International Journal of Advanced Research and Development
ISSN: 2455-4030, Impact Factor: RJIF 5.24
www.advancedjournal.com
Volume 2; Issue 3; May 2017; Page No. 21-25

Priority sector lending: Genesis, developments and trade off with bank's profitability

[1] Pratibha Naruka, [2] Dr. Manju Yadav

[1] Department of Social Sciences, University of Rajasthan, JLN Marg, Jaipur, Rajasthan, India
[2] Guide, Department of Social Sciences, University of Rajasthan, JLN Marg, Jaipur, Rajasthan, India

Abstract

The importance of credit for development in priority sector hardly needs any emphasis. But recently the debates about cost – benefit analysis of the priority sector lending has drawn significant attention. Arguments about PSL being a liability on commercial banks in respect of higher NPAs, low profitability, diversion of funds, no effective end use of advances, government interference has gained ground. On basis of above certain Scholars advocate reducing the scope of PSL including the M. Narsimham to who recommended to slash PSL target to 10% of banks credit outstanding.

This paper examines the ground level impact of the PSL and tries of establish link between credit surge and development in the concerned subsectors and holds low profitability of banks as just a short term phenomenon. For the purpose of the study extensive review of relevant literature and various committees has been done in order to reemphasize PSL as a cornerstone of Indian Financial inclusion framework.

Keywords: priority sector, commercial banks, RBI, economic development, small scale industries, nationalization

1. Introduction

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

Lending by the commercial banks to certain sectors of economic activities designated as priority sector has done a great signal service to the development off the economy. Sectors such as, agriculture, fisheries, animal husbandry, self-employment activities, service activities, small scale enterprises and so on play a very vital role not only in the acceleration of economic development but also in promoting social justice to a large number of vulnerable groups in the society. The role of priority sector in a developing country like India can hardly be undermined. The priority sector, contributes to employment generation activities, exportable surplus. Marketable surplus and also generation of income opportunities to a large number of people.

Provision of credit by the commercial banks to the priority sector can break the vicious circle of poverty and hence can contribute to rapid growth with social justice. Therefore, the priority sector lending by the commercial bank can contribute to economic development in a variety of ways.

2. Objective

This paper aims is to showcase the inevitability of the priority sector lending for socio economic development of the unprivileged. Also it reiterates the need for strengthening of the PSL norms and to tailor make them to suit the dynamics of the Indian economy.

3. Evolution of Priority Sector Lending

Chronological developments witnessed since the genesis of priority sector lending may be grouped in four phases which are tabulated here under:

Grounding Phase

1967 - Coining of the term "Priority sector"
1969 - Emphasis on priority sector lending on Nationalization of 14 major banks
1972 – Concession in interest rate for priority sector lending introduced through DRI (Differential Rate of Interest) scheme.

Specification Phase

1974 - Priority sector lending to reach 1/3rd of the outstanding bank credit by March 1979 in banks.
1977 - Export credit excluded from priority sector credit (except to SSI) 1978 - Priority sector lending to reach l/3rd of the outstanding credit by March 1980 in Indian private sector banks.
1979 - 6 more banks nationalized and stress on priority sector lending increased. Proportion of priority sector credit to be raised to 40 percentage of outstanding bank credit by March 1985. Concept of "weaker section" introduced with sub target of 10 percentage of net credit within priority sector lending.

Streamlining Phase

1982 - Broadening of the concept of priority sector by including pure competition loan & housing loan also redefining retail trade, small business etc.

1983 - Direct agriculture credit to be raised to minimum of 16 percentages by March 1987 and to be further raised to minimum of 18 percentage by March 1990

Reinforcement Phase

1989 - Foreign banks also advised to undertake priority sector lending. - 10 percentage of total credit by March 1989 to be raised to 12 percentages by March 1990 and further to 15 percentage by March 1992.

1990 - Interest rate linked with "size of loan" doing away with concessional rates of other counts except DRI and export loans.

1993 - Foreign banks to undertake priority sector lending up to 32 percentage of their credit including their export credit.

Importance of Priority sector lending

PSL can help economic development directly as well as indirectly in the following ways:

1. It can reduce the chronic debt owing to non- institutional sources and the financial hardships caused by manmade and natural calamities.
2. It will enable the persons engaged in priority sector to produce a marketable surplus and thereby contribute to the development process.
3. Credit is viewed as productive input and policy makers think that it is possible to promote specific agricultural activities by delivering pre-determined amounts of loans to farmers.
4. In the agricultural segment, the credit enables the famers to expand areas under irrigation for remunerative crops, increase the use of modern inputs and thereby increase per acre and total yield of crops.
5. Credit for allied activities also helps the borrowers to increase their income. The borrowers can witness remarkable increase in his business turn over and income in the post loan period. The increase in income can bring an improvement in the quality of life of the borrowers.
6. The PSL can also help to bring high rates of adoption of new technology.
7. Besides making available finance for development, banks can play a catalytic role in developing infrastructure, transferring technology and knowhow, offering guidance and above all educating the rural people of varied target groups.
8. PSL may encourage entrepreneur ability which contributes to economic growth in two ways:
   i) By providing timely and adequate amount of credit to those with technical skills and entrepreneur talents who are not coming forward on a higher economic terrain for want of sufficient capital, and
   ii) By attenuating uncertainty and absorbing risk in arranging capital needed for their plans to be implemented.

4. Important Committee Report on Priority Sector Lending

The First Narasimham Committee (1991) [1]

It acknowledged the role of the Priority Sector Lending programmes in extending the reach of banking system to the neglected sectors of the economy and therefore it recommended that the priority sector should be redefined to include the marginal farmers, tiny sector, small business and transport sector, village and cottage industries etc. The committee had drawn attention to the problem of low and declining profitability of banks and stated that there is need for gradual phasing out of the directed credit programme. This recommendation was not accepted by the government and the directed credit requirement continues unchanged.

The Second Narasimham Committee (1998) [2]

This committee observed that directed credit had led to an increase in non- performing loans and had adversely the efficiency and profitability of banks. It was observed that 47% of all non-performing assets have come from the priority sector. At the same time, the committee recognized that the small and marginal farmers and the tiny sector of industry and small businesses have problems with regard to obtaining credit and some earmarking may be necessary for this sector. Under the present dispensation, within the priority sector, 10% of net bank credit is earmarked for lending to weaker sections. The Committee recommended that given the special needs of this sector, the current practice may continue. The Committee also proposed that given the importance and needs of employment oriented sectors (like food processing and related service activities in agriculture, fisheries, poultry and dairying), these sectors should also be covered under the scope of priority sector lending.

Nachiket Mor Committee (2014) [3]

In order to enable greater regional and sector wise specialization among banks, the committee recommended that the RBI revise the PSL targets and require banks to meet an Adjusted PSL target of 50% against the current requirement of 40%. Districts and sectors should be weighted based on the difficulty in lending to them, and a bank lending to a difficult sector in a difficult to reach district can benefit from a multiplier value based on the specific sector and district. Every sector-district combination has a weight associated with it and the bank will have to reach an adjusted PSL value of 50% taking these weights into transition of NBFCs into banks by including more sectors in the Priority Sector Lending (PSL) classification.

5. Impact of Priority sector lending: Empirical Evidences

Hegadal R.V. (2012) [4] found that there is a positive impact of priority sector loan on the borrowers is found vindicated by the responses of the loan beneficiaries covered by the study in Haveri district of Karnataka. More than 90 percent of the respondent borrowers have mentioned that the loan facility has led to increase in their income, investment, production, savings, employment, consumption level, etc. Further they have been able to reduce their old debts and private borrowings due to the loan facility under the priority sector lending by banks. There has been positive impact on their business. There is an all-round improvement in their standard of living.

Gomathinnayagam, V (2010) [5] found that the results on the relationship between PSL and SDP show a very positive nexus between the two variables which indicates that the growing sector wise credit flow through the PSL has been contributing to the economic development of Pondicherry. The Correlation Co-efficient between these two variables was 0.98. The correlation co-efficient between per capita PSL and the Per capita Income was 0.97. This implies that there is almost one to one correspondence between PSL and SDP.

Ayyanar G. (2014) [6] observed that he impact of priority sector lending by the commercial banks in Madurai district of Tamil Nadu has been positive in various ways. He concluded that generation of output, income, employment and assets increased appreciably in the post loan period than in pre loan period. The average income per sample borrower increased from Rs.4799 in per-loan to Rs.5264 in post-loan years showing a rise of 9.70 per cent pre-loan year for all sample farmer borrowers. It was the highest for marginal farmers (21.84 per cent) followed by small farmers (11.73 per cent) and lastly medium and large (5.80 per cent). The average amount of increase per sample farmers' borrowers of each year has been increased from Rs.1996 for marginal farmers to Rs.4024 for small farmers and further to Rs.8377 for medium and large farmers in pre-loan year. The respective figures for post-loan year were Rs.2432, 4496 and Rs.8863. These amounts being low for marginal, small and medium and large farmer indicate the poor economic condition of the sample farmer borrowers. There has been increase in the additional income of 24.33 percent of the beneficiaries of the priority sector loan after availing the loan amount. Purchase of additional land has gone up by 10 percent and increase in assets of the loan beneficiaries has gone up by 43.33 percent. Increase in production due to priority sector lending has been estimated to be 40 percent. There has been an addition of irrigation by 20.33 percent. Self-employment of loan beneficiaries has gone up by 10.33 178 percent. Thus the impact of priority sector lending by the commercial banks in the study area has largely been positive in raising the economic status of the loan beneficiaries.

Begum, Syeda Musfia (2015) [7] had investigated the impact of institutional finance on farmers' economy Golaghat and Jorhat districts of Assam. She found a strong relationship between borrowing and technological change on the farm economy of sample cultivators. Borrower groups were better endowed with land holdings, farm and household assets, recorded higher rates of adoption of new technology when compared with non-borrower groups. More than 90 percent of the respondent borrowers have mentioned that the loan facility has led to increase in their income, investment, production, savings, employment, consumption level, etc. Further they have been able to reduce their old debts and private borrowings due to the loan facility under the priority sector lending by banks. There has been positive impact on their business. There is an all-round improvement in their standard of living.

Rajeswari, G (2013) [8] studied Priority sector lending in Sirikulam district of Andhra Pradesh. The study revealed that there is a high positive correlation between the priority sector advances and state domestic product. The priority sector advances cause 98 per cent of variation in GDP of the district. The regression coefficient value implies that one rupee increase in priority sector advances leads to an increase in gross domestic product (GDP) of the district by Rs.10.11. Per capita income of the district also showed an increasing trend during the study period. It has almost increased 3 times (increased from Rs.12407 to Rs. 35959) during the reference period. The results of the sector wise analysis shows that there is a high degree of positive correlation between the advances to primary sector, secondary sector, tertiary sector and Gross Value Added to these sectors. The regression coefficient value implies that one rupee increase in primary sector advances leads to an increase in gross value added of agriculture Sector of the district by Rs.4.37 and one rupee increase in secondary sector advances leads to an increase in Gross Value Added of Agriculture Sector of the district by Rs.8.06. The regression coefficient value for services sector indicates that one rupee increase in services sector advances leads to an increase in Gross Value Added of Services sector of the district by Rs.24.93. A comparison of the regression co-efficient suggests that the gross value added exerted by lending to agriculture loans is less (4.37) compared to industries sector (8.06) and other priority sectors (24.93). The loans given to other priority sectors were more productive as they generate Rs.24.93 for every one rupee loan. Non-farm sector occupy the second position indicating the potential for development of industries in the district. The analysis of loans to various sectors also suggests that targets for other priority sector occupy next position to crop loans and the public sector banks and private sector banks have achieved their targets in more number of years compared to crop loans. This indicates the demand for loans to transport operators, self-employed persons, housing loans and education loans in the district.

Deepha jeya merlin, D (2015) [9] studied 506 beneficiaries of Kanyakumari district of Kerala. She used a multiple regression which showed the that the priority sector lending benefited the beneficiaries in a major way and the broader areas of improvement were in social conditions, savings and investment, employment generation and asset creation. Thus it can be established that the priority sector credit has a direct bearing on the livelihood of the beneficiaries and more targeted credit will uplift the bottom of the pyramid to a higher income strata.

In the light of these studies we get ample evidence of success story of Priority sector lending and reinforce our faith in its effectiveness and it being an anchor of the inclusive socio-economic development of the country.

6. Recent Developments in PSL norms

The Reserve Bank of India has revised the priority sector lending norms in March 2015 according to which direct banks to lend to certain segments by prescribing targets as a percentage of their total business.

Categories under latest definition of priority sector will include

- Agriculture
- Micro, Small and Medium Enterprises
- Export Credit
- Education
- Housing
- Social Infrastructure
- Renewable Energy
- Others

The new norms require banks to ensure that 8% of their loans go to small and marginal farmers. New sectors like renewable energy and social infrastructure will get a boost as these are now classified as priority sector. Any bank that lends up to Rs 10 lakh to a household for solar power and biomass-based generators can classify the loan as priority sector.

Earlier, there were sub-limits for direct lending and indirect lending to agriculture. These two segments have been merged making it easier for banks to achieve the 18% agriculture target as large loans to processed food industry are also now covered under agriculture. The challenge for banks lies in disbursing 8% of their total credit to small farmers and 7.5% of bank credit to micro enterprises.

Foreign banks, which until recently enjoyed relaxed priority sector norms, will face new challenges. Under the new norms, the sub-targets for small and marginal farmers and micro enterprises would be made applicable post 2018 after a review in 2017 for foreign banks with more than 20 branches. Foreign banks with less than 20 branches will move to the total priority sector target of 40% of loans or 'Credit Equivalent Amount of Off-Balance Sheet Exposure', whichever is higher, on a par with other banks by 2019-20. What this means is that if any foreign bank issues a guarantee for Rs 1 crore, it will have to disburse loans worth Rs 40 lakh in the priority sector.

Banks can also lend up to Rs 5 crore per borrower for building social infrastructure such as schools, healthcare facilities, drinking water facilities and sanitation facilities in tier II to tier VI centers.

Home loans up to Rs 28 lakh in metros and Rs 20 lakh in other centers will form part of the directed lending as long as the cost of the property is not more than Rs 35 lakh and Rs 25 lakh, respectively.

Under the new norms loans, up to Rs 10 lakh, including vocational courses, irrespective of the sanctioned amount, will be reckoned as part of priority sector lending.

Provision in Union Budget 2017-18 for Priority sector lending

Expansion of Infrastructure definition

The government's move to confer the much-awaited infrastructure status to affordable housing will have a multi-pronged impact across various industries and will be largely beneficial for the real estate sector.

It will ensure easier access to institutional credit under priority sector lending and help in reducing developers' cost of borrowing for affordable projects. The approval process for affordable projects will be simplified; it will create clear guidelines and increase transparency in the segment

Impetus to Renewable Energy

The Budget has given a boost to renewable energy, announcing another 20,000 mw of solar park development in phase II and a slew of duty reductions on components for fuel cell-based power generating and biogas systems, as well as wind energy equipment. The Budget announced solar power supply at about 7,000 railway stations in the medium term but a beginning has already been made at 300 stations.

7. Conclusion and Suggestions

The above analysis show that Priority sector lending has tremendous significance in terms of upgrading the indicators of inclusive growth to the society.

Further refinement in PSL will instill confidence among the weaker section as they will get loans at a cheaper rate. However, care should be taken that such advances are not misused by people other than the needy. The risk of NPA might also increase at certain times, but we believe the long term benefits will eventually win over short term losses. Priority sector lending will remain a liability if banks remain short-sighted and follow their cliché methods of lending. It has potential for a plethora of opportunities the moment banks reach economies of scale in the remote areas. A good strategy for the commercial banks will be appointment of a team of local people to provide door-to-door services. The employees have to come out of the boundaries of the bank to create a bond with the borrowers. The rules laid down to offer loans to the poor people should be simpler and easier to comprehend unlike the current processes. The borrowers will also feel at ease if local people are recruited for value added service as there won't be any language barrier.

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