CHAPTER-I

INTRODUCTION

In the present chapter, the role of commercial banks in the process of economic development and genesis of priority sector lending is discussed. Also, the issue relating to non-performing assets (NPAs) in priority sector lending in the Indian context is discussed.

1.1 ROLE OF COMMERCIAL BANKS IN THE ECONOMIC DEVELOPMENT

Banking is an important segment of the tertiary sector and acts as a backbone of economic progress. The banks render vital services to the masses belonging to the various sectors of the economy like agriculture, industry whether small scale or large scale. The banking system is one of the few institutions that impinge on the economy and affect its performance for better or worse. They act as a development agency and are the source of hope and inspiration of the masses.

Some studies based on the experiences of individual countries and some other based on comparative data from developed and under developed countries support the hypothesis that the financial inter-mediation has a positive role to play in the development process because finance plays a significant role in the economic development. Without finance the economy is like a fish without water.

As an economic institution, banks are supposed to be more directly and positively related to the performance of the economy than most non-economic institutions are. Schumpeter, the first modern economist, regarded the banking

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2 V. Avtar Krishan, (1991); *Public Sector Banks in India*, H.K. Publishers and Distributers, New Delhi, p. 3.
3 S. Meenakshi, (1992); *Regional Disparities of Commercial Banking in India*, Kanishka Publishing House, Delhi, p. 17.
4 To mention a few Bennett (1957), Waintum (1972) and Lakdawala and Mody (1975).
system as one of the two key agents (the other being entrepreneur) in the whole process of economic development.\(^6\)

Banking has played a very important role in the economic development of all the nations of the world. The banking system touches the lives of millions and has to be inspired by the larger social purpose and has to sub-serve the national priorities and objectives.\(^7\)

Within the banking institutions, the role of commercial banks has occupied a new meaning and significance, in view of the changing structure and requirements of a developing economy. The increased horizon of commercial banks identifies itself with the problems and responsibilities for making banking an instrument for bringing about social and economic transformation of a developing country. Social responsibilities have undergone far-reaching changes. Banks have become the primary movers and pace setter for the achievement of socio-economic objectives of the country.\(^8\)

The resources of individual savers are meager and scattered. Commercial banks play an important role in mobilizing savings of economically surplus units, which are widely scattered. Commercial banks, in view of their vast branch network spread over the country, obtain the savings on a short or medium term basis, are placed in an especially privileged position to collect them. If the banks fail to tap these savings, the surplus money lying idle in the hands of the people could not be of any use in a nation's endeavour of economic development.

Savings and investments are the most important ingredients of capital formation, for an economy; therefore, the promotion of domestic savings is must to boost the process of capital formation and development. In fact capital formation is a function of generation, mobilization and canalization of savings into productive activities/investments. Thus, the commercial banks are in the nature of a catalyst, converting savings into capital for productive investment.\(^9\)

\(^9\) C.L. Dhawan, (1975); 'Role of Banks as a Vehicle of Economic Progress and Instrument of social Change', *The Bankers*, December, p. 25.
According to Nurkse, low income leads to low savings, which in turn leads to low capital formation.\(^\text{10}\) However, when the savings of economically surplus units are pooled together in commercial banks, it results in a large reservoir of social capital. It helps in capital formation and capital accumulation, which are very necessary for building infrastructure and setting up of basic and key industries. Among the factors determining economic growth in underdeveloped countries, capital is of supreme importance.\(^\text{11}\) Developing economies do not suffer as much from a lack of national resources as they do from the under-utilization of existing resources. Capital formation is, therefore, the sin-qua-non for activating these dormant and un-exploited resources. It is needless to say that capital formation largely depends on the effectiveness of institutions, which funnel the money capital flows.\(^\text{12}\)

If any country wants to increase its rate of capital formation, it is very important to build an efficient commercial banking system equipped with an adequate coverage so that apart from mobilizing savings, it may also be able to foster the banking habits in a society.\(^\text{13}\) The commercial banks create the awareness among the rural and urban people about socially wasteful spending and provide them the golden opportunities to make investment in more income generating assets.

Lewis has emphasized the key role of bank credit in bringing about a structural transformation in an underdeveloped economy. In the expansion of the capitalist sector, bank credit becomes a factor of fundamental importance. Keynes and Schumpeter too have emphasized the role of credit in economic development. It is more important that the hindrances and rigidities, which operate in the under-developed countries, should not be strengthened by the paucity of credit.\(^\text{14}\)

Commercial banks are the concerns which provide various types of services to customers in return for payment in one form or another. They have been in existence

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\(^\text{10}\) R. Nurkse, (1973); *Problems of Capital Formation in under Developed Countries*, Oxford University Press, Delhi, p. 68.


\(^\text{14}\) D. Rockfeller, (1985); *Credit Management in Banking*, quoted in *Bank Credit and Economic Development* in J.K. Sharma (Ed.), Classical Publishing Company, New Delhi, p. 34.
in India for the past several decades. Historically, commercial banks were started and
developed by the industrialists/businessmen in the metropolitan cities and port towns.
Banking was, therefore, concentrated mainly in big cities. Within these big cities also,
it was mainly the well placed traders, businessmen and the industrialists who availed
of most of the credit facilities. The small common man or the agriculture sector did
not receive loan at all.\textsuperscript{15}

A developing economy faces many problems, like poverty, scarcity of capital,
lack of entrepreneurship etc. There is dependence on agriculture and at the same time
agriculture is not modernized. Means of transport are also underdeveloped.\textsuperscript{16} There is
a growing concern over the increasing regional disparities in these countries, concern
emanates both from the intellectual curiosity as well as political compulsions created
by the development process. The commercial banks can work as catalytic agents of
growth by following the right kind of policies in their working, depending upon the
socio-economic conditions prevailing in the country.\textsuperscript{17} They have stupendous
investment potential and can make a significant contribution in eradicating poverty,
unemployment and in bringing about progressive reduction in inter-regional and inter-
sectoral disparities through rapid expansion of banking services.\textsuperscript{18}

Although the financial system of India is still characterized by the existence of
both the organized and unorganized segments, institutions in the organized financial
system have grown significantly and are playing an increasingly important role. The
unorganized sector comprises of the moneylenders and indigenous bankers catering to
the credit needs of a large number of persons. Organized financial sector has a wide
mixture which is comprised of commercial banks, co-operative banks and the other
financial institutions. Amongst the institutions in the organized sector, commercial
banks are the oldest institutions having a wide network of branches, commanding
utmost public confidence and having the lion's share in total banking system.\textsuperscript{19}

\textsuperscript{15} H.S. Dau, (1996); \textit{Social Banking for Economic Development}, Deep and Deep
Publications, New Delhi, p. 112.
\textsuperscript{16} S.K. Misra and V.K. Puri, (1983); \textit{Indian Economy}, Himalaya Publishing House,
Bombay, pp. 30-31.
\textsuperscript{17} S. Singh, (1977); \textit{Performance Budgeting for Commercial Banks in India}, The McMillan
Company of India Ltd., Delhi, p. 14.
\textsuperscript{18} B.L. Natiya, (1975); “Banks and New Entrepreneur”, \textit{The Bankers}, Feb, p.18.
\textsuperscript{19} V. Puhahendi and B. Jayaraman, (1999); “Rural Credit Delivery-Performance and
Challenges before Banks,” \textit{Economic and Political Weakley}, Vol. XXIV, No.4, Jan. 16-
Rural credit has special role to play in bringing about a backward economy on the rails. In India, concern for rural credit was manifested as early as in 1951 with the setting up of All India Rural Credit Survey. It was observed by the committee that supply led (inexpensive) formal credit was necessary to displace, “evil money lenders,” who exploited the poor with their monopoly power to charge high rate of interest and were therefore net contributor to rural poverty. The report emphasized that state led expansion of cheap credit was necessary to allow poor and rural households to adopt new technologies and thus to escape the cycle of poverty and Indebtness. The committee recommended nationalizing the Imperial Bank of India to become State Bank of India. Accordingly, State Bank of India was set up on July 1, 1955. With this, a large number of branches were opened in the unbanked areas. In 1960, eight banks which were the subsidiaries of State Bank of India were also nationalized. This brought one-third of the banking segment under the direct control of the Government.20

Although the Indian banking system made considerable progress during the decade of 1950s and 1960s, yet, the benefits of this did not flow down to the general public in terms of access to credit. In fact, till 1968 commercial banks were not involved to any significant extent in providing direct finance to agriculture. The Informal Group on ‘Institutional Arrangement for Agriculture Credit’ suggested in 1964 that commercial banks which through their rural branches were gradually mobilizing more and more resources should deploy these resources for development activities being undertaken in rural areas. All India Rural Credit Review Committee also observed in its report in 1969 that the role played by the commercial banks in the past for financing agriculture was negligible. It was against this background that the scheme of social control over banks on December 14, 1967 was introduced. Radical transformation of banks, of their organization and lending policies were the main aim of this scheme.21

The study group under the chairmanship of Dr. D.R. Gadgill on ‘Organizational Framework for the Implementation of Social Objectives’ highlighted

the continued existence of credit gaps and revealed that bank advances continued to be earmarked for the big industry and traders. Consequently, 14 major banks were nationalized on July 19, 1969 to make the system reach out to the small man and to the remote rural areas. Further, 6 more banks in 1980 were nationalized, which brought a large segment of the banking business under Government ownership. The nationalization of bank was designed to make the system reach out to the small man and the rural and semi urban area, to extend credit coverage to sectors like agriculture, small scale industries, retail trade, self employed scheme, education etc, popularly known as the priority sector.\(^\text{22}\)

**1.2 GENESIS OF PRIORITY SECTOR LENDING IN INDIA**

Bank nationalization in 1969, coincided with the adoption of the Fourth Five Year Plan with its emphasis on agrarian development which led considerable emphasis on technology and modernization. The F. K. F. Nariman Committee of Bankers (1969) proposed that each bank should concentrate on certain districts. This led to the, “Lead Bank Scheme,” under which every district in the country has been assigned to a particular commercial bank to help it to develop integrated banking facilities. Certain sectors of the economy, i.e. agriculture, small scale industries, small traders were accorded special priority and were called as the priority sector.\(^\text{23}\)

Priority sector occupies a special place in the Indian economy and is an important feature of the Indian banking policies. Priority sector lending is the crux of social banking. Under the priority sector lending, bank credit is provided on liberal terms and conditions. The socialization of bank credit is the theme of priority sector lending by the commercial banks.\(^\text{24}\)

The concept of priority sector lending is mainly intended to ensure that assistance from the banking sector flows in an increasing measure to those sectors of the economy which, though accounting for a significant proportion of national product, has not received adequate support of institutional finance in the recent past. When one talks of priority sector the emphasis is on the needs of the common man


\(^\text{23}\) Ibid.

who is engaged or willing to be engaged in a productive activity which is socially useful and economically viable, but handicapped for the lack of finance on reasonable terms. It also emphasizes on the need of the backward regions which are stagnating for the lack of finance and enterprises.\textsuperscript{25}

Priority sector is and will continue to remain, the bread and butter, both literally and figuratively, of Indian economic growth. 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.\textsuperscript{26}

The commercial banks help the agriculture sector in a number of ways. They open a network of branches in rural areas to provide agricultural credit. They also finance agriculture sector for the modernization and mechanization of farms, for the marketing of their produce, for providing irrigation facilities, for high yielding seeds and fertilizers. They provide medium and long term finance for the purchase of tractors and other equipment’s, for electrification and installation of electric or diesel pump sets, or for developing or improving land etc. the commercial banks are moving fast towards the attainment of agricultural development goals.\textsuperscript{27}

The Commercial Banks also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming and horticulture. In India for financing agriculture various schemes have been undertaken.\textsuperscript{28} The small and marginal farms, landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through regional rural banks in India. These regional rural banks operate under commercial banks.\textsuperscript{29}

\textsuperscript{25} H.N. Aggarwal, (1979); \textit{A Portrait of Nationalized Banks}, Inter-India Publication, Delhi, p. 186.
\textsuperscript{26} N.A. Mujumdar, (1998); “Credit Support to Priority sectors-A Macro Perspective”, \textit{Economic and Political Weekly}, Vol. XXXII, No.4, January 24, pp. 149-152.
\textsuperscript{27} S.G. Shah, (1968); Agricultural Finance by Commercial banks, \textit{Arth Vikas}, Jan, p.66.
\textsuperscript{28} \textit{Report of Banking Commission} (1972), p. 64.
\textsuperscript{29} V.A. Krishan (1987); \textit{Performance Appraisal of Commercial Banks in India}, Unpublished Thesis, Department of Commerce and Business Administration, Himachal Pradesh University, Shimla, p. 6.
Since commercial banks are the single most important source of institutional credit in India, they fulfill their credit requirements of all types of rural people and help in up-liftment of the rural areas.\textsuperscript{30}

The growth of agriculture is an important pre-requisite, not only for the reason of food security, but also in terms of forward and backward linkages that the agriculture sector has with the rest of economy.\textsuperscript{31} According to the Planning Commission, in an underdeveloped economy where agricultural production on the whole, is very low, there is no conflict between agricultural and industrial production. However, economists like Schultz, Viner etc. are of the view that agriculture should be given priority over industry. It is so because industry requires large amount of capital. It is therefore, more profitable to give priority to agriculture and small scale industries over large scale industries.\textsuperscript{32}

From the point of view of employment generation also, priority sector (i.e. agriculture, small scale industries and others) holds out good promise. In order to provide employment to ever rising population in the country, priority sector can help a lot, since this sector is quite labour intensive. Priority sector is instrumental in equal distribution of wealth and income. It is so because in priority sector capital is not concentrated in few hands, it is evenly distributed in small quantities.\textsuperscript{33}

There is an additional logic of providing importance to priority sector. Priority sector is not concentrated at one place but it is equally dispersed throughout the country. An encouragement of priority sector in a backward region can help it in coming at par with the rest of the regions. Encouraging agriculture or SSIs serves as complementary to large scale industries. It produces such goods as are required by large scale industries. Priority sector can also have a great role to play in the growth of export sector of the country also. Further, development of priority sector leads to

\textsuperscript{30} S. B. Gupta, (1990); Monetary Economic Institutions and Policy, S. Chand and Company, New Delhi, p. 86.
\textsuperscript{31} M.L. Jhingan, (1986); Money Banking and International Trade, Konark Publications, New Delhi.
\textsuperscript{33} Ibid.
the optimal exploitation and use of local resources of a region, and thereby initiating the process of development.\(^{34}\)

Initially, priority sector was defined to include agriculture, small scale industries and exports, and each major bank was given a target and the performance of bank in this regard was to be monitored continuously by the RBI. With the purpose of encouraging banks to increase their priority sector lendings, the RBI took two concrete steps: one was to provide liberal refinance facilities to banks and other was to introduce credit guarantee scheme as a support measure for bank lending to the priority sector.\(^{35}\)

After bank nationalization, lending to priority sector was seen as an essential component of national agenda. Still the composition of priority sector was left vague till 1970's, resulting in wide differences between banks in the compilation of priority sector lending statistics. So the RBI constituted an Informal Study Group on Statistics Relating to Priority Sectors. This Study Group recommended expanding the scope of priority sector lending to include not only agriculture (direct and indirect), small scale industries and industrial estates, but also road and water transport operators, retail trade, small business, professional and self employed persons and education. This definition was adopted and it remained unchanged till the end of 1970's.\(^{36}\)

In 1980, a major review of the components of priority sector was undertaken by a working group headed by K.S. Krishnaswamy. Krishnaswamy group after a detailed review of the composition of priority sector came to the important conclusion that while the main drawback of priority sector bank credit found its way to more affluent sections, which, according to it, was not at all justified. In order to rectify the situation, the group recommended the incorporation of weaker sections, so that, the concessions that are being offered to the priority sector as a class could be oriented to meet the needs of the weaker sections. Credit was earmarked for the weaker sections of the society (small and marginal farmer, landless labourers, SC/ST


etc.). To achieve this task banks opened more branches in rural areas which had no banking facilities.\(^\text{37}\)

Krishnaswamy, while endorsing the existing composition of priority sector, recommended of fixing lending targets for all major categories included under priority sector, except exports. The group did not endorse the proposal of fixing lending targets for exports, since it was predominantly an activity undertaken by the more affluent sections in the economy. Starting from 1969, there was only a single target for priority sector lending till the end of 1970's. During the mid 1970's, the RBI advised the banks to raise the proportion of credit to priority sector to 33.30 per cent of net bank credit (NBC) by March 1979. This target was gradually raised to 40 per cent which was to be achieved by March 1985.\(^\text{38}\)

The Ghosh Group (1982) made important recommendations regarding the nature of agricultural advances and targeting, with direct and indirect farm lending to have a separate targets. Direct lending target was fixed at 14 per cent (of total credit) taking into consideration the need for increasing credit flow for farming operations, and was to be raised to 16 per cent by March 1987, 17 per cent by March 1989 and finally to 18 per cent by March 1990. Out of which the maximum limit for direct agricultural credit is 13.5 per cent and of indirect agricultural credit is 4.5 per cent.\(^\text{39}\)

The fixing of lending targets for priority sector as a whole, and sub-targets for agriculture and weaker section has had a very positive impact on the channeling of credit to the hitherto neglected sectors of the economy, while giving ample access/scope to small borrowers to institutional credit. Between 1969 and 1991, more than 50,000 new branches were set up by the banks primarily in unbanked rural locations.\(^\text{40}\)

Since the initiation of banking sector reforms in 1991, India’s banking sector has seen some significant and favorable changes related to reduction of cash reserve


ratio and statutory liquidity ratio, interest rate deregulation, reforms in priority sector lending, entry of private sector banks, banking deregulation and prudential regulation.\textsuperscript{41} With respect to priority sector credit, the important policy measures introduced by the RBI during the decade of 1990’s are as follows:

(1) In 1992, a target of 10 per cent for export credit was introduced for foreign banks. However, export does not form part of the priority sector lendings for domestic banks. In 1996-97, the target for export sector credit was raised from 10 to 12 per cent for foreign banks, although the target on overall advances to priority sector has remained unchanged.

(2) In 1993, the overall priority sector lending target for foreign banks was raised from 15 to 32 per cent (10 per cent each on SSIs and export sector), while there is a sub-target for SSIs for foreign banks, no target on advances to SSIs was imposed on domestic private sector banks.

(3) The RBI redefined SSIs with investment in plant and machinery upto ₹ 6 million (₹ 7 million in case of ancillary units and export oriented units). All advances granted to SSIs, within this definition were treated as priority sector advances by RBI.

(4) In 1995-96 banks facing shortfall in achieving the priority sector sub-target of 18 per cent for agriculture were advised to contribute an amount equal to shortfall (subject to a maximum of 1.5 per cent of NBC, treated as priority sector advances) to the Rural Infrastructure and Development Fund (RIDF), set up at NABARD. Further, banks facing a shortfall in achieving the priority sector target were advised to provide Rs. 10 billion on a consortium basis to Khadi and Village Industries Commission (KVIC) at an interest rate of 1.5 per cent below the average prime lending rate of five major banks.

(5) In 1996-97, banks were further notified that the credit extended to dealers in drip/sprinklers, irrigation systems and agricultural machinery would be regarded as indirect finance to agriculture and thus priority sector lendings. In the same year, banks were informed that all short term advances to traditional plantations (such as tea, coffee, rubber and spices), regardless of the size of

\textsuperscript{41} N.A. Mujumdar, (1998); “Credit Support to Priority Sectors- a Macro Perspective”, Economic and Political Weekly, Vol. XXXII, No. 4, January 24, pp. 147-152.
holding, would be treated as direct agricultural advances and, therefore priority sector lendings.

(6) In 2000-01, micro-finance extended by banks to individual borrowers directly or indirectly was recognized as part of priority sector lendings.

Reflecting these changes, as on March 2001, the priority sector credit by the banks comprises the followings:

1. Agriculture (direct and indirect)
2. SSIs (including the setting up of industrial estates and covering units with original cost of plant and machinery not exceeding ₹ 10 million)
3. Small business (original cost of equipment used for the business not exceeding ₹ 1 million and a working capital of ₹ 50,000)
4. Small road and water transport operators (owing upto 10 vehicles)
5. Retail trade (upto ₹ 50,000)
6. Professional and self employed persons (upto ₹ 50,000)
7. State sponsored organizations for SC/ST
8. Education (education loans granted to individuals)
9. Housing loans (direct and indirect) upto ₹ 50,000.

On the basis of the recommendations made in September 2005 by the Internal Working Group (Chairman: Shri C. S. Murthy), set up by the Reserve Bank of India to examine, review and recommend changes, if any, in the existing policy on priority sector lending including the segments constituting the priority sector, targets and sub-targets etc. and the comments/suggestions received thereon from banks, financial institutions, public and the Indian Banks’ Association (IBA), it has been decided to include only those sectors as part of the priority sector, that impact large sections of

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the population, the weaker sections and the sectors which are employment-intensive such as agriculture, and tiny and small enterprises.

Accordingly, at present the broad categories of priority sector for all scheduled commercial banks will be as under:44

**1.2.1 Agriculture (Direct and Indirect) finance**

Direct finance to agriculture includes short, medium and long term loans given for agriculture and allied activities (dairy, fishery, piggery, poultry, bee-keeping etc.), directly to individual farmers, Self-Help Groups (SHGs) or to Joint Liability Groups (JLGs) of individual farmers without limit and to others such as corporate partnership firms and institutions for taking up agriculture/allied activities. Direct finance also includes the following categories:

1. Short-term loans for raising crops i.e. for crop loans. This will include traditional/non-traditional plantations and horticulture.

2. Advances up to ₹ 10 lakhs against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months, irrespective of whether the farmers were given crop loans for raising the produce or not.

3. Working capital and term loans for financing production and investment requirements for agriculture and allied activities.

4. Loans to small and marginal farmers for purchase of land for agricultural purposes.

5. Loans to distressed farmers indebted to non-institutional lenders against appropriate collateral or group security.

6. Loans granted for pre-harvest and post-harvest activities such as spraying, weeding, harvesting, grading, sorting, processing and transporting, undertaken by the individuals, SHGs and cooperatives in rural areas.

7. Finance up to an aggregate amount of ₹ one crore per borrower for the purposes listed at 1, 2, 3 and 6 above.

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8. One-third of loans in excess of ₹1 crore in aggregate per borrower for agriculture and allied activities.

**Indirect finance** to agriculture includes loans given for agriculture and allied activities as specified below:

1. Two-third of loans to entities covered fewer than 2 above in excess of ₹1 crore in aggregate per borrower for agriculture and allied activities.

2. Loans to food and agro-based processing units with investments in plant and machinery up to ₹10 crores.

3. (i) Credit for purchase and distribution of fertilizers, pesticides, seeds, etc.

   (ii) Loans up to ₹40 lakhs granted for purchase and distribution of inputs for the allied activities such as cattle feed, poultry feed, etc.

4. Finance for setting up of agro-clinics and agribusiness centers.

5. Finance for hire-purchase schemes for the distribution of agricultural machinery and implements.

6. Loans to farmers through Primary Agricultural Credit Societies (PACS), Farmers’ Service Societies (FSS) and Large-sized Adivasi Multi Purpose Societies (LAMPS).

7. Loans to cooperative societies of farmers for disposing of the produce of members.

8. Financing the farmers indirectly through the co-operative system (otherwise than by subscription to bonds and debenture issues)

9. Existing investments as on March 31, 2007, made by banks in special bonds issued by NABARD with the objective of financing exclusively agriculture/allied activities may be classified as indirect finance to agriculture till the date of maturity of such bonds or March 31, 2010, whichever is earlier. Fresh investments in such special bonds made subsequent to March 31, 2007 will, however, not be eligible for such classification.
10. Loans for construction and running of storage facilities (warehouse, market yards and godowns), including cold storage units designed to store agriculture produce/products, irrespective of their location. If the storage unit is registered as SSI unit/micro or small enterprise, the loans granted to such units may be classified under advances to small enterprises sector.

11. Advances to custom service units managed by individuals, institutions or organizations who maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines, etc., and undertake work for farmers on contract basis.

12. Finance extended to dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, irrespective of their location, subject to the following conditions:

   (a) The dealer should be dealing exclusively in such items or if dealing in other products, should be maintaining separate and distinct records in respect of such items.

   (b) A ceiling of up to ₹ 30 lakhs per dealer should be observed.

13. Loans to Arthias (commission agents in rural/semi-urban areas functioning in markets/mandies) for extending credit to farmers, for supply of inputs as also for buying the output from the individual farmers/ SHGs/ JLGs.

14. Fifty per cent of the credit outstanding under loans for general purposes under General Credit Cards (GCC).

15. The deposits placed in RIDF with NABARD by banks on account of non-achievement of priority sector lending targets/sub-targets and outstanding would be eligible for classification as indirect finance to agriculture sector till the date of maturity of such deposits.

16. Loans already disbursed and outstanding to State Electricity Boards (SEBs) and power distribution corporations/companies, emerging out of bifurcation/restructuring of SEBs, for reimbursing the expenditure already incurred by them for providing low tension connection from step-down point to individual farmers for energizing their wells and for Systems Improvement
Scheme under Special Project Agriculture (SI-SPA), are eligible for classification as indirect finance till the dates of their maturity/repayment or March 31, 2010, whichever is earlier. Fresh advances will, however, not be eligible for classification as indirect finance to agriculture.

17 Loans to National Co-operative Development Corporation (NCDC) for on-lending to the co-operative sector for purposes coming under the priority sector are to be treated as indirect finance to agriculture till March 31, 2010.

18 Loans to Non-Banking Financial Companies (NBFCs) for on-lending to individual farmers or their SHGs/JLGs.

19 Loans granted to NGOs/MFIs for on-lending to individual farmers or their SHGs/JLGs.

1.2.2 Small scale industries (Direct and Indirect) Finance:

Direct Finance in the small scale industries sector include credit to:

1. Manufacturing Enterprises

   (a) Small (manufacturing) Enterprises: Enterprises engaged in the manufacture/production, processing or preservation of goods and whose investment in plant and machinery (original cost excluding land and building and the items specified by the Ministry of Small Scale Industries vide its notification no. S.O. 1722 (E) dated October 5, 2006) does not exceed ₹ 5 crore.

   (b) Micro (manufacturing) Enterprises: Enterprises engaged in the manufacture/production, processing or preservation of goods and whose investment in plant and machinery (original cost excluding land and building) does not exceed ₹ 25 lakhs, irrespective of the location of the unit.

2. Service Enterprises

   (a) Small (service) Enterprises: Enterprises engaged in providing / rendering of services and whose investment in equipment (original cost excluding land and building and furniture, fittings and other items not
directly related to the service rendered or as may be notified under the MSME Act, 2006) does not exceed ₹ 2 crore.

(b) Micro (service) Enterprises: Enterprises engaged in providing / rendering of services and whose investment in equipment (original cost excluding land and building and furniture, fittings) does not exceed ₹ 10 lakhs.

(c) The small and micro (service) enterprises includes small road & water transport operators, small business, professional & self-employed persons, and all other service enterprises.

3. Khadi and Village Industries Sector (KVIS): All advances granted to units in the KVI sector, irrespective of their size of operations, location and amount of original investment in plant and machinery. Such advances are eligible for consideration within the priority sector.

**Indirect Finance** in the small scale industries sector includes credit to:

1. Persons involved in assisting the decentralized sector in the supply of inputs to and marketing of outputs of artisans, village and cottage industries.

2. Advances to co-operatives of producers in the decentralized sector viz. artisans village and cottage industries.

3. Existing investments as on March 31, 2007, made by banks in special bonds issued by NABARD with the objective of financing exclusively non-farm sector may be classified as indirect finance to small scale industrial sector till the date of maturity of such bonds or March 31, 2010, whichever is earlier. Investments in such special bonds made subsequent to March 31, 2007 will, however, not be eligible for such classification.

4. The deposits placed with SIDBI by foreign banks, having offices in India, on account of non-achievement of priority sector lending targets/sub-targets and outstanding would be eligible for classification as indirect finance to small scale industrial sector till the date of maturity of such deposits or March 31, 2010, whichever is earlier.
Loans granted by banks to NBFCs for on-lending to small and micro enterprises (manufacturing as well as service).

1.2.3 'Other Priority Sector' Credit: it includes the credit to followings:

1.2.3.1 Retail Trade Credit includes the following:

1 advances granted to retail traders dealing in essential commodities (fair price shops), consumer co-operative stores and;

2 advances granted to private retail traders with credit limits not exceeding ₹ 20 lakhs.

1.2.3.2 Micro Credit includes the following:

1 Loans of very small amount not exceeding ₹ 50,000 per borrower provided by banks either directly or indirectly through a SHG/JLG mechanism or to NBFC/MFI for on-lending up to ₹ 50,000 per borrower.

2 Loans to poor indebted to informal sector loans to distressed persons (other than farmers) to prepay their debt to non-institutional lenders, against appropriate collateral or group security, would be eligible for classification under priority sector.

1.2.3.3 Advances sanctioned to State Sponsored Organisations for Scheduled Castes/Scheduled Tribes for the specific purpose of purchase and supply of inputs to and/or the marketing of the outputs of the beneficiaries of these organisations.

1.2.3.4 Education loan includes the followings:

1 Educational loans granted to individuals for educational purposes up to ₹ 10 lakhs for studies in India and ₹ 20 lakhs for studies abroad. Loans granted to institutions are not being eligible to be classified as priority sector advances.

2 Loans granted by banks to NBFCs for on-lending to individuals for educational purposes up to ₹ 10 lakhs for studies in India and ₹ 20 lakhs for studies abroad.
1.2.3.5 **Housing loan** includes the followings:

1. Loans up to ₹ 20 lakhs, irrespective of location, to individuals for purchase/construction of a dwelling unit per family, excluding loans granted by banks to their own employees.

2. Loans given for repairs to the damaged dwelling units of families up to ₹ 1 lakhs in rural and semi-urban areas and up to ₹ 2 lakhs in urban and metropolitan areas.

3. Assistance given to any governmental agency for construction of dwelling units or for slum clearance and rehabilitation of slum dwellers, subject to a ceiling of ₹ 5 lakh of loan amount per dwelling unit.

4. Assistance given to a non-governmental agency approved by the NHB for the purpose of refinance for construction/reconstruction of dwelling units or for slum clearance and rehabilitation of slum dwellers, subject to a ceiling of loan component of ₹ 5 lakhs per dwelling unit.

**The weaker sections** under priority sector include the following:

1. Small and marginal farmers with land holding of 5 acres and less, and landless labourers, tenant farmers and share croppers.

2. Artisans, village and cottage industries where individual credit limits do not exceed ₹50,000.

3. Beneficiaries of Swarnjayanti Gram Swarojgar Yojana (SGSY).

4. Scheduled Castes and Scheduled Tribes.

5. Beneficiaries of Differential Rate of Interest (DRI) scheme.

6. Beneficiaries under Swarna Jayanti Shahari Rozgar Yojana (SJSRY).


8. Loans to distressed poor to prepay their debt to informal sector, against appropriate collateral or group security.
1.3 RATIONALE OF BANKING SECTOR REFORMS

The poor generation of income and profit over a period of time almost made the banking institutions unviable in nature. There were number of reasons for this financial chaos in the commercial banks, which for a long period of time had been affecting the overall business and earning capacity of the banks. For example, the high rate of S.L.R. and C.R.R. in the past to a large extent reduced the business capacity of the commercial banks. The banks were statutorily required to keep 15 per cent of their aggregate demand and time liabilities as Cash and Reserve Ratio (CRR) with the apex central bank. Besides it, they were also required to invest 38.5 per cent of their net demand and time liabilities as Statutory Liquidity Ratio (SLR) in approved government securities. Apart from this banks were further required to invest 10 per cent of total demand and time liabilities accumulated by the banking system during a specific period, as impounded reserve.45

This implies that the banking system was called upon to divert 63.5 per cent of their total deposit resources in meeting statutory obligations. This directed investment programme seriously affected the resource position of the banks. As a result of these statutory provisions the banks were left with only 36.5 per cent of aggregate deposit resources to look into the interest of other competing sectors.46 Because of these investments, banks earned very little rate of interest, which led to poor profit earning by the banks.

Further, the implementation of Directed Credit Programme (DCP) assigned by the government to the public sector banks is held as the other most important factor responsible, for making the banking system inefficient and vulnerable. Under DCP, banks are called upon to channelize 40 per cent of total bank credit in favour of the targeted priority sectors, which were neglected badly in the pre-nationalization period. They were required to attain this target by the year 1985. Apart from this, the banks were also required to meet the credit needs of certain target groups under various beneficiary schemes like IRDP, DRI, TRYSEM, NREP etc.47

The rate of interest on priority sector lending was kept artificially low to enable the large number of borrowers to avail such loans. The losses in income from such sectors were compensated by charging higher rate of interest from borrowers belonging to non-priority and non-food sectors. This cross subsidization of loans was thought to be helpful for banks in planning their credit allocation. However, this system could not ensure higher and smooth earning for the banks. In fact priority sector lending had become a major reason of financial strain for the commercial banks because of poor recovery rate also. The poor recovery of loans particularly, the agricultural loans had seriously aggravated the problem of NPAs and have put a question mark on the issue of sustainability of the commercial banks as such.\(^{48}\)

Even the losses incurred on account of priority sector lending too could also be tolerated to some extent, had the system of priority sector lending been completely rational and flawless. In fact the system of priority sector lending has also been subject to number of deficiencies, problems and leakages. Further, it was also observed, that in number of instances, assets provided by the banks under different schemes were also neither in accordance with the absorption capacity of the beneficiaries nor the quality of services were maintained in distributing the assets among the identified groups, on account of which the effectiveness of priority sector lending has continued to be much below the desired level. Therefore, the loans provided to beneficiaries have not helped much to create any tangible assets.\(^{49}\) Thus the absence of tangible assets and poor recovery of loans in turn led to poor capital formation and reduction in income generating capacity of the banks.

1.4 FINANCIAL SECTOR REFORMS IN INDIA AND PRIORITY SECTOR LENDING

In view of the above cited emerging weaknesses, the government of India went in for setting up of various committees to give recommendations to improve the working of commercial banks in India. For example, in 1986 Khusro Committee was set up mainly to review the agricultural credit. In the year 1990, Goiporia Committee


to look into the customer services in India was set up. In the year 1991, Ghosh Committee to enquire the various aspects of fraud and malpractices in the banks and Nayak Committee to examine the adequacy of institutional credit to SSIs and other related aspects were also set up.

By the late eighties, not only the commercial banks, rather whole of the Indian economy was stuck up in the quagmire of unprecedented financial crisis. Government of India with a view to bring about a revolution in the functioning of the economy went for Structural Adjustment Programme in the year 1991. Hence, in this background with an intention to improve the performance of financial sector, in August 1991 the Government of India appointed Narasimhan Committee under the chairmanship of M. Narasimhan to review the different aspects relating to the structure, organization and functioning of financial system in India. It was considered to transform the system of priority sector lending in a more selective and sharply founded arrangement, taking into account the social concern for weaker sections and tiny units. The Committee's report was tabled on December 17, 1991 in the Parliament House.50

The Committee emphasized mainly that there should be phased out reduction of S.L.R. to 25 per cent over a period of five years. It suggested for phasing out Directed Credit Programmes and was of the view that there should be redefinition of the priority sector. The Directed Credit Programme for the “redefined” priority sector should be at 10 per cent of the aggregate bank credit. In order to have large business, the Committee was of the view that there should be a progressive reduction in CRR. Further, it recommended that there should be deregulation of interest rates so as to reflect the emerging market conditions. The Committee emphasized over total transparency in the balance sheets of the banks. The Committee argued that the duality of control over banking system by the Banking Division and Reserve Bank of India (RBI) should come to an end.51

In 1991, interest rates were almost completely de-controlled when the interest rate on government debt as well as the deposit and lending rates of the commercial

banks were strictly controlled and were artificially fixed at a low level, supported by mandatory requirements for banks and insurance companies to invest high proportions of their assets in government securities. The banking system was also subject to strict interest rate regulation. The Reserve Bank of India prescribed the structure of deposit rates for term deposits of different maturities, and also the structure of lending rates with different rates for different categories of borrowers. There has been a major liberalization in this area. Mandatory requirements for investment by banks in low interest government securities have been sharply lowered and interest rates on government securities are now determined by the market on the basis of periodic auctions conducted by the RBI.

Narasimhan committee strongly recommended for withdrawal of priority sector lending limit from 40 per cent to 10 per cent of net bank credit. However, the government did not accept this recommendation. The committee argued that, priority sector lending should have been a temporary arrangement, till the lagging sectors become self supportive. The committee observed that it is the high time to withdraw the limit of priority sector lending to 10 per cent of net bank credit. However a large section of public opinion and economists came against this proposal, and finally it was not accepted.

The Second Banking Sector Reforms Committee under the Chairmanship of M. Narasimhan to review the progress in the banking sector reforms and make suitable recommendations accordingly was set up on 19th December 1997, this time it was called the Committee on Banking Sector Reforms. The Committee was asked to review the progress of banking sector reforms particularly with reference to recommendations made by the Narasimhan Committee (I), and to chart out a programme on banking sector reforms necessary to strengthen the India’s banking system which can make it internationally competitive. The Narasimhan Committee on Banking Sector Reforms submitted its report to the Government in April 1998. This covered the entire gamut of issues, ranging from capital adequacy, bank mergers, and creation of global-sized banks, recasting bank boards and revamping bank legislation. However, detailed recommendations with respect to the banking policy, institutional, supervisory and technological dimensions were also given by it.

India made a relatively early beginning compared with other developing countries, in upgrading prudential norms and standards relating to capital adequacy, income recognition and assets classification. Provisioning have been upgraded and brought into closer alignment with, in line with the Basle Committee recommendations, and enforced full compliance over a 3 year period. These standards have been fully applicable since 31st March, 1996. The second Narasimham Committee has recommended further tightening of these norms to ensure full alignment and this is to be done in phases. The degree of competition in the banking system has been increased significantly as new private sector banks have been given licenses and foreign banks have been allowed to expand much more liberally than in the past. Public sector banks still dominate the system, but greater competition within the banking system appears to have an impact on their performance.53

The most adverse effect of financial liberalization came from those policies which eased priority sector lending norms for nationalized banks. Until the 1980s, nationalized banks had obligations to fulfill priority sector lending targets. But in the post-liberalization period, the priority sector definition was widened to include many more activities and the emphasis in banking shifted primarily towards maintaining the capital-adequacy level prescribed by the Basle accord. As a result, most banks now avoid lending to small farmers and small scale industries, as they are perceived to be less creditworthy customers. This had dramatic effects on the viability and productivity of small enterprises, which are the largest employers in the country and therefore has, indirectly affected income distribution and poverty scenario in the country.54

The decline in priority sector lending has led to a significant reduction in rural credit from formal channels, which has had major effect in terms of costs and the feasibility of cultivation. The irony is that the rural sector continues to contribute savings in the form of deposits into the banking system, leading to low and falling ratios of credits to deposits in rural banks. The reduced access to and higher cost of agricultural credit obviously means not just increased costs of cultivation, which has

53 G.B. Shah and D. Rajashekhar, (2005); “Banking Sector Reforms and Credit Flow to Agriculture”, Economic and Political Weekly, January, 8, 2005.
not been given adequate policy attention, but also adversely affected private investment in agriculture and allied activities.\(^5\)

Opening up the economy and financial sector liberalization also had major negative consequences for weaker sections of the population. The introduction of prudential norms for public sector banks and the Basle NPA benchmark made banks avoid lending to borrowers in agriculture and to small enterprises. As a result, credit flows to agriculture and to small and medium enterprises (SMEs) went down drastically in recent years. This reinforced the problems faced by these sectors due to trade liberalization and the complete removal of quantitative restrictions (QRs) on imports.\(^6\)

These reforms are already changing the way banks function. Higher prudential standards are forcing the banks actively to seek quality borrowers in order to improve their asset quality. Interest rate liberalization gives the banks flexibility to offer borrowers more attractive interest rates. Quality borrowers on their part are also able to demand better terms because of competition among banks and because the opening up of both domestic and foreign capital markets, enables them to look for cheaper sources of funds outside the banking system. All of this adds to competitive pressure leading to better results.\(^7\) In short, better regulation and competition is working to the advantage of better quality borrowers which should improve the allocative efficiency of the system.

### 1.5 NON-PERFORMING ASSETS (NPAs) IN PRIORITY SECTOR LENDING

It has been argued by a number of economists that a well-developed financial system enables smooth flow of savings and investments and hence supports economic growth. A healthy financial system can help achieve efficient allocation of resources across time and space by reducing inefficiencies arising out of market frictions and other socio-economic factors. Amongst the various desirable characteristics of a well-functioning financial system, the maintenance of a few non-performing assets (NPA) is an important one. NPAs beyond a certain level are indeed cause for concern.

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\(^6\) B.L. Chandak (2003); “Trade Credit and Industrial Slowdown”, *Vinimaya, NIBM Publication*, Vol. XXIX, No. 1, April-June.

\(^7\) www.rbi.org.
for everyone involved because credit is essential for economic growth and NPAs affect the smooth flow of credit. Banks raise resources not just on fresh deposits, but also by recycling the funds received from the borrowers. Thus, when a loan becomes non-performing, it affects recycling of credit and credit creation. Apart from this, NPAs affect profitability as well, since higher NPAs require higher provisioning, which means a large part of the profits needs to be kept aside as provision against bad loans. Therefore, the problem of NPAs is not the concern of the lenders alone but is, indeed, a concern for policy makers as well as those who are involved in putting economic growth on the fast track.58

In India due to the social banking motto, the problem of bad loans did not receive priority from policy makers initially. However, with the reform of the financial sector and the adoption of international banking practices the issue of NPAs received due focus. Thus, in India, the concept of NPA came into the reckoning after reforms in the financial sector were introduced and an appropriate accounting system was put in place. The banks who have extended credit to the priority sector and achieved the target suffocated on account of mounting NPAs and those who failed to reach their target suffered by having invested in low-yield Rural Infrastructure Development Fund (RIDF) set up by NABARD.59

Consequent upon liberalization and the efforts for integration of Indian financial system to the international level, the Reserve Bank of India adopted the Basle Norms in 1991-92 and brought in the first phase of banking sector reforms. RBI framed prudential income recognition norms and banks were asked to identify and provide for bad loans or non performing loans and were given one year to achieve the same.60 As per the RBI income recognition norms, an asset becomes an NPA if principal or interest thereon is unpaid for two quarters. However, international rating agencies like Standard and Poor are of the view that the asset quality in the Indian banking system is far below. International Standard Institutions think that Indian

banking practices are not up to international mark as laid down by Basle Norms, which consider an account as NPA if principal or interest is not paid for a quarter. With a view to moving towards international best practices and to ensure greater transparency, it had been decided to adopt the 90 days overdue norm for identification of NPAs from the year ending March 31, 2004. Accordingly, a Non Performing Asset (NPA) shall be a loan or an advance where:

1) Interest/ installment of principal remains overdue for a period of more than 90 days in respect of a term loan.
2) The account remains ‘out of order’ for a period of more than 90 days, in respect of an overdraft/cash credit.
3) The bill remains overdue for a period of more than 90 days in case of bills purchased and discounted.
4) Interest/ installment of principal remains overdue for two harvest seasons, but for a period not exceeding two and half years in the case of an advance granted for agricultural purpose, and
5) Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

Advances against bank’s term deposits, NSCs, IVPs, and Life Policies will not be classified as NPAs if the outstanding balance is fully covered by such securities. These advances come under the exempted category for the purpose of income recognition and asset classification.

**Classification of Bank Assets:** Reserve Bank of India has issued guidelines on provisioning requirement with respect to bank advances. In terms of these guidelines, bank advances are mainly classified into:

**Standard Assets:** Such an asset is not a non-performing asset. In other words, it carries not more than normal risk attached to the business.

**Sub-standard Assets:** It is classified as non-performing asset for a period not exceeding 18 months.

**Doubtful Assets:** Asset that has remained NPA for a period exceeding 18 months is a doubtful asset.

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61 [www.rbi.org](http://www.rbi.org)
Loss Assets: Here loss is identified by the banks concerned or by internal auditors or by external auditors or by Reserve Bank India (RBI) inspection.

In terms of RBI guidelines, as and when an asset becomes a NPA, such advances would be first classified as a sub-standard one for a period that should not exceed 18 months and subsequently as doubtful assets.

The Narasimham Committee (I) felt that the classification of NPAs as followed by RBI was not in accordance with the international standards. It believed that a policy of income recognition should be objective and based on the record of recovery rather than on subjective considerations. The Committee believed that a system of income recognition and provisioning is fundamental to preserve the strength and stability of the banking system.

1.6 CONCLUSION

In the post bank nationalization period, some sectors of the economy i.e. agriculture, small scale industries and small traders have been accorded priority in lending and certain fixed credit targets have been set for the same. However, the shift towards 'mass banking' from 'class banking' coupled with some statutory conditions led to a negative cumulative effect on profits of the banks, leading to various Financial Sector Reforms in the economy. However, despite these reforms, priority sector lending is still and will continue to be an important focus and area of concern of all the public sector banks in the near future because of hard socio-economic realities of the economy.