*Priority Sector Lending – Status, Issues and Future Agenda**

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Colleagues from College of Agricultural Banking (CAB); in-charges of Priority Sector Lending in various banks assembled here and my colleagues from various regional offices of the Reserve Bank who have joined over video conference- a very good morning to all of you! I consider hosting of this conference on credit flow to priority sector by the CAB, a very timely initiative indeed. Such conferences are extremely important as they provide a platform for exchange of views and feedback that serves as inputs for policy formulation. I believe that policies framed in isolation will look good on paper but would not serve much purpose when implemented on ground.

Introduction

2. The overarching philosophy behind prescribing the priority sector target for banks is to enable sections of society, which though credit worthy, are unable to receive credit from the formal system, either in adequate measure or in a timely manner. There are economic reasons why some sectors/borrowers do not receive adequate finance. At any given point of time, the lendable resources at institutions are limited and there is always a trade-off between how much time and effort can be put in and what kind of topline and bottom line the new businesses would generate. Given this sort of business dynamics, it is possible that the sectors which rightly deserve bank credit get excluded. This is precisely the motivation behind institution of priority sector lending norms. These guidelines are revised from time to time keeping in view the developments in the economy.

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Priority Sector Lending (PSL): a business case

3. Before I come to specifics, let me touch upon certain policy and strategy issues. The PSL Guidelines have been in existence for a long time now – there are targets, sub targets, but sadly most of the time, these norms are viewed more as a matter of compliance. The first and the most important message which I would like the PSL chiefs of the banks present here to carry to your senior management and the Board of Directors is that lending to priority sector is good business for all the right and justifiable reasons. Perhaps, it would be possible for you to put across your arguments more persuasively now than ever before. I say so because in the last few years we have seen over exposure of banking system to large corporates and consequences thereof. The excessive lending to corporate sector was the outcome of what I call 'least input and maximum output' approach. With little effort one could create large credit volumes whereas creating similar volumes in the priority sector would have required commitment of larger resources in terms of branch staff and operating people.

4. There is another dimension to why focusing on smaller loans would become all the more necessary now and that is the regulatory aspect. Couple of noteworthy changes have happened in the recent past (i) there is a revision of single and group borrower exposure limit; and (ii) an overall ceiling on exposure of an entity to the banking system has been mandated. These developments would push the corporates to gradually shift to markets for meeting their funding requirements. Apart from bitter experience of the past and need for risk diversification, earning potential presented by priority sector lending is another reason why banks should look elsewhere for better business opportunities. Having said that, we have already been witnessing a conscious move by the banks into 'retail' segment from corporate. I am not suggesting that movement to retail is not okay, but

from overall economic and credit perspective, retail loans are not productive loans in the hands of the borrower as they neither generate income nor they lead to further economic activities. On the contrary, loans to segments such as agriculture, small and micro enterprises do support economic activities, generate income and also surplus. Such borrowers then become worthy recipients of retail credit. That is the larger philosophy and reason for moving over to priority sector as a business case.

Is there a true priority sector vertical?

5. The second thing which I want to mention, something which is more relevant for public sector banks, to some extent for Regional Rural Banks (RRBs) and possibly for some private sector banks as well, is about the way the priority sector vertical works. Typically in a public sector bank, the responsibility for priority sector is spread across several verticals. There is a rural credit or an agricultural finance vertical, a separate Micro, Small and Medium Enterprises (MSME) vertical, the affordable housing segment may be part of retail and the renewable energy and the medium industries, included in the priority sector in the last revision, quite possibly, may be with mid-corporate or large credit or corporate group. There may even be another financial inclusion vertical sitting still separately. I am not sure whether there is any coordinated effort between these verticals to chalk out a comprehensive strategy for lending to priority sector. Resultantly, the priority sector vertical is reduced to a data collection and statement generating vertical. Further, I am also not sure how many Bank Boards discuss priority sector strategy in the board meetings.

6. It is necessary that all these verticals evolve within themselves and come together as a cohesive group, prepare a strategy and then take it to the Board for broader discussion and guidance. The priority sector activity should not remain confined to being a mere data collection exercise.

Is there a linkage between plan approved by State Level Bankers' Committee (SLBC) and plan of the priority sector vertical?

7. There are several agencies involved with priority sector activities of banks. There is the SLBC structure wherein District Credit Plan (DCP) is prepared and the Lead Bank offices operate at district level. NABARD prepares the Potential Linked Credit Plan (PLP), SLBC adopts it and then it is distributed amongst all banks. I have a suspicion that between the overall priority sector strategy and what happens at the SLBC and DCP level, there may not necessarily be any logical linkage. In the Reserve Bank we are looking at revamping the entire structure of SLBC and as such, some of these will undergo a change.

Data extraction and its implications for priority sector

8. Currently we have a project underway within the Reserve Bank which would enable extraction of data directly from banks' Core Banking Systems (CBS). In the entire credit planning exercise data infirmity has been a major factor and in some sense, has become an impediment for banks in arriving at right conclusion and right strategies. This project is at a fairly advanced stage now. However once this is implemented, it should not once again be seen as a data cleaning and compliance exercise. This is a great opportunity for banks because they can use the data, apply analytics and prepare the right sort of strategy. They can decide on their focus area and product once this robust set of data is available. It is important that the senior-level functionaries appreciate this exercise in that sense.

Research

9. The last point that I would like to make on the broader policy and strategy aspect is that time has come for individual banks to also invest in research – not very intense academic research – but research to the extent that is helpful in making policies and business strategies relevant for their own purpose.

10. Let me now come to some recent changes and emerging opportunities in the priority sector.

Diversified universe

11. In the last revision the scope of priority sector has been enhanced substantially. Some new sectors like renewable energy, medium enterprises, agro processing, social infrastructure and agricultural infrastructure have been included. Thus, new activities have been allowed but at the same time, to make sure that the most deprived within this large umbrella are not put to disadvantage, certain sub-limits for small and marginal farmers and micro enterprises have also been introduced. This kind of revision and structure gives the flexibility to each one of you to identify your area of strength and put maximum effort there. This way you can generate surplus and trade that in the Priority Sector Lending Certificate (PSLC) market while buying certificates in areas where others have generated surplus. This is how the whole philosophy of PSLC will work. I will dwell upon the developments in the PSLC market a little later.

Potential for job creation, self-employment and implications for priority sector

12. There are few emerging opportunities. One arises from the demographic changes which lead to entry of large number of job-seeking youth within the system. It would not be realistic to expect all of them to be absorbed only in the formal sector. Many of them would be gainfully employed in pursuing vocations like low-level manufacturing, services or would operate small enterprises. Thus, large number of people will have the potential of being self-employed and that by translation would mean business for banks. There are various Government of India (GoI) initiatives like Make in India, Start Up India which are aimed at providing a fillip to this eco- system. But unless there is research, analysis of data, policy and strategy, these opportunities cannot be exploited completely.

Rapid urbanisation and its implication for priority sector

13. The other broad phenomenon which is unraveling and would likely accelerate in the days ahead is rapid urbanisation. At present about 32 per cent of the population lives in urban areas and it is expected that in next ten to fifteen years, this figure will be around 42 per cent. This phenomenon once again brings to the fore the need for proper communication among various verticals and a cohesive strategy for the bank as a whole. For example, the people shifting from rural to urban areas- they may be your client in rural area but when they migrate to semi-urban or urban areas, is there any exchange of information between the rural and the semi-urban/ urban branches about where these people are migrating? Such communication assumes significance because when they migrate they would have new needs and they might adopt a vocation, which may need funding; that's why I am suggesting that as a business strategy banks need to have an integrated approach. They must create appropriate communication channels to tap such potential in the migrating population.

Is Financial Inclusion (FI) a part of priority sector?

14. As I mentioned earlier, in many banks FI is a separate vertical. In such situation again there would be absence of coordination. One very strong and nuanced point which you really have to carry back from this conference and work on is that we

become conditioned to working in a certain kind of organisational set up, we continue to work in silos, a thought never comes to the mind that there may be a need to integrate all this and it can throw up a very interesting and new structure. I suggest that you can include the FI vertical as part of the priority sector vertical if it exists separately within your overall strategy.

Low cost credit delivery through technology

15. Finally what you need to bear in mind is that the small and marginal farmer, micro enterprises, affordable housing very well become half or more than half of the priority sector. However, if this segment is to be served profitably, it can only be done with intense use of technology and therefore, banks need to have low cost delivery model. Quite a few banks both from public and private sector have developed technology-based low cost credit delivery models and are doing quite well.

Use of alternative credit scoring models

16. The segment comprising of micro enterprises *etc.*, if you try to fit them in regular credit rating/ scoring model that will not work. If you want to judge them against the usual norms of debt equity ratio, debt service coverage ratios *etc.*, it will be a non-starter. Therefore, you have to look at the method of credit scoring again. A lot of work in this regard has been done in our financial system and many players have moved to credit scoring where payment history, remittance history, bill payment history *etc.* are collected as data points for analysing borrowers' repayment capabilities. Today all these data points are available one way or the other. Some of the banks have used it for developing pre-approved limits for small borrowers. This is done in advance and borrowers do not need to approach the banks rather it is the banks that approach the borrowers. We have had hunting limits for corporates and now the time has come when this has to be made available to small borrowers and the common person.

17. These are some issues that I wished to share with you on the execution side of priority sector. One has to be mindful of the opportunities which are emerging and take advantage of these opportunities to make priority sector lending successful.

Performance under priority sector lending

18. Now I will quickly come to some of the issues around credit flow to priority sector. When I look at the performance under newly introduced sub-targets for 2016-17, though the data are provisional, I find some interesting trends. Both public sector and private sector banks have done well under overall priority sector lending targets. Public sector as a group is slightly below 40 per cent mark whereas private sector banks have exceeded 40 per cent by a good margin. Foreign banks with more than 20 branches are adhering to their roadmap as they have to gradually reach the milestones. Foreign banks with less than 20 branches, as of now, also appear to be on track.

19. While in the case of small and marginal farmer target, the public sector banks have slightly exceeded the sub-limit of 8 per cent; the private sector banks have fallen short of these targets and achieved around 5 per cent during 2015-16. Even in 2016-17, it has not improved substantially. On the other hand, the public sector banks could not achieve the sub-target under micro enterprise while the private sector banks could exceed the target (more than 8 per cent) in this segment. It quietly brings a larger point that the priority sector activities of private sector banks still remains predominantly urban-focussed even while they have developed good rural network and if not so, alternatively the hub and spoke model is functioning. I will leave it to the strategies of banks as to the areas on which they want to focus; however, one has to be conscious that there may not be an unending supply

of PSLCs if there is a gross deficit coming from one particular sub-segment. Perhaps it will be a good business strategy to leave the deficit in marginal terms and not in a larger percentage as it may later on prove to be a costly situation.

Enablers in priority sector lending

20. Now let me briefly touch upon some of the enablers which have been put for the increased credit flow particularly to MSME sector because this is a sector which is very important and crucial for job creation which is both a requirement and a challenge for the country.

a. MSME Sector

(i) Factoring transactions

To increase liquidity support for the MSME sector, the Reserve Bank had allowed factoring transactions on 'with recourse' basis to be classified as eligible for priority sector by banks. Further, the factoring transactions taking place through Trade Receivables Discounting System (TReDS) are also eligible for classification under priority sector. It is understood that many banks have their own vendor finance platforms akin to TReDS where they are undertaking factoring transactions on 'without recourse' basis to MSME and 'with recourse' to the corporate. Since two entities licensed under TReDS have become operational, it is expected that it will lead to better price discovery and more favorable rates for MSMEs . With added benefit of priority sector status, banks may actively consider undertaking 'without recourse' factoring transactions through TReDS.

(ii) Capacity building

Over the last two years, CAB has taken a major initiative for capacity building of bankers for lending to MSMEs, popularly known as National Mission for Capacity Building of Bankers for Financing MSME Sector (NAMCABS). I understand till now more than 5,000 bankers have been trained. If we reflect back, NAMCABS has put emphasis on three categories of participants, (i) policy makers at the corporate office (ii) officers sitting in specialised MSME branches and (iii) the trainers in the individual bank's training establishments. However, CAB cannot be expected to train the entire banking community. Idea was to create a focus group within the bank which could act as the force multiplier. But if these trained resources are not gainfully employed, then it defeats the very purpose of the capacity building efforts being made by the College.

(iii) Cluster approach

Empirical evidence suggests that the MSME lending is much more meaningful and strong if cluster approach is adopted. Rather than financing stray units on standalone basis, if the banks are looking for business opportunity and furthering credit flow to units having strong repayment potential, then cluster approach becomes very much meaningful. I would suggest that not only should banks focus on financing in existing clusters, but also encourage promoting of such clusters. To do so, banks need to have a strong data base support and in-house research to identify the area, the activity and develop a delivery model.

(iv) Co-origination of loans

The next point relating to MSME and more so to micro units is something about which I have been speaking in various fora for quite some time. This is on co-origination of loans where some work is being done within the Reserve Bank. If one looks at the sector, which has received maximum credit from banks, it is the financial intermediation sector. This means banks have been lending to Non-Banking Financial Companies (NBFCs) / Micro Finance Institutions (MFIs) / housing finance companies for on-lending purposes. To my mind, this is an example of lazy banking and no one gets benefitted at the end- neither the banker nor the ultimate borrower. So can we develop a regular co- origination model? Banks and NBFCs/ MFIs can join together in origination of loans in a certain agreed structure of risk sharing and various covenants around the loan. This will provide a good avenue to banks to expand their portfolio and diversify their risk. It will be remunerative also and at the same time will help banks' priority sector compliance as well. This is under discussion in the Reserve Bank and we will take a final view in some time.

b. Priority Sector Lending Certificates (PSLCs)

The response to the PSLCs trading has been encouraging. In the first year itself, about ₹1,265 billion worth of offers were put on the PSLC platform, out of which roughly ₹498 billion worth of offers were settled, which is a good beginning. Among the four categories under PSLCs trading, higher trading is observed under PSLC-Small and Marginal Farmers and PSLC- General Category. Among the four categories, the transaction volume is about ₹230 billion under small and marginal farmers, ₹200 billion under general category and rest of the amount under other two categories. As expected, most of the trading occurred especially at the end of the quarters, since the priority sector lending targets are currently monitored quarterly. The PSLCs which were traded in the first quarter were traded at higher premium and this is obvious because the PSL rights get extinguished by March 31st. PSLC platform is an order matching platform but a disquieting feature that we have observed is that some entities strike a bilateral trade and then put it on the platform which vitiates the spirit of anonymous order matching. PSLC should be used as it is designed and meant to be used and not merely as a reporting platform.

21. Before concluding, I would quickly mention a few things, which are relevant to all categories of banks – public sector, private sector, regional rural banks and small finance banks.

(i) Low cost housing and sanitation

Within priority sector, low cost housing is emerging as a high potential area and banks should focus on that. In the last revision, we have allowed lending to individual sanitation infrastructure to qualify as priority sector. There is also a national mission for Swachh Bharat and a movement for creation of toilets in individual household by Government of India. Within the overall priority sector planning, banks must look to focus on providing lending for creation of sanitation infrastructure.

(ii) Agriculture value chain financing

The second area is agri-financing. Until and unless, there is an organised movement to finance agriculture value chain, this will remain more a compliance activity and will not provide the kind of benefit the economy should receive. Unless agri-financing is dovetailed with value chain, the credit flow to this segment will be more of a compliance matter.

(iii) Financing water conservation and solar pumps as an economic activity

The third area is water conservation. From my personal experience from my previous stint in a commercial bank, I can say that water conservation can be exploited as an economic activity for bank credit in many parts of the country. In time of drought, it supports crop cultivation and in long term, facilitates raising of ground water table. Banks should look at it critically. Again this activity requires research, survey and building-up a model to reach out to farmers. Similarly solar pump-sets could be another area for bank finance. All these efforts will be very much meaningful for small and marginal holdings. These are the kind of things, which can prove meaningful but this will be an incomplete exercise without simultaneously providing support to financial literacy.

(iv) SHG bank linkage model

Another area is SHG model. SHG model has been a robust model in the past. There has, however, been some slowdown of late; but banks should also look critically into the credit delivery through SHG bank linkage model.

(v) Rural posting

Specifically in public sector banks, there is a need to critically look at the entire policy of rural posting. There are rules and other regulatory requirements, but within that framework banks need to have a more meaningful policy for rural posting. Bank staff posted in rural areas should remain there for a reasonable period and second, whatever period they are there, they should deliver to an optimum extent. I know this is a major issue in the functioning of rural branches of banks and as in-charges, you need to look into this area closely.

(vi) Small Finance Banks (SFBs)

The Reserve Bank has recently come out with a detailed compendium of priority sector guidelines for SFBs. SFBs have also been allowed to trade in PSLCs once they are operational even without waiting for acquiring 'scheduled' status. More than 15 per cent of trade happening under PSLCs is by SFBs, which is a healthy trend. From the current year itself, the SFBs have been allowed to participate in SLBC meetings but there is no requirement for them in the annual credit plan until April 2018. For SFBs, payment banks as their BCs could emerge as a good combination as many payment banks have wide last-mile reach.

Conclusion

22. I would like to conclude here just by mentioning that all of you as in-charges of priority sector lending in your respective banks can make a difference in a large constituency, which is priority sector. Each credit extended by banks to priority sector can be a life changing event and the priority sector credit as a whole can change the lives of a multitude of people of this country. You have to consider your role as that of a change agent. I urge all of you to schedule a discussion with your Top Management, convey to them the take-away from this conference and then take it to your Board.

I wish you all the best and thank CAB for inviting me to address this gathering.