 3.24 percent in 1974 to 7.05 percent in 1982 subsequently the ratio decreased to 5.40 percent in 1986.

• The rising interest income loss and low recovery in respect of priority sector credit adversely affected the profitability and fund recycling capacity of the public sector banks. This may weaken the prospects for institutional support in future at an increasing scale in capital formation particularly in agriculture and allied sectors and small scale industry. Moreover administrative cost and risk of delivering priority sector credit are higher than those of commercial credit. Mr. Vaishnoi has expressed the view that as a result this further weakens the viability of the priority sector lending.

The author of this study has concluded that the entire gamut of priority sector schemes, procedures and system of credit delivery needs to be reviewed and revised for improvement in operational efficiency and profitability of the public sector banks.

2.5 **The Approach and Recommendation of the Committee on Financial Subsystem Headed by Narasimhan**

The committee on the financial sector reforms studied the credit programme / priority sector lending to cover various sectors. The committee emphasized the need for review of norms at least in respect of those who were able to stand on their feet. The committee has maintained that the directed credit programme (Priority sector lending) has affected seriously the viability of the banking system. It
believes that the use of credit policies for bringing about redistribution and justice does not lead to desirable results. Hence the objectives of redistribution and justices should be pursued through the use of fiscal instruments rather than credit system. The committee’s recommendations on the viability of bank credit to priority sectors have been critically examined here.

He has observed; given the overall resources constraint, an increase of credit of the priority sector has meant a certain pruning of credit to other sectors (p 13). The committee implicit suggestion is to correct the distortion of excess credit to the priority sector. The argument of the committee is countered by a writer that over the last two decades we have been harboring the impression that it was excess credit to trade and industry that was to be curtailed.

Referring to the subsidies extended to programmes like the IRDP which was a core element in the priority sector lending the committee has observed.

“Subsidies in some of the development programmes i.e., IRDP should also be withdrawn as they have distorted the pattern of lending (p 48)”. The committee’s observation goes against the priority of helping finance activities for borrowers who would not otherwise have been able to undertake these even at the rate prevailing in the organized sector. The objective is to bring progressively a large segment of our rural population within the ambit of the organized credit market. An element of concession and subsidy for the rural poor not for consumption loans but for ensuring productive activities
with part subsidies from the government is an instrument of enlightened non-market intervention in our credit structure.

The committee has suggested discontinuing the credit to the priority sectors when it says.

“If the logic of extension of credit to the priority sector is to make these sectors economically viable by enhancing protection and productivity, two decades of such preferred credit is a long enough period to attempt an evolution of its continuing need. Despite considerable need for productive lending, there is evidence that the contribution of bank credit to growth of agriculture and small industry has made an impact and served its purposes (P 43)”.

The committee’s views though positive about the productive lending are inadequate to support the need for discontinuing the credit to the priority sectors. The committee has taken the view that the institutional credit is cheaper compared to the sources like the unorganized or informal sector. The Committee opines, “There is no need for the further element of subsidy to extend the coverage of credit even wider. In this sense there is coverage of credit even wider. In this sense there is a regressive character to the subsidization in that the beneficiaries of subsidies have become a new class of privileged whose satisfaction is at the expense of those continuing to be denied the benefit of institutional credit (p 32-33).

The Committee has referred to the loan delinquencies apart from the overt subsidization. It asserts “as unintended and unwarranted subsidization with attendant adverse effects on income and profitability
The delinquency in the directed credit programme has been considered with concern. The committee has rightly mentioned. “Altogether the proportion of the inflated portfolio in agriculture and small industrial credit is estimated to be as high as over 30 percent. It might be pointed out at this stage that not all the contamination of the loan portfolio in terms of delinquent accounts can be laid at the door of directed credit programmes in the priority sectors. There is at least as much incidence of delinquency in respect of conventional (i.e., medium and large scale) sectors as there is in the case of priority sector. There is further urgent need to address the issue of inflated loan portfolio to the various directed credit sector” (p 31).

2.6 Target Fixing for Priority Sector Lending

The Narasimhan committee has recommended that priority sector bank credit should be reduced to 10 percent from 40 percent. Fixing of target for priority sector lending is considered as a rational way of going about it. However others may argue that target fixing was arbitrary and irrational. But it did succeed in conveying the messages that the dispensers of credit can not overlook the interest of growth, employment and social justice.

There is the view that we could have attempted target fixing through a system of direct and indirect incentives, preferential refinance and other persuasive measures. However the recommendation of the Committee on Financial Reforms (Narasimhan Committee) to curtail the target for priority sector lending to 10 percent would send out an
unfortunate signal to the dispensers of credit that the basic objective for which priority sector lending was developed two decades ago is being diluted.

The Committee has proposed for redefinition of priority sectors. It includes categories such as small and marginal farmers, tiny sector of the industry, small business and transport operators, village and cottage industries, rural artisan and other weaker sections. The Committee recommended a target of 10 percent of aggregate credit to these redefined priority sectors, but proposes that review of this policy should be undertaken at the end of three years, so that the need for further extension of directed credit programmes can be examined. The Committee’s proposal of 10 percent target is the minimum level to be achieved and there will be no bar for any bank to exceed this level just as in the present system of norms.