Chapter II

Priority Lending Practices - International and Indian Experience

The financial system of most countries experienced dramatic changes over the past decade in both financial regulation and structure. The governments or central banks in most countries used directed credit controls to channel credit to preferred sectors such as agriculture, small scale industries, business enterprises and housing on subsidised terms. That means selective credit control is used as a tool to achieve the development objectives. This strategy of financing development can be studied under two heads: one with reference to developed countries and the other with reference to developing countries.

Developed Countries:

After the World War II, governments began to take a greater interest in the financing of high priority sectors. Direct government intervention in the financial system of several industrial countries increased with the nationalisation
of large commercial banks after the 1930's depression and Second World War (for example, France and Italy).

Most developed countries used direct controls to regulate the overall expansion of credit and to influence the sectoral allocation of financial resources. Several countries put interest rate ceilings on deposits and loans (Clive Crook (Ed.), Policy and Research Series, World Bank, 1990). In the United States of America for example, restrictions have been imposed on bank lending (negative instruments)\(^1\) for stock exchange speculation ever since 1934 and there have been restrictions on consumer credit and real estate credit from time to time. In U.K. during the war, banks were instructed to give priority to loans, which assisted the war effort, and to discriminate against personal loans and those for speculative purposes. After the war priority was given for advances, which helped exports or saved imports (Furness, L. Eric, 1975:56). The supplementary special deposit scheme or Corset scheme was introduced in December 1973 to restrict the level of lending by banks. The Bank of England employed the corset technique several times during the 1970s for controlling the rate of monetary expansion.

\(^1\) Negative Instruments - one way of organising credit instruments is in terms of positive and negative instruments. The instruments such as restrictions, credit ceilings, margin requirements are designed to reduce or eliminate the flow of credit to certain sectors or purposes, are negative instruments. Positive instruments are designed to channel the flow of credit into specified areas.

The Japanese banks have played a more important role in financing private industrial investment, than banks in any other part of the world (Takeuchi, Ichiro (1976:136-45). The `over loan' policy\(^2\) in Japan enhanced the role of banks in government's macro-economic policy. On the monetary side, the monetary authorities have followed an artificial cheap money policy and placed quantitative controls on bank loans to support the policy with financial priority given to key industries, thereby facilitating business capital investment. In so far as the banks followed the *Preferential Loan Policy*, they were supplied with central bank credit with relative ease, so it is no wonder that they increased loans without regard to their liquidity positions. This regulatory framework favoured the provision of bank loans for industrial investment.

In Australia, the Reserve Bank in the past resorted to qualitative controls by asking banks to disburse credit to particular classes of borrowers like primary producers or exporters or to avoid lending for purposes like speculative stock building (Asha, P. (1987). RBI Occasional Papers: 35). The authorities in

\(^2\) Overloan Policy referred to the situation in which banks lent more to borrowers than they took in as deposits.
Germany and U.S. conducted selective credit policies through special institutions. France, Italy, Sweden and other European countries used detailed and comprehensive controls. Housing Finance and Contractual Savings assumed great importance in most industrial countries.

Central banks in Italy, Japan, Netherlands, Sweden and West Germany have used various techniques such as asset reserve requirements and government borrowing and re-lending to preferred sectors (with or without subsidies), such as housing, agriculture, export, small business and under-developed regions. In Sweden Risk bank has always played an active role in promoting various economic and social programmes for preferred and priority sectors such as housing principally through asset reserve requirements. Moral suasion is used in U.S.A., U.K. and Japan (where it is known as ‘window guidance’) for controlling banks lending policy (Asha, P. (1987). RBI Occasional Papers: 35-8).

**Developing Countries:**

In many developing countries governments direct the allocation of credit through various mechanisms. The most common means of directing credit are, by imposing lending requirements on banks, refinance schemes, loans at preferential interest rates, credit guarantees and so on. These programmes
generally targeted small scale industries, agriculture, state owned enterprises and (to a lesser extent) housing, exports and under-developed regions. Such promotional techniques are sought to be justified on the grounds that these are typically the sectors, which tend to suffer for want of credit.

Directed credit plays a very prominent role in almost all developing countries as commercial banks themselves do not provide necessary credit to priority sectors. Governments in developing countries wanted a financial system that would mobilise deposits and make loans to preferred sectors. To accomplish their objectives, governments introduced sweeping changes in financial practices. In Africa, most governments tended to nationalise the largest commercial banks. In South Asia they nationalised practically all the commercial banks. In almost all developing countries, governments took control of substantial segments of the financial system. With regard to policies in the financial area, government directed the financial institutions (especially commercial banks) to lend to selected sectors on subsidised terms. Interest rates were also kept quite low (Balasa, Bela (1981); World Bank Staff Working Paper, No. 464).

In Pakistan in 1986, government targeted 70 per cent of new lending by the national banks, which dominate the banking system, although this proportion
was reduced substantially by 1988. In Yugoslavia in 1986, 58 per cent of short-term loans were directed credits. In Brazil in 1987, government credit programmes accounted for more than 70 per cent of the total credit outstanding. In Turkey, in the early 1980s roughly three quarters of all financial system advances were made to government directive or at preferential interest rates or both, although the proportion has since fallen. In Malaysia directed credits accounted for an estimated 30 per cent of bank portfolios.

At one point Korea had 221 formal directed credit programmes. In 1986, the Phillipines had 49 schemes for agriculture and 12 for industry. In Brazil commercial banks were required to allocate between 20 and 60 per cent (depending on bank size) of their net deposits to agriculture. In Nigeria banks were required to allocate credit to two sectors viz., agriculture (15 per cent) and manufacturing (40 per cent). Actually the government control of financial resources was almost total via establishment of detailed credit allocation guidelines for each of the 16 sectors into which the economy was divided (Crook, Clive (ed.) (1990). Policy and Research Series, No. 15, World Bank: 37-9).

Selective credit controls are perhaps the most effective instrument through which the volume and direction of credit can be influenced. If there is a strong
and widespread demand for credit from credit worthy borrowers of all types, it is easy to provide credit to priority sectors. But the problem in a developing country is often the lack of effective demand for credit from indigenous borrowers in high priority sectors, particularly agriculture and industry. So the only answer to this problem is to provide subsidies to high priority sectors. The Central Bank of Nigeria has considerable powers of credit control. The bank has authority to fix the minimum proportion of lending that each commercial bank must grant to indigenous borrowers, industry and agriculture. The Bank of Ghana also introduced selective credit controls in an attempt to deflect credit towards industry and agriculture. In Kenya in 1972 the banks were required to adopt a moderate stand on all requests for advances except in the case of agriculture, exports and small scale African enterprises (Furness, L. Eric, (1975): 63-4).

In Bangladesh different policy instruments have been used for different sectors at different times. Loans to small business, small loan category and exports were the earliest to be regarded as priority sectors. In February 1975 banks were notified that the small loan category be given priority in any credit allocation following from an increase in deposits. In September 1975, a lending target of TK 1 Crore per bank was fixed for nationalised commercial banks lending to this category. During the same period restrictions on housing loans
were lifted. The differential credit ceilings were introduced in Bangladesh in 1981 to 'subsidise' certain sectors like agriculture and exports. Almost the entire gamut of policy instruments has been applied to agricultural credit. As part of the small enterprises development policy in the Philippines the banking system has a special programme. Most of the term loans to small enterprises are provided through two government programmes; the Small and Medium Industry lending (SMI) activities of the development banks of the Philippines and the Industrial Guarantee Loan Fund (IGLF).

In Korea, nationwide commercial banks, for example, are required to make available 35 per cent of their loanable funds to small business and local banks must allocate 55 per cent of their loans to small and medium scale companies (Virmani, Arvind (1984). World Bank Staff Working Paper 672:24-5).

In most Latin American countries, directed credits plays an important role in the total credit of the banking system. Directed credit accounted for 30 per cent of the total bank credit in Colombia in 1986, while it accounted for 80 per cent of total bank credit in Brazil and over 40 per cent of bank credit in Argentina. This instrument has also been largely used in Peru and Mexico. In all cases directed credit has been the result of strong pressures applied to the
government to provide medium and long term credit at reasonable interest rates to finance priority activities, including industrial and agricultural development, urban infrastructure and exports.

Brazil is probably the major Latin American country which uses directed credit to the largest extent. Argentina also has made large use of directed credit. As of March 1987, over 40 per cent of total bank credit was rediscounted by the Central Bank. In Peru, the government, through the Central Bank, has passed regulations mandating commercial banks to lend to specific sectors (particularly agriculture). The Bank Agrario, Banco Minero and Banco Industrial, all publicly owned have provided large amounts of credit in recent years many times based on political pressure rather than economic and financial criteria. These credits have by and large been provided at preferential interest rates. Chile has a system of credit allocation, which resembles free market situation, and there are no sectoral guidelines. The government influences housing credit to middle and lower income group through state guarantees of loans and subsidies to qualified borrowers. Uruguay also has a credit system which allocates funds with little government intervention, excluding the housing finance market which is practically monopolised by the government owned Banco Hipotecario, and a large proportion of the commercial bank credit which is provided by publicly

In Indonesia, to strengthen the development of small industries, the government has implemented several programmes, first among them is foster-parent programme that consists of assistance on marketing, management, technical processing (product design and diversification) and financing. Second, financing of small industries development through profits of state enterprise (BUMN). Third, to provide small business credit (KUK). Fourth, selling large company shares to co-operatives. Fifth, training for small businessmen. These policies are intended to promote the development of small industrial sector to achieve more balanced regional development (Bachrum, S. Harahap, (1993). Small Industry Bulletin for Asia and the Pacific, No. 28: 8).

Government of Nepal has given considerable importance to industrial development as the means of economic development. The role of cottage, small and medium industries is more significant in Nepal, because of resources constraint and also market consideration (Pradhan, B. Kalyan, (1993). Small Industries Bulletin for Asia and the Pacific, No. 28: 41).
A range of initiatives has therefore been developed in New Zealand to assist small and medium sized business to improve their performance. Direct government assistance to small business is, however, intended only as a supplement and not a substitute for their own resources (The Ministry of Commerce, Govt. of New Zealand, (1993). Small Industries Bulletin for Asia and the Pacific, No. 28:42).

Thailand's strategies to develop small and medium industries include identification and stimulation of entrepreneurial talents, human resource development programmes, information exchange networks, linkage between small and medium industries and large industries, strengthening of public-private co-operation at national as well as regional level, emphasis on improvement of product quality and design, marketing organisation and provision of greater financial incentives and access to lending institutions (The Ministry of Industry (1993), Govt. of Thailand, Small Industries Bulletin for Asia and the Pacific, No. 28:53).

Bangladesh, Kenya, Nigeria, Peru, Thailand, Turkey and Uruguay, each of the seven countries maintained directed credit programmes such as, (i) regulation on the portfolio composition of intermediaries' ex-requirements to devote a
certain portion of lending to specific activities; (ii) Central bank rediscounting of credit to priority sectors, usually at subsidized rates; and (iii) Control of intermediaries through direct ownership (Hanson, A. and R.Neal (1986). Industry and Finance Series, No. 14: 790-8).

**Credit Guarantee Schemes:**

Small business enterprises in both industrialised and developing countries have difficulties in obtaining loans. Commercial banks are reluctant to provide credit to these sectors because of the perceived high risks of lending to Small enterprises. Hence, credit guarantee schemes have been introduced to enable commercial banks to provide credit.

Credit guarantee schemes are set up with the purpose of covering some portion of the losses incurred when borrowers default on loans. The purpose of such schemes is to encourage commercial banks to lend to small business with viable projects and good prospects of success, but which are unable to provide adequate collateral or which do not have a suitable record of financial transaction to prove that they are credit worthy.
Credit guarantee schemes are set up in almost all developed as well as developing countries. In the United States the credit guarantee scheme guarantees up to 70 per cent of the loan amount. The Small Business Administration (SBA) loan guarantee programmes has been relatively successful in inducing commercial banks to lend funds to small business.

Guarantees for lending to small enterprises were initiated in Canada under the Small Business Loan Act (SBLA) of 1961 under which approved loans are guaranteed to 90 per cent by the government. The Federal Business Development Bank's (FBDB) direct lending is another support for small business.

Loan guarantees in France are of two kinds, one for medium term loans and the other for long term loans. Actually the guarantee is for 100 per cent loan, but in many cases (particularly for smaller loans), the banks provide a counter guarantee of 50 per cent. In the Federal Republic of Germany guarantees are given by 34 locally based private credit guarantee Associations and the guarantee varies from 50 to 100 per cent of the loan, the average is 75 per cent.
There are approximately 80 mutual consortia funds, one or more for each province in Italy. The percentage guaranteed and the limit of the guarantee sum is decided case by case by the Board of Consortium. In Netherlands, the Ministry of Economic Affairs guarantees loans granted to small and medium sized business.

In Portugal after the revolution of 1974, an Institute for Small and Medium Enterprises was created in 1975 to provide guarantees in order to save the small enterprises, which were in danger of collapse. In Indonesia, A.S. Krindo, a publicly financed Credit Insurance Corporation provides guarantee up to 75 per cent. In Korea, The Korea Credit Guarantee Fund (KCGF) was established as a special public corporation by the Credit Guarantee Fund Act of June 1976 and provides guarantee up to 80 per cent.

The Credit Guarantee Corporation (CGC) of Malaysia Berhad was established by Bank Negara Malaysia in 1972, which has the responsibility of risk sharing up to 60 per cent. In Nepal, the Credit Guarantee Corporation was established in 1974 and it provides guarantee up to 75 per cent of the credit. In Philippines, the Industrial Guarantee and Loan Fund (IGLF) were established in
1952 and it provides: (i) 25 per cent collateral short guarantee and (ii) Credit-risk guarantee of 60 per cent to small loans and 40 per cent to medium loans.

In U.K., Small Firms Division of the Department of Industry provided 80 per cent guarantee from 1981 to 1984 and reduced it to 70 per cent after 1984.

**Asia and the Pacific:**

In Japan there were 52 local public-law credit guarantee corporations, which provide 100 per cent guarantee.

In New Zealand the Small Business Agency, a division of the Development Finance Corporation of New Zealand provides 100 per cent guarantee for credit, to a maximum of NZ $ 2,00,000 per borrower.

**Developing Countries:**

Sri Lanka introduced a Small Industry Credit Guarantee Scheme in the 1970s administered by the Central Bank. The guarantee is provided to 60 per cent of the loan or SL Rs.4,00,000/- whichever is less. In Thailand Small Industry Credit Guarantee Fund was set up by Industrial Finance Corporation of Thailand in 1985. In general, it provides guarantees of 80 per cent and 100 per cent in exceptional cases.
**Africa:**

In Cameron a credit guarantee fund was established in 1975, which provides guarantee to 80 per cent of the credit. In Ghana, a credit guarantee scheme was set up by the Bank of Ghana in 1969, which provides guarantee up to 66 per cent. In Liberia, a Credit Guarantee Scheme was set up at the National Bank of Liberia (NBL) in 1979, which provides guarantee to 66 per cent of the amount of default. In Morocco, the Cairre Centrale de Garantie set up in 1970s, which provides government guarantee up to 80 per cent. In Tunisia a guarantee fund, The Fund National de Garantie (FNG) was set up in 1989, which provides guarantee for 50 to 75 per cent of outstanding loan.

In Latin America and Caribbean, The Central Bank of Barbados introduced a credit guarantee scheme in 1979 and provides guarantee up to 80 per cent. In Columbia, a credit guarantee fund, Fondo National de Garantia (FNG) was set up in 1983, which provides 80 per cent guarantee. In Haiti, Industrial Development Fund was set up by the Central Bank of Republic of Haiti in 1983 and provides 75 per cent guarantee. In Jamaica, until 1982, a credit guarantee scheme was operated by Premier Investment Corporation (Subsidiary of Bank of Jamaica), and in 1982 the National Development Bank replaced it and provides guarantee up to 50 per cent.
Table 2.1 presents details of various credit guarantee schemes that are in operation in different developed as well as developing countries. It is clear from the Table that in almost all countries the percentage of risk sharing ranges from 80 to 100 per cent, whereas in few countries it is from 40 per cent to 75 per cent. It is clear from the table that Japan was the first country to establish 52 local public-law credit guarantee corporations 50 years ago and the Philippines followed it by establishing The Industrial Guarantee Loan Fund in 1952. In Canada, Netherlands, India and Ghana, credit guarantee schemes were started during the sixties. France, Portugal, New Zealand, Korea, Malaysia, Nepal, Sri Lanka, a few African countries and Latin America followed them during seventies. It was in the eighties that the U.K., Indonesia, Thailand, Tunisia and other Latin American countries started credit guarantee programmes (Levitsky, Jacob and Ranga N. Prasad, (1987). World Bank Technical Paper, No. 58).
<table>
<thead>
<tr>
<th>Name of the Country</th>
<th>Guarantee Institution</th>
<th>Purpose</th>
<th>Risk Sharing</th>
<th>Year of Establishment</th>
<th>Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Developing Countries</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1) N. America</td>
<td>Small Business Administration</td>
<td>Fixed Capital</td>
<td>90% 90%</td>
<td>1968</td>
<td></td>
</tr>
<tr>
<td>(a) U.S.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Canada</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>II. Europe</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) France</td>
<td>SDRs or OCM 34</td>
<td>100%</td>
<td>1978</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) Germany</td>
<td>credit guarantee Associations 80</td>
<td>50-90% average 75%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Italy</td>
<td>Mutual Consortium Funds</td>
<td>50%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) Netherlands</td>
<td>Ministry of Economic Affairs</td>
<td>80% reduced to 70%</td>
<td>Since 40 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) Portugal</td>
<td>The Institute for Small &amp; Medium Enterprises</td>
<td></td>
<td>1975</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(f) U.K.</td>
<td>Department of Industry</td>
<td></td>
<td>1981</td>
<td></td>
<td></td>
</tr>
<tr>
<td>III. Asia and the Pacific</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Japan</td>
<td>52 Local Public-law Credit Guarantee Corporation</td>
<td></td>
<td>Since 50 years</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) New Zealand</td>
<td>Dent. Finance Corporation (Small Business Agency)</td>
<td></td>
<td>1978</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Name of the Country</td>
<td>Guarantee Institution</td>
<td>Year of Establishment</td>
<td>Purpose</td>
<td>Risk Sharing</td>
<td></td>
</tr>
<tr>
<td>---------------------</td>
<td>-----------------------</td>
<td>-----------------------</td>
<td>---------</td>
<td>--------------</td>
<td></td>
</tr>
<tr>
<td>IV. <strong>Asia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>India</td>
<td>RBI Deposit Insurance and Credit Guarantee Corporation, NABARD, SIDBI</td>
<td>1960-22 districts</td>
<td></td>
<td>60% 0.2 Million</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>A.S. Krindo - F</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>The Korea Credit Guarantee Fund</td>
<td>1983-whole country</td>
<td></td>
<td>50% excess of 0.2 million</td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>The Credit Guarantee Corporation</td>
<td>1976</td>
<td></td>
<td>75%</td>
<td></td>
</tr>
<tr>
<td>Nepal</td>
<td>The Credit Guarantee Corporation</td>
<td>1972</td>
<td></td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>The Industrial Guarantee Loan Fund</td>
<td>1974</td>
<td></td>
<td>60%</td>
<td></td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>Small Industries Credit Guarantee Scheme</td>
<td>1952</td>
<td></td>
<td>75%</td>
<td></td>
</tr>
<tr>
<td>Thailand</td>
<td>Small Industry Credit Guarantee Fund</td>
<td>1970</td>
<td></td>
<td>25% short guarantee 40% medium loans 60% Small loans</td>
<td></td>
</tr>
<tr>
<td>V. <strong>Africa</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cameroon</td>
<td>Credit Guarantee Fund</td>
<td>1975</td>
<td></td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td>Ghana</td>
<td>Bank of Ghana</td>
<td>1969</td>
<td></td>
<td>66% - 2/3%</td>
<td></td>
</tr>
<tr>
<td>Liberia</td>
<td>National Bank of Liberia</td>
<td>1979</td>
<td></td>
<td>66% - 2/3%</td>
<td></td>
</tr>
<tr>
<td>Morocco</td>
<td>The Caisse Centrale LC Guarantee</td>
<td>1970</td>
<td></td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td>Tunisia</td>
<td>A Guarantee Fund (FNG)</td>
<td>1981</td>
<td></td>
<td>50 to 75% outstanding loan</td>
<td></td>
</tr>
<tr>
<td>VI. <strong>Latin America &amp; The Caribbean</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Barbados</td>
<td>The Central Bank of Barbados</td>
<td>1979</td>
<td></td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td>Columbia</td>
<td>Fondo Nacional Degarantia (FNG)</td>
<td>1983</td>
<td></td>
<td>80%</td>
<td></td>
</tr>
<tr>
<td>Haiti</td>
<td>Central Bank of Republic of Haite</td>
<td>1983</td>
<td></td>
<td>75%</td>
<td></td>
</tr>
<tr>
<td>Jamaica</td>
<td>Until 1982 a premier Interest Corporation, National Denk, BK.</td>
<td>1982</td>
<td></td>
<td>50%</td>
<td></td>
</tr>
</tbody>
</table>

The experience of developed as well as developing countries shows that, Financial Regulation, Directed Credit Programmes and Credit Guarantee Schemes have been employed to promote the development of the neglected sectors, particularly small scale sectors in almost all the countries. In the light of this experience we can analyse the Indian situation.

**Origin of Priority Lending in India:**

After Independence, India's objective was to achieve economic development through the process of planning. During the era of planning, many basic and policy measures were undertaken, efforts were made to establish a socialistic pattern of society, the Industrial Policy was formulated, priority and neglected sectors were declared and nationalisation of private sector business were notable among the important steps in the strategy of development. All these factors had their impact on both the functioning and the development of commercial banking in India. Consequently, the banking system witnessed many structural changes. Notable among them are the following.

Under a promotive and directive role steps were taken by the government to improve the structure and functioning of commercial banking. It included the declaration of priority and neglected sectors for financing by these banks on a
priority basis and introduction of schemes like the Differential Rates of Interest, Credit Guarantee Scheme, Export Interest Subsidy Scheme and a scheme of social control over banks. It was a mixture of private sector initiatives and public sector outlook - a "Golden Mean" between "Rigid Regimentation" and Laissez Faire Policy.

The issue of bank nationalisation dates back to 1948. Some of the members of the socialist and communist parties felt that the nationalisation of banks would be a valuable means of increasing the pace of economic development of the country. The nationalisation of the Reserve Bank of India in 1949 was the first step in this direction. Another was the passing of the Banking Companies Act in 1949. Then the Imperial Bank of India, the management of which had continued to be in the hands of British Officers was nationalised in 1955. It was even held by some that the nationalisation of banks would be the penacea for all ills afflicting the economic life of people in India. The scheme of social control of banks was devised to put off the demand for the nationalisation of banks.

The major developments in Indian banking during 1967-68 centred around the implementation of social control over banking. The policies and practices of the banking system must serve the basic development needs of all sectors of the
economy in conformity with the national policy and priorities. In this respect, the Congress Government initiated a new banking policy in 1967, described as the "Social Control" of Banks. The AICC Resolution in fact introduced the concept of social control. According to the AICC Resolution, Social Control of banks under the effective guidance of the State helps in the mobilisation of deposits and also allocation of credit to the socially desirable sectors of the economy, which would ensure enlarged material benefits to the nation at large. The term "Social Control of Banks" thus refers to a sort of stiff regulation of banking activities through appropriate policy measures and legislation.

The scheme of social control of banks was introduced by the Government on December 14, 1967, when the then Finance Minister, Morarji Desai, made a statement in the Lok Sabha while explaining its objectives, main features and the mode of functioning. In his statement, Mr. Desai categorically stated that there was no need for nationalising banks at the time and social control measures alone would effectively serve the purpose. The main objective of social control was to achieve a wide spread of bank credit to different sectors of the economy and different areas, to prevent its misuse and to direct its flow to priority sectors and to make it a more effective instrument of economic development. General steps had been instituted by the Government for exercising social control over banks
with the objective of making banking more purposeful, more dynamic and more helpful to the common man.

The changes sought to be brought about in the implementation of social control were organisational as well as functional. Under organisational changes the Boards of Directors of banks were to be reconstituted. Under functional change, first of all, a National Credit Council (N.C.C.) at an All India level was established in December 1967. The N.C.C. consisted of representatives from large, medium and small scale industries, agriculture, co-operative sector, trade and bankers and professional accountants. The Finance Minister was its Chairman and the Governor of Reserve Bank, Vice-Chairman. As the basic objective of the social control policy was to ensure in the immediate future, an equitable and purposeful distribution of credit within the resource available, keeping in view the relative priorities of developmental needs N.C.C. was given the responsibility of determining priority sectors and planning of overall credit.

Also the Reserve Bank of India has administered a credit guarantee scheme, on behalf of the Government of India, since July 1960, to provide guarantee for advances granted to small scale industries by specified banks and financial institutions. The objective of the package of social control measures
was to highlight the complaints "that several priority sectors such as agriculture, small scale industries and exports have not been receiving their due share of bank credit".

The functional mode of banking had considerable changes by the late sixties as banks adopted the policy of directing credit to the priority sectors. The board was reconstituted. The bank also introduced changes in its branch expansion policy in order to extend banking facilities to wider areas and also to mobilise large deposit resources. But the Government felt that the progress made by commercial banks under social control was inadequate to reach its social goals. It was observed that even after the reconstitution of the management boards, the industrialists and business magnets remained on the Boards and could still use their influences. As such, public ownership of banks was felt as an inevitable means to achieve the goal of socialism.

The idea behind bank nationalisation was explained by the late Prime Minister, Indira Gandhi, in the following words: "While the nation is committed to establishing a socialistic pattern of society, the government felt that the public ownership and control of the commanding heights of the national economy and of its strategic sectors were essential and important aspects of the new social
order which we are trying to build. As the financial institutions are among the most important levers for the achievements of social objectives, the nationalisation of major banks was felt to be a significant step in the process of mobilisation of people's savings and channelising them towards productive purposes”.

The issue of nationalisation remained a subject of great controversy. The debate that ensued, for and against nationalisation in India, was as follows:

The Industrial Policy Resolution of 1956, supported banking as an Industry to be in the public sector. It was argued that public deposits kept with the banks must be in the public hands, so that private individuals may not use them in furtherance of their own interests.

It was alleged that "private banks had facilitated the concentration of economic power in the hands of a few, permitted the creation of industrial and business monopolies and also mis-utilisation of funds for socially undesirable activities. Another criticism was that the directors of banks had been basically industrialists and they held directorships of companies at the same time. A study of interlocking directorships between banking and other companies made by Dr.
R.K. Nigam in 1963 revealed that 188 directors of 20 big banks held 1,452 directorships of other companies. The interlocking of directorships tended to lead to investment of bank funds in the directors own fields of business, which deprived other genuine applicants to credit facilities. It further resulted in monopoly and concentration of economic power in the hands of a few. Also nationalisation would promote the confidence of the public in banks, thereby bringing about a rapid and very large increase of deposits.

The main argument favouring nationalisation was its harmony with the government policy of social welfare, which requires that the ownership and control of the material resources of the community are to be so distributed as best to sub serve the common good. Whereas banks favoured big borrowers rather than small ones. As per Reserve Bank data, in 1967 as much as 70 per cent of the total bank credit was given to borrowers of over Rs. 5.00 lakhs. There has been a traditional preference of commercial banks for financing mainly the organised sectors like wholesale trade, medium and large scale industries rather than smaller traders, industrialists and agriculturists. The financial operations of these banks added fuel to the fire of inflationary trends in the economy by financing speculative operations and investing in securities of stock and bullion exchanges on the one hand, while on the other hand, they deprived the priority and
...ected sectors of the economy from getting their legitimate credit needs fulfilled.

Credit planning is a sin-qua-non for the effective and successful implementation of economic plans. It envisages a more purposeful direction of credit towards the priority and neglected sectors of the economy, so that the financial resources might be utilised to the maximum social advantage. The increasing importance of credit planning further raised the demand for nationalisation of commercial banks.

It was contended that private commercial banks concentrated their branches in urban and metropolitan areas (they are urban based) and neglected semi-urban and rural areas and hence, left rural deposits untapped and immobilised. Thus it was argued that nationalisation would remove this disparity in the banking spread. Out of 564,000 villages in India, only about 5,000 villages were being served by private commercial banks. Nationalisation was felt necessary to contribute to the growth of agricultural sector, which is the kingpin of Indian economy. The allegation was also made for the practice of setting aside huge sums (about Rs. 100 crores for the entire banking industry as "Secret Reserve") by the private commercial banks. The advocates of bank
nationalisation opined that nationalisation would release these funds to the
government for productive and plan purposes and their mis-utilisation which is
detrimental to the interest of employees and depositors would come to an end. It
was also argued that nationalisation of banks would enable the government to
obtain all the large profits of the banks as its revenue, thus creating a new
resource for financing the plans. Nationalisation as opined by protagonists
would replace the profit by service motive in the functioning of the commercial
banks.

The antagonists on the other hand had put forward arguments against
nationalisation in the following manner. For achieving the social objectives,
nationalisation was not the only means. They charged the government for the
concentration of economic power and further argued that the interlocking of
directorships helped the industrial magnates provide fraternal patronage to the
banks, which in turn helped them prosper. Thus the association of Tatas with the
Central Bank of India, Birlas and Goenkas with the United Commercial Bank
and so, has helped the banks prosper.

It was argued that "the remedy will be worse than the disease as by such
step there will be only a shift of power vesting with a few politicians and
bureaucrats at whose hands the banking industry will be a mere pawn in the game of political parties. Regarding the allegation on banks providing credit for speculation and hoarding it was refuted on the ground that ostensibly it was difficult to differentiate between speculators and genuine producers. So far as inflationary trends were concerned these were the result of many factors and bank lending as one of them had a negligible impact on prices. If the bank lending was so effective a measure to cause inflation, then the mere extending bank credit during depression would have solved the problems. Credit to priority sectors could have been provided with other less stringent measures such as instructions to commercial banks rather than nationalisation. They further argued that the poorer and neglected sections of the priority and neglected sectors would be the sufferers in nationalised banks because of lack of influence/power. It was also feared that to provide finance to priority sectors the needs of big industry and trade, specially those getting credit earlier would suffer after nationalisation. It was argued that the practice of "Secret Reserve" was developed primarily to meet unperceived losses and unexpected contingencies so as to conserve and consolidate the financial position of banks and to stabilise and assure a particular rate of dividend".
It was further protested that complete nationalisation would stop healthy competition and cease to give better service to the community. The Reserve Bank of India under the scheme of Social Control could achieve integration and co-ordination through the regulation of banks. But the supporters of bank nationalisation insisted that the process of integration and co-ordination of banks to the attainment of social objectives would be attained rapidly if commercial banks were nationalised. As a result the far-reaching measures affecting the banking system was the nationalisation of 14 major banks in July 1968 and 6 other banks in April 1980.

After the recent bank scam there is revival of anti-nationalisation thinking. Many argue that such large misuse of funds would not have happened if banks were in private sector. They blame that nationalisation of banks itself has given place for such huge misuse. But in India, the history of private banks shows that they are not necessarily successful. There were several bank failures in the fifties and sixties. The gains of bank nationalisation in the country have been substantial and it is important that these cannot be completely neglected. But, the banking system in India has become over-regulated and over-administered. So, there should be freedom for banks to perform. However, as the Narasimham Committee (1991) has also stated, the question of efficiency, productivity and
profitability is *ownership neutral* and a mere change of ownership cannot *per se* lead to financial and economic inefficiency. The experience of other countries shows that under any system of finance mistakes will be made. The goal is not perfection but a system, which mobilises resources efficiently, minimises allocative mistakes, and curbs fraud and stops instability from turning into crisis.

So, the need of the hour is not complete privatisation but a different orientation to regulation i.e., Social Control.

Both developed and developing countries are practicing the priority sector lending in order to develop the neglected sectors in the economy. In developed countries, after the Second World War governments began to take a greater interest in the financing of high priority sectors. Agriculture, Small Scale Industries, Housing and Export are the sectors, which are given priority in almost all the countries. Directed credit programmes, selective credit control or financial regulation and credit guarantee schemes are some of the measures adopted to help the priority sectors. Commercial banks were directed to provide finance at concessional rate to these sectors. The Central Bank or the other guarantee institutions are providing refinance facilities also for the promotion of priority lending in majority of the countries. The intention of refinance is to
enable the commercial banks to extend more and more finance to those sectors that lack collateral securities.

In some cases negative credit instruments such as restrictions, credit ceilings, margin requirements are designed to reduce or eliminate the flow of credit to certain sectors such as share market speculations and so on. And in majority of the cases positive credit instruments are used to channel the flow of credit into specified areas.

In developing countries directed credit accounted for 30 per cent to 80 per cent (Brazil) of bank credit. Many schemes were formulated to implement the directed credit programmes. In Korea there were 221 formal directed credit programmes. But in developing countries, there is lack of effective demand from indigenous borrowers especially in the agricultural sector. So along with directed credit it is also necessary to provide subsidies in order to stimulate borrowing. In Uruguay credit system allocates funds to priority sectors with very little state intervention, which is to be really appreciated.

One thing that is common in both developed as well as developing countries is that commercial banks do not come forward to provide loans to small
business enterprises, as they consider it highly risky. So in order to encourage commercial banks to provide more and more credit to these sectors and to cover the losses incurred when borrowers default on loans credit guarantee schemes were introduced. The Central Bank as well as other guarantee institutions is doing this job.

**Summary of the Findings:**

Different country cases reveal that both developed as well as developing countries have recognised priority sectors and are giving preferential treatment in order to achieve the economic development and balanced growth of the economy. With this, the importance of the preferential treatment of the priority sectors in India is also very well seen. While many argue that commercial banks should play a prominent role in the development of these sectors by providing them financial assistance at concessional rates of interest those who are against priority sector lending argue that commercial banks are suppose to function commercially. As banks have to deal with public funds, they are suppose to pay them back on demand and they also have to maintain interest, administration and so many other expenditures it is very much necessary to use the funds in a profitable manner. So the commercial banks instead of being allowed to work
commercially are burdened with the responsibility of achieving social welfare, then it will be against the militancy of banking operations.

Also in order to provide funds at low rate of interest to priority sectors, there is no other way for banks than to use the method of cross subsidisation in order to sustain themselves. Again the non-priority sector borrowers are victimised and are burdened with high interest rate, which may finally lead to inflation and other related problems.

But still, the priority sectors such as agriculture, small scale industries and other small business operations are not in a position to withstand the market competition and are at infant stage. Without proper protective policy and financial support in the form of concessional interest and preferential credit facilities, it may not be possible for these sectors to stand on their own feet. This would affect the economy as a whole in an adverse manner, which might worsen the economic situation of the country as a whole, by unbalanced development of the sectors, region, and in turn leads to increased inequality in the distribution of income and wealth. There is no need to explain the ill effects of concentration of economic power in the hands of a few. So, in order to avoid such worsening situation at the internal as well as international level it is very much necessary to
nurture these sectors by providing necessary help. Apart from these priority sectors have gained prominence in our country by the nature of their labour intensive techniques, which helps us to solve the problem of poverty at the macro level and increasing unemployment problem at the micro level.