CHAPTER – II

GENESIS AND EVOLUTION OF PRIORITY SECTOR IN INDIA

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GENESIS AND EVALUATION
OF PRIORITY SECTOR IN INDIA

India has a long history of both public and private banking. Modern banking in India began in the 18th century, with the founding of the English Agency House in Calcutta and Bombay. In the first half of the 19th century, three Presidency banks were founded. After 1860s introduction of limited liability, private banks began to appear, and foreign banks entered the market. The beginning of the 20th century saw the introduction to join stock banks. In 1935, the Presidency banks were merged together to form the Imperial Bank of India, which was consequently renamed the State Bank of India. Also that year, India’s Central Bank, the Reserve Bank of India (RBI), began operation. Following independence, the RBI was given broad regulatory authority over commercial banks in India. In 1959, the State Bank of India acquired the state-owned banks of eight former princely states. Thus, by July 1969, approximately 31 percent of scheduled bank branches throughout India were government controlled, as part of the State Bank of India.¹

Shri Morarji Desi, 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 has been a public concern that several

‘priority sectors’ such as agriculture, small-scale industries and exports are not receiving their due share of bank credit. With the introduction of Banking Laws (Amendment) Bill 1967 in the Lok Sabha on December 23, 1967 the policy of ‘social control’ on banks was instituted. Meanwhile, the National Credit Council has been set up to assess credit needs, to define priorities and to provide guidelines to the banking system.²

An enunciation of the need to channelize the flow of credit to certain sectors of the economy, known as the priority sectors, in the larger interests of the country, can be traced to the Reserve Bank’s credit policy for the year 1967-68. In view of the severe imbalances which had developed in the economy in the preceding two years as a result of shortfalls in agricultural output and slowing down of industrial production, credit policy for the slack season 1967 was liberalized on a selective basis with a view, among other purposes, to enlarging the flow of credit to the priority sectors such as agriculture, exports and small-scale industries (SSI).³

2.1 Genesis of Priority Sector Lending

The genesis of directed lending, which is euphemistically called ‘Priority Sector Lending’ can be traced back to the days of ‘Social Control’ imposed on the Indian banks. Conceptional formalisation of priority sector

³ Ibid., p. 2.
was done over a period of time, widening their coverage and raising their target level.

The study group on the Organisational Framework for the Implementation of Social Objectives in October 1968 under the Chairmanship of Prof. D.R. Gadgil was appointed by the National Credit Council (NCC) and the Committee of Bankers appointed by RBI under the Chairmanship of Shri. F.K.F. Nariman recommended that commercial banks should increasingly forward to finance activities in rural areas and suggested earmarking of districts to banks so that they could take a lead role in the districts allotted in providing integrated banking facilities.

On the recommendations of these groups, RBI introduced the ‘Lead Bank Scheme’ in December 1969 to ensure co-ordination among various banks and Governmental agencies for developmental efforts requiring bank credit. All the districts in the country except metropolitan cities were allotted among public sector banks and a few private banks to assume lead responsibility in each district. The description of the priority sectors was formalised in 1972 on the basis of the report submitted by the Informal Study Group on Statistics relating to advances to the priority sectors constituted by the Reserve Bank in May 1971.

Accordingly, some additional sectors were brought under priority sector. The items included were retail trade, professionals and self-employed and education. Advances to transport operators and for
establishment of industrial estates, which were considered as a part of advances to small-scale industries till then, were treated as separate sectors under priority sector. The inclusion of items in priority sector has two advantages, viz., priority in allocation of credit and concessions in terms of conditions including rate of interest.

2.1.1 Lead Bank Scheme

The genesis of Lead Bank Scheme can be traced to the study group headed by Prof. D.R. Gadgil (Gadgil Study Group) on the Organisational Framework for the Implementation of the Social Objectives, which submitted its report in October 1969. The study group drew attention to the fact that commercial banks did not have adequate presence in rural areas and also lacked the required rural orientation. As a result, the banking needs of the rural areas in general and the backward regions in particular, could not be adequately taken care of by the commercial banks and the credit needs of rural sector of the economy, particularly agriculture, small-scale industry and services sectors remained virtually neglected. The study group, therefore, recommended the adoption of an ‘Area Approach’ to evolve plans and programmes for the development of an adequate banking and credit structure in the rural areas.

A Committee of Bankers on Branch Expansion Programme of public sector banks appointed by Reserve Bank of India under the chairmanship of Shri. F.K.F. Nariman (Nariman Committee) endorsed the
idea of area approach in its report (November 1969). It recommended that in order to enable the public sector banks to discharge their social responsibilities, each bank should concentrate on certain districts where it should act as a ‘Lead Bank’.

Pursuant to the above recommendations, the Lead Bank Scheme was introduced by Reserve Bank in December 1969. The scheme emphasized making specific banks in each district the key instruments of local development by entrusting them with the responsibility of locating growth centres, assessing deposit potential, identifying credit gaps and evolving a co-ordinated approach to credit deployment in each district, in concert with other banks and credit agencies.\(^4\)

2.1.2 Priority Sector

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4 Usha Thorat (2009). “High Level Committee to review the lead bank scheme.” Reserve Bank of India.
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At his meeting with the Chairman Custodians of public sector banks on July 22, 1970, Shri. Y.B. Chavan, the then Finance Minister made the suggestion that the lower interest rates should be charged to carefully selected lower income groups, who deserve financial assistance for productive endeavour but cannot easily negotiate with banks, while higher rates should be charged to the more affluent borrowers.

In September 1970, in pursuance of this suggestion, the RBI constituted a Committee under the Chairmanship of Dr. R.K. Hazari to examine the question of differential interest rates. The committee submitted its report on May 1972 and accordingly the scheme of ‘Differential Rate of Interest’ was initially launched in 1972 for implementation by public sector banks in 162 selected districts in the country. Within a year, the operation of the scheme was extended to 265 districts and later to the centre country in 1977.5

Initially there were no specific targets for priority sector lending. However, in November 1974 with a view to enlarging the flow of bank credit to the neglected sectors, the public sector banks were advised by the Government of India that their priority sector lending should reach a level of not less than one-third of their outstanding by March 1979.

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In 1980, Reserve Bank set up a Working Group on Priority Sector Lending and 20-Point Economic Programme (under the Chairmanship of Dr. K.S. Krishnaswamy, the then DG, RBI) to work out the modalities for implementation of two decisions taken in March 1980 by the Government of India, viz., that banks should aim at raising the proportion of their advances to the priority sector from 33 1/3 per cent to 40 per cent by 1985, and that the banks should actively promote the implementation of the 20-Point Programme which aimed at improving the lot of the weaker sections of the population. The group identified the categories of beneficiaries requiring assistance from the banking system in pursuance of the 20-Point Programme and spelt out the manner in which assistance could be rendered.

At most of the beneficiaries under the programme fell in the relatively under-privileged group within the priority sector, the group suggested certain changes in the approach to priority sector lending. In particular, it introduced the concept of ‘weaker sections’ within the priority sector and recommended separate sub-targets for lending to the weaker sections in the two main categories of the priority sector, namely, agriculture and SSI, within the overall enhanced target of 40 percent for lending to the priority sector. Housing loans upto ₹ 5,000 for construction of houses for SC/ST and weaker sections, assistance to any governmental agency for construction of houses for SC/ST and low-income groups (where loan component does not exceed ₹ 5,000 per unit) and pure
consumption loans granted to the weaker sections under the Consumption Credit Scheme were recommended for inclusion in priority sector.\(^6\)

On 14\(^{th}\) January 1982, the then Prime Minister had announced a new 20-Point Programme. At the meeting with the Chief Executives of public sector banks held on 15\(^{th}\) February 1982 at Delhi, the then Finance Minister, referring to the new 20-Point Programme, desired quick action in identifying the points directly or indirectly concerning the banks and in working out specific measures to be taken by the banking system in support of the programme.

Accordingly, in March 1982, the RBI constituted a Working Group under the Chairmanship of Shri. A. Ghosh, the then Deputy Governor, RBI to review and redefine the role of banks in the implementation of the programme. The Working Group submitted its report on the 17\(^{th}\) June 1982. It is felt that the recommendations will go a long way in enabling the banking system to implement the new 20-Point Programme which is to be considered as an extension of the earlier programme with greater thrust in improving the standard of living of the rural poor and other weaker sections of the society and creating necessary infrastructure and other facilities vital for the purpose.

2.1.3 Service Area Approach (SAA)

It was felt with the establishment of large network of branches that the time was opportune to adopt a system of assigning specific areas to each bank branch in which, it can concentrate on focussed lending and contribute to the development of the area. It basically aimed a planned and orderly development of a command area or a service area. In order to examine the operational aspects involved in the implementation of this approach, the RBI appointed a committee under the Chairmanship of Shri. P.D. Ojha, the then Deputy Governor, RBI and Chairmen some of the public sector banks as its members.

In 1989, The Service Area Approach (SAA) was adopted wherein villages were identified and assigned to bank branches based on their proximity and contiguity and by adopting a cluster approach. Credit plans were prepared on an annual basis for the service area of each branch which involved co-ordination between the various developmental agencies and credit institutions. Due to allotment of villages to designated bank branches, the activities of the ‘service area branches’ were restricted to the allotted villages and they were unable to provide financial assistance outside their service areas, despite being in a position to do so. Similarly, borrowers belonging to these villages were required to approach the ‘designated bank branches’ for their credit needs and were not in a position to avail of services of any other bank branches, irrespective of whether
they were satisfied with the services provided by the designated bank branches or not.\textsuperscript{7}

The Report of the Committee on the financial system (Narasimham Committee) tabled in the Parliament on the 17\textsuperscript{th} December 1991, advocated to reduce priority sector credit to 10 percent of aggregate credit to redefined group as to include small and marginal farmers, the tiny sector of the industry, small business and transport operators, village and cottage industries, rural artisans and other weaker sections. The categories that should go out of priority sector include large agriculturists, small-scale industries, professionals and self-employed, retail trade and education. The committee has further proposed that a review may be undertaken at the end of three years to see if directed credit programmes need to be continued. Simultaneously, the stipulation of concessional interest to the re-defined priority sector should be revised with a view to its eventual elimination in about three years.\textsuperscript{8} But the Government did not accept the recommendations and following a review of priority sector advances, directed to public sector banks to maintain 40 percent coverage for the priority sector.

The Committee on Banking Sector Reforms (Narasimham Committee – II) (1981) again gave careful consideration to the issue of directed credit and noted the reasons why the Government could not accept

\footnotesize{\textsuperscript{7} Ibid., p. 89.  
\textsuperscript{8} Committee on the Financial System, Reserve Bank of India, 1991, Sh. Narasimham – 1 Report.}
the earlier recommendation. It observed that directed credit had led to an increase in non-performing loans and had adversely affected the efficiency and viability of banks. It was observed that 47 percent of all NPAs emanated 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. In its report, the committee recognized that the small and marginal farmers and the tiny sector of industry and small business have problems with regard to obtaining credit and some embarking may be necessary for this sector.

Under the present dispensation, within the priority sector, 10 percent of NBC 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 2 lakhs and a phased moving away from overall priority sector targets and sub-sector targets. The committee also recognised that enhancement of credit to these sectors is
critically dependent on the availability of adequate infrastructure in these areas.\(^9\)

The committee (M.V. Nair Committee), constituted ‘to re-examine the existing classification and suggest revised guidelines with regard to priority sector lending classification and related issues’ by the Reserve Bank of India, pursuant to the announcement by the Governor in Monetary Policy Statement 2011-12, to re-examine the existing classification and suggest revised guidelines with regard to priority sector lending and related issues. The need for directed lending in India would continue considering that there is lack of access to credit for a vast segment of the society.

Commercial banks need to play significantly enlarged role for developing and deepening financial service in the rural areas and urban markets. Credit remains a scarce commodity for certain sections/sectors and they continue to remain outside purview of the formal financial system. Therefore, those sectors where sufficient credit does not flow, those people who do not get adequate credit may get the benefit of directed lending.\(^10\)

### 2.2 Changes to the Priority Sector

The current change to the priority sector lending norms has been an increase in the loan limit for micro and small enterprises in the services

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\(^10\) Committee to re-examine the existing classification of Priority sector lending, Reserve Bank of India, 2012 – M.V. Nair Committee Report.
sector to ` 5 crores per borrower from ` 2 crore earlier. Similarly, there was an increase in loan limit to ` 2 crores from the earlier ` 1 crore in case of lending to dealers/sellers of fertilisers, pesticides, seeds, cattle and poultry feeds, agricultural implements and other inputs which are classified as indirect finance to the agriculture sector. Also, the reclassifications of the priority sector lending (PSL) regime have been done based on the feedback received from stakeholders regarding enhancement in certain loan limits to be classified as PSL advances within the broad contours of the priority sector architecture.

RBI has also raised the limit on pledged loan to ` 50 lakhs from the current ` 25 lakhs as direct agricultural lending in the case of individual farmers and as indirect agriculture loans in the case of corporate, partnership firms and institutions engaged in agriculture and allied activities.11

2.3 Sector Deployment of Priority Sector Credit

The sectoral deployment of credit during the year 2011-12 under priority sector was ` 12,991 billion out of which agriculture credit was ` 5,226.23 billion and small scale industries was ` 2,591.91 billion.12

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The annual sectoral deployment indicates the growth in volume over a period of time.

**2.4 Priority Sector Advance (To Total Advance)**

The priority sector advance by the commercial banks has been analysed using trend and it has been found that the percentage has flattened off in the later segment of the years under consideration. The detailed share of priority sector advances to total advances by the commercial banks is given in figure 2.2.
Figure 2.2

Share of Priority Sector Advances in Total Advances of Scheduled Commercial Banks (percent)

Source: RBI.

Figure 2.2 indicates that the share of priority sector advance has not attained to 40 percentage mark set by RBI. The directed credit off take is limited and commercial banks are constrained by various factors which the research attempt to analyse and explore.

In the schumpeterian framework of development, bank credit has an immense role to encourage innovation in terms of finding new products, new markets, new technologies, new resources and new organisation to initiate development process. In the post-war development theory agriculture was considered crucial for industrial progress. Even before independence there was some concern on the part of the government and Reserve Bank of India (RBI) for achieving synchronisation of banking and credit policies with the requirements of the economy. Indian statesmen of
earlier years were quite conscious of these. Banking was recognized as an instrument for mobilising savings and purveying credit in areas and sectors which did not hitherto have access to banking facility.13

2.5 Credit System: Existing Infrastructure

In India, a multi-agency approach to rural credit was adopted. From the initial steps to provide Takkavi loans by the Government, cooperatives emerged as the first institutional arrangement to provide loans to farmers. Though Cooperative Act came in 1904, till 1950s the progress in terms of outreach by cooperatives was limited. This led to the Nationalisation of Commercial Banks in 1969 and again in 1980, to step up credit supply to the rural people. Then, came Regional Rural Banks (RRBs) in mid-1970s. Thus, the credit architecture consisted basically of cooperatives, commercial banks and regional rural banks. In terms of agency-wise share in rural credit, the progress of institutionalisation was impressive. The share of institutional agencies in the borrowings of cultivator households increased from mere 7.3 percent in 1951 to 66.3 percent in 2011.

During 1990, the share of non-instrumental agencies increased to reach 38.9 percent in 2002. This may be due to increased role in dealers of various inputs in financing cultivators, diminished interest of commercial banks in rural finance after Financial Sector Reforms of 1991, deterioration of health of cooperative system, among others. Ironically, the states with

higher degree of commercialization had higher share of non-institutional sources.\textsuperscript{14}

### 2.6 Credit Support to Priority Sector

Priority sectors are and will continue to remain, in the medium term, the bread and butter, both literally and figuratively, of Indian economic growth. Since priority sectors are critical to high and sustained growth of GDP, public sector banks are directed to support these sectors irrespective of whether there are credit target or not.\textsuperscript{15}

### 2.7 Consumption Factor in Repayment of Priority Sector

Consumption expenditure of the borrower is important in determining the regularity or irregularity of loan repayment in priority sector (PS) credit by banks. The share of priority sector credit non-performing assets in total NPAs of banks over the period end-March 2001 to end-March 2011, it is evident that it was increasing in all the three categories of banks; in 2009, the figures dipped owing to the Agriculture Debt Waiver and Debt Relief Scheme, 2008; and the rise in 2011 was high in the case of public sector banks and foreign banks.

Project appraisal is vital for any loan given by a financial institution. The aim of the appraiser is been to estimate as realistically as possible the


factors that determine the viability of the activity financed. However, it is a common observation that the borrower’s consumption expenditure is taken hypothetically without taking into account ground realities. Many a time, the calculation are decade old, without taking into account the increases in consumption expenditure due to inflation and/or change in consumption pattern of the borrower.

The focus is on whether the borrower can repay the loan instalment from the income generated. It would be quite wrong to presume that since small borrowers are those from the “bottom of the pyramid”, their consumption expenditure would be small and hence one can be casual while appraising the finance for those activities.

However, the family size of the small borrowers which, more often than not, is large. According to the 59th Round National Sample Survey on household consumption expenditure (NSSO) conducted in January-December 2003, the average household size in rural India was 5.0, including 1.8 children per household. Not all of them would be fully and or gainfully employed. There would be no subsidiary occupation to supplement the earnings from main occupation which is either farming at a marginal/small scale or agriculture labour.

Before availing of the bank loan, ‘financial exclusion’ is often the norm for this section of the population. In addition to this, marginal propensity to consume is higher in the case of priority sector borrowers
than other borrowers. Consumption for survival, rather than for saving, is the main motive behind earning any income. According to the same NSSO survey, the average rural monthly per capita consumer expenditure was `554 in 2003.

Even in the case of not-so-poor small borrowers, whose basic consumption needs have already been met, the proportion of incremental income going towards consumption would decline but for consumer durables that would increase conforming by and large to what in economics is popularly known as the Engel’s Law.

This is apart from their high disposition to indulge in expenses on social extravaganzas such as marriages or similar other social functions. The consumption expenditure of small borrowers is of “daily” nature, whereas the repayment of bank loan is generally of “monthly” nature. Therefore, there is always an inherent tendency among such borrowers to postpone the latter in favour of the former.

In the case of small borrowers, if the asset financed is impaired (e.g., breakdown of tractor and death of cows/buffaloes/bullocks) they have to divert resources from the activity for making good the losses. This also comes on the way of repayment of loan.

The best way to overcome the difficulties posed by higher consumption expenditure by priority sector borrowers in the post-loan period is to widen and deepen financial inclusion programme and financial
literacy and credit counselling campaigns being passionately implemented by the Government, RBI and banks.\(^{16}\)

2.8 Summary

The priority sector was a synonym for directed credit and it evolved in India as a result of shortage in credit flow to the crucial economic activities during the early sixties. However, the need for the directed credit still remains a necessity and has evolved through experimentation and collective focus. Even though various bottlenecks have cropped in, the social objective remains the same and the future direction is also straight and guided.