Revised Guidelines on Priority Sector Lending: Rationale and Logic*

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Shri Alok K. Misra, Chairman, IBA and CMD, Bank of India; Shri Pratip Chaudhuri, Chairman, State Bank of India; CMDs/CEOs of other banks; other senior members of the banking fraternity, delegates to the conference, members of the print and electronic media, other distinguished guests, ladies and gentlemen. It is, indeed, a matter of great pleasure for me to deliver this special address at the annual FICCI – IBA Global Banking Conference – FIBAC 2012. FIBAC has become one of the important events in the banking calendar and has emerged as a forum for serious deliberations on issues facing the banking industry and generation of several new thoughts and ideas. The theme of this year's conference emphasises on attaining sustainable excellence through customers, employees and technology. Drawing from the theme, my talk today would focus on bank finance to vulnerable sections of the population, which have, hitherto, been largely neglected and hence, require special emphasis in order to attain the goal of sustainable banking excellence. The interplay of the three elements of customers, employees and technology would be key to this.

2. I see that the BCG has released a knowledge paper on Productivity in Indian Banking in the inaugural session of the Conference. Banks, as is widely accepted, perform the important function of financial intermediation in the economic system. High productivity in performing this function requires banks to have operational and allocational efficiency. Operational efficiency entails performing the intermediation function at the lowest cost. Allocational efficiency requires that resources are allotted to the most deserving and productive segments of the population. The entire scheme of priority sector lending in India is aimed at attaining greater allocational efficiency, thereby facilitating effective financial intermediation by banks. I feel that an effective and transparent framework for priority sector lending, which is the objective of our revised priority sector guidelines, would help attain improved productivity/efficiency and ultimately, the goal of sustainable excellence in banking. The guidelines have generated considerable debate and I thought it proper to use this forum to clarify our thought process behind the guidelines and allay some of the apprehensions expressed by banks.

The Evolution

3. Before deliberating on the mainstay of today's topic let me briefly touch upon the evolution of priority sector lending in India. Indian banking is a unique example of harmonious blend of commercial banking with social banking. Bank credit has an immense role in the development of the economy. Besides economic growth, it should also lead to removal of poverty and equitable distribution of income. Several Committees have looked into the aspect of rural credit and priority sector credit in India. The Indian Central Banking Enquiry Committee (1931) was one such committee constituted in pre independent India. During 1960s, came the concept of Social Control, which was to ensure an equitable distribution of credit keeping in view the relative priorities of our developmental needs. The description of the priority sectors was formalised in 1972 on the basis of the report submitted by the Informal Study Group on Statistics relating to advances to the Priority Sectors constituted by the Reserve Bank in May 1971. In November 1974, banks were advised to raise the share of priority sector in their aggregate advances to the level of 33 1/3 per cent by March 1979.

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4. Subsequently, on the basis of the recommendations of the Working Group on the Modalities of Implementation of Priority Sector Lending and the Twenty Point Economic Programme by Banks (Chairman: Dr. K. S. Krishnaswamy), all commercial banks were advised to achieve the target of priority sector lending at 40 per cent of aggregate bank advances by 1985. Sub-targets were also specified for lending to agriculture and the weaker sections within the priority sector. The eligible activities and entities qualifying for priority sector have undergone many changes since then. The guidelines on priority sector were last revised in the year 2007 based on the recommendations of an internal group. In addition, several Committees including the Committee on Financial Sector Reforms (Narasimham Committee) has looked into the aspect of priority sector.

5. The need for improving credit flow to certain sectors, prevalent at the time of bank nationalisation, remains important today also, as large segments of the population continue to be deprived of access to credit from the formal financial system. We are well aware that this segment of the population mainly consisted of farmers; especially small and marginal farmers, artisans, weavers, and weaker sections. Over a period of time, the role played by commercial banks increased financing of priority sectors, *viz.*, agriculture and small scale industries.

6. There has been an argument that the share of agriculture in GDP is very low and also that there is not enough credit absorption capacity for agriculture credit and hence, the target for direct agriculture is on the higher side.

Table 1 : Sectoral Composition of GDP (at Factor Cost)

(per cent)

Year	Agriculture	Industries	Services	Total
1950-51	51.88	11.10	34.63	100.00
1960-61	47.65	13.68	36.60	100.00
1970-71	41.66	15.98	40.91	100.00
1980-81	35.69	18.05	45.26	100.00
1990-91	29.53	20.56	49.61	100.00
2000-01	22.31	20.69	57.00	100.00
2010-11	14.51	19.95	65.54	100.00
2011-12	14.01	19.22	66.77	100.00

Notes : Data for 2008-09 are Provisional Estimates, 2009-10 are Quick Estimates and 2010-11 are Revised Estimates.
Source: CSO ; Base Year:2004-05; Data at Constant Prices

Table 2: Outstanding Credit of Scheduled Commercial Banks According to Occupation

(per cent)

At end	Agriculture	Industries	Others	Total
Dec/1972	9.0	61.2	29.8	100.0
Jun/1981	16.7	49.1	34.1	100.0
Mar/1991	15.0	47.6	37.5	100.0
Mar-2001	9.6	43.9	46.5	100.0
Mar-2011	11.3	39.6	49.1	100.0

Source: BSR Returns, RBI; Others include transport operators, professional and other services, personal loans, trade finance and all others

The declining share of agriculture in GDP cannot be accepted as a valid reason for prescribing lower targets, as agriculture is an important sector considering the livelihood it generates for almost two-third of India's population. It is also critical for ensuring food security and poverty alleviation. Besides, it needs to be borne in mind that this sector does not have recourse to other sources of finance such as equity, Commercial Papers, *etc.* The inherent weakness in the co-operative structure restricts its ability to cater to credit needs of the agricultural sector.

7. The All India Rural Credit Survey carried out in 1954 indicated that formal credit institutions provided less than 9 per cent of rural credit needs in India. Moneylenders, traders and rich landlords accounted for more than 75 per cent of rural credit. As per the 'Situation Assessment Survey of Farmers' conducted as a part of the 59th round of National Sample Survey (January-December 2003), at an all-India level, estimated number of rural households was 147.90 million, of whom 60.4 per cent were farmer households. Out of this, 74.97 million households were small and marginal farmer households (SFMF). Out of the 74.97 million SFMF in the country, only about 46.3 per cent, *i.e.*, 34.70 million farmer households had access to credit, either from formal or informal sources. The most important source of credit for farmers, in terms of percentage of outstanding loan amount, was banks (36 per cent), followed by moneylenders (26 per cent). This

indicates that a vast majority of farmers are still deprived of credit from formal financial institutions. Dependence on usurious moneylenders continues to afflict the rural poor.

Background for the Revised Guidelines

8. The changing economic conditions and our learnings from the operation of the priority sector lending scheme over the years led to a felt need for revisiting the priority sector guidelines and updating it in line with our current national priorities. It was also felt that more clarity needs to be given to the entire gamut of priority sector and to ensure that the target sectors get credit in time and in right quantities. The need for revising the guidelines was also raised at various fora, both within and outside RBI. In this background, an expert committee was appointed by RBI under the Chairmanship of Shri M.V. Nair (the then CMD, Union Bank of India and former Chairman, IBA) with members drawn from across banking, agriculture, MSE and other sectors. The Committee submitted its Report to the RBI in the last week of February, 2012. The same was placed on the RBI website and comments/suggestions were called for from all stakeholders and the general public. After taking into account the comments/suggestions received and after due deliberations, RBI came out with the revised guidelines on July 20, 2012.

Basic Philosophy of the New Priority Sector guidelines

9. Before going into the nuances of the new priority sector guidelines, I would like to highlight the four basic pillars/philosophy upon which these guidelines are based. These are:

- Priority sector refers to those sectors of the economy which, though viable and creditworthy, may not get timely and adequate credit in the absence of this special dispensation. Typically, these are small value loans to farmers for agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections. Those sectors which are able to get timely and adequate credit would not qualify for priority sector status.
- Priority sector activities have to be carried out by banks as a part of their normal business operations. It should not be viewed as Corporate Social Responsibility. On the part of the Reserve Bank, one important facilitation in this regard has been that pricing of all credit has been made free, though with the expectation that pricing should not be exploitative.
- Banks should lend directly to beneficiaries instead of routing these loans through intermediaries. This will ensure better management of risks and also reduction in transaction costs for such loans.
- Our Priority Sector efforts would not be successful unless we create innovative structures, products and processes. Market players should be willing to take risks and innovate.

Wrong Notions about Priority Sector Classification

10. I would also like to dispel two wrong notions commonly cited regarding priority sector lending:

- Priority Sector guidelines are aimed at helping banks attain the targets: The objective of these guidelines is not to facilitate banks to achieve the priority sector targets but to ensure easier access to credit to those deserving beneficiaries who are otherwise not getting it, or finding it difficult.
- If a sector is not classified as priority sector, it will not get bank credit: Non-classification of a sector as priority sector does not imply that banks should not extend credit to the sector. It only implies that the sector would receive credit even without priority status and hence violates the principle stated above. In fact, the available data suggests that while flow of credit is more for non-Priority Sector advances, it is less costlier than Priority Sector credit.

Let me re-emphasise that unless the basic philosophy behind these guidelines are understood and the wrong notions are clarified, it would not be possible to engage in meaningful deliberations on the subject of priority sector lending.

PSL Targets and Descriptions

11. The revised guidelines aim at implementing the essence of the recommendations of the Nair Committee without dismantling the established and accepted structure of priority sector lending. The overall target under priority sector is retained at 40 per cent as suggested by the Nair Committee. The targets under both direct and indirect agriculture are retained at 13.5 per cent and 4.5 per cent, respectively. The focus of the guidelines is on direct agricultural lending to individuals, Self Help Groups (SHGs) and Joint Liability Groups (JLGs).

12. However, one significant innovation that we have introduced is that bank financing of agriculture through non-financial intermediaries such as Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large-sized Adivasi Multi Purpose Societies (LAMPS) ceded to or managed or controlled by such banks, has also been treated as direct agriculture. This dispensation would facilitate direct agricultural finance by banks which do not have wide presence in rural areas and would, otherwise, have struggled to meet the targets.

13. We have kept the definition of agriculture sector unchanged with the exception that credit to institutions has been treated as indirect finance and credit to food and agro processing industries has been shifted from agriculture to micro and small enterprises. The existing definition of the industries sector including Micro and Small Enterprises has also been retained.

14. In the services sector, however, we have made some changes and expanded the definition of services sector to include services which were not specifically listed earlier, with the rider that credit limit is fixed at ` 1 crore. While the services sector is contributing around 67 per cent of our economy, data from major 47 banks at end Mar 2012 indicates that services sector received only 23.6 per cent (` 10.17 trillion) of bank credit, 18.4 per cent (` 7.87 trillion) was accounted for by personal loans whereas agriculture sector received 12.2 per cent (` 5.23 trillion) and industries received 45.8 per cent (` 19.67 trillion)[1]. This highlights the inadequate flow of credit to services sector. There is a need for banks to go to the interiors, to mofussil towns and cities and expand credit linkage in those areas. There is a mass of people residing in these places that are willing to provide security to obtain credit, but are, currently, not getting the credit. Providing loans to these segments, particularly for productive purposes, will also help in tackling the problem of retail inflation.

No New Targets/sub-targets

15. One important area where we have diverged from the views of the Nair Committee is that we have not imposed any new targets under the priority sector framework. The Nair Committee had recommended certain additional sub-targets for credit to micro enterprises, small and marginal farmers and realignment of certain existing targets. We have consciously decided against this as we believe that fresh targets would distort the allocation of credit.

16. Besides, though we have not prescribed fresh targets, the interests of small and marginal farmers and other individuals will be taken care by shifting the direct part of agricultural loans to corporates, partnership firms and other institutions to indirect agriculture.

Target for foreign banks

17. As all of you are aware, foreign banks operating in India had been given a special dispensation on priority sector lending. The sole argument for this preferential treatment was their limited branch network. Now, the stage has come where there is a need to have a relook into this preferential treatment; again based on the same logic of branch network.

18. Nair Committee has recommended that foreign banks may also be mandated to achieve overall priority sector target of 40 per cent of adjusted net bank credit (ANBC) and focused priority sector target of 7 per cent of ANBC for lending to micro enterprises, at par with domestic banks. We have adopted a graded approach

[1] MPD Data of major 47 banks as on Mar 23, 2012

while fixing priority sector targets for foreign banks with smaller banks with less than 20 branches having a target of 32 per cent and foreign banks with 20 or more branches being mandated to attain a target of 40 per cent. Several foreign banks have expressed their firm belief in the India growth story and have shown keen interest in contributing to and actively participating in the same. If that be so, for such banks, with a larger presence in India, we would like to eliminate the regulatory arbitrage by prescribing targets similar to Indian banks.

Is this necessary?

19. Definitely Yes. After nationalisation, the task of financial inclusion was considered, primarily, to be the responsibility of public sector banks alone. However, over the years, it has become evident that public sector banks alone cannot deliver on this mandate. This is not due to a lack of willingness on their part, but due to structural inadequacies and lack of autonomy in areas such as recruitment of staff from particular locations, compensation practices, *etc.* In fact, I have always believed that financial inclusion in India would be brought in by foreign/private sector banks and considerable progress is being made by some of them in this regard.

20. One basic question that often arises is that what is the need for foreign banks' presence in India and what is the value added by their presence? It is felt that their presence is required not just for innovations in corporate finance and derivatives business, but also in areas such as agriculture and MSE finance. They can draw upon their global experience to develop innovative solutions and delivery models that would deliver credit in a cost effective manner to agricultural and rural areas. This will spur the domestic banks also. As an analogy, an example of innovation that comes to my mind is computerisation, which was first introduced by foreign banks in India and was, subsequently, taken up by private sector and public sector banks. The impact that this innovation has had on banking in India needs no mention. Some other such areas include ATMs, technology banking, *etc.*

21. Foreign banks are encouraged to open branches in the rural areas as well and to play an equal role, along with domestic banks, in lending to the priority sector. India being a growing economy, there exist enough opportunities and avenues for foreign banks having 20 or more branches to invest in 'priority sector' areas (especially in agriculture and MSEs) and meet the target set, which is to be achieved over a period of five years. The time has come for foreign banks having large and long presence in India to play an active role in the priority sector, shoulder to shoulder with Indian banks and it is felt that there cannot be any distinction here.

Why 20 branches and above?

22. The number is not just an abstract one. We have done considerable research before the guidelines were finalised. These banks have had presence in India for nearly 100 years, *i.e.*, even before some of the public sector banks were born. These banks know the Indian economy and are well versed with the Indian culture. We welcome these banks to join and help the growth story of India.

23. We would like these banks to come back to us with detailed plans on how they would be meeting this target. We are willing to discuss any difficulty faced by foreign banks in this regard. We have an open mind on this.

Loans to Non-Bank Financial Intermediaries for on-lending

24. In terms of the pre-revised guidelines on lending to priority sector, bank loans to other NBFCs (other than MFIs including NBFC-MFIs) for on-lending were not classified under priority sector. We have retained these guidelines. Loans through MFIs (including NBFC-MFIs), which adhere to criteria prescribed by RBI, have been given PSL status as the credit is expected to be going to the most vulnerable sections of the society and low income groups of the population.

Housing

25. In the pre-revised guidelines, housing loans up to ₹25 lakh were categorised as PSL irrespective of the location. The revised guidelines prescribe that loans up to ₹25 lakh for housing in metropolitan centres with population above ten lakh and ₹15 lakh at other centres would be treated as PSL. This is expected to fine tune

the disbursal of need based housing loans in all centres. One of the additions in the revised guidelines aimed at augmenting credit flow in the housing sector is that loans for housing projects exclusively for economically weaker sections and low income groups, provided the cost does not exceed ` 5 lakh per dwelling unit, have been recognised as priority sector for the first time to boost the provision of houses to weaker sections and low income groups.

26. As a stated policy, bank loans for on-lending by NBFCs, except MFIs, are not permitted as priority sector in the pre-revised and revised Priority Sector guidelines. Since HFCs are essentially NBFCs, it is not logical to treat bank loans to HFCs for on-lending, as priority sector. Further, banks being financial intermediaries, need to lend directly instead of relying on NBFCs/HFCs for providing credit.

Investments by Banks in Securitised Assets and Outright Purchases

27. Purchases/investments in securitised assets are an important avenue for meeting priority sector requirements for banks without significant branch presence. This is also critical for banks which do not have the expertise to originate small value loans. Such banks can rely on the expertise of other intermediaries, who can originate the loans, which can then be taken over into the bank's books through securitisation. I would only like to advise that such transactions should not be done merely to tide over the regulatory requirement at year- ends.

28. Banks are allowed to continue to classify their investments in securitised assets and outright purchases, where the underlying assets qualify for PSL status, under respective categories of PSL, provided they follow the RBI guidelines on securitisation and outright purchases. Pricing for the ultimate beneficiary has been capped at Base Rate plus 8 per cent. Here we have slightly differed from the Nair Committee recommendations, which had linked it to bank's Lending Rate plus 6 per cent. We felt that linking it to Base Rate would ensure greater transparency in pricing and ease of monitoring. The ceiling on pricing, in contrast to the general freedom given to banks in pricing loans, is because free market still does not exist for the poor and hence, pricing is prone to distortions. The Nair Committee's recommendation to restrict the bank loans for on-lending, buy-outs and securitisation to a maximum of 5 per cent of ANBC is not accepted. This is to allow banks to build up PSL portfolio through the route of outright purchase/investments in securitised assets.

Investments/Purchase/Assignment transactions undertaken by banks with NBFCs, where the underlying assets are loans against gold jewellery

29. In terms of the pre-revised guidelines on priority sector, investments made by banks in securitised assets originated by NBFCs, where the underlying assets were loans against gold jewellery, and purchase/assignment of gold loan portfolio from NBFCs were not eligible for classification under **agriculture**. Such pool of loan assets against gold jewellery is generally extended by these NBFCs without proper credit appraisal and without verification of end use of funds. Some of our special scrutinies have confirmed this aspect. In the revised guidelines, such investments and outright purchases do not qualify for **PSL status**.

Other Highlights

30. A few other highlights of the revised guidelines are:

(i) Loans to individuals for educational purposes, including for vocational courses upto ` 10 lakh in India and ` 20 lakh abroad: The limits are not changed. However, the vocational courses were added recently under this.

(ii) Loans to individuals for setting up off-grid solar and other off-grid renewable energy solutions for households: This was not allowed in the pre-revised guidelines.

Management Information System (MIS)

31. Let me now turn to an area which is absolutely critical. There are several gaps in data on priority sector coverage and the existing data is not fully reliable. In the light of this, it was decided against prescribing fresh targets under priority sector. We, however, emphasise

that there is an urgent need for data cleansing so that we are able to generate fast, reliable and consistent MIS on the coverage of priority sector lending across all sections of the economy. This would prove to be a valuable input for refining our policy framework and strategies in this area. A separate circular would be issued on this subject.

32. One of the objectives of the revised guidelines is to ensure greater transparency in priority sector lending. I would urge banks to work towards this goal by having the courage and conviction to highlight any shortfall in achieving the targets instead of including ineligible loans under priority sector category. The generation of reliable MIS would be crucial to attaining this transparency.

Conclusion

33. The priority that senior management of banks accord to priority sector would determine the success of our efforts in this area. Without this commitment, it would not be possible to accomplish this task. Let me assure you that the top management at the Reserve Bank is fully committed to this goal, as is evident from the amount of time we spend on this subject at our meetings and outreach visits and the number of enabling policy initiatives that we have taken in this regard. Financial inclusion and priority sector credit are closely interconnected subjects as financial inclusion is the process and priority sector loans are the business effect/end product of the same in the books of the banks. If we are doing financial inclusion, then these targets are achievable, if not, then these are not. The new guidelines, then, is the new mantra. We need to be consistent in our approach towards financial inclusion and priority sector lending.

34. We are happy to share with all stakeholders our logic and rationale for the new guidelines and discuss further refinements, if any, and most importantly, how can we facilitate the achievement of these guidelines and ensure its effective implementation and monitoring. In fact, just last week, we have had a round of discussion with the CMDs/CEOs of banks. We would, however, emphasise that the basic conceptual framework for issuing these guidelines need to be appreciated by all players so that the goal of credit linking the deserving but deprived segments of the economy is successfully accomplished. Besides, as mentioned earlier, an efficient framework for extending bank finance to the vulnerable sections needs to be viewed as an essential prerequisite to attaining allocational efficiency in the economy, thereby contributing to productivity and efficiency of the banks in particular and the economy in general, which is the core objective of this summit.

35. I hope that this Conference devotes some time to deliberating this important subject and comes to a common appreciation of the logic and reasoning behind these guidelines and sees them as a vehicle to improve the productivity and efficiency of the Banking System. I wish the deliberations a great success.

Thank you.