Priority Sector Lending (PSL) and Inclusive Growth

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As per the Reserve Bank of India (RBI), "Priority Sector" refers to those sectors of the Indian economy that may not get timely and adequate credit in the absence of a special dispensation. Typically, these are small value loans to farmers and allied agricultural activities, micro and small enterprises, poor people for housing, students for education, and low income groups and weaker sections. Besides, Priority Sector (PS) also includes other categories of loans as announced by the RBI from time to time. The origins of Priority Sector Lending (PSL) can be linked to the voiced need in the late 1960s in India for "social control over banking" in line with the prevailing socialistic political mood in the country. The idea gaining currency was that banks should be allocating more credit to social sectors of the economy. Post the first round of bank nationalisation in 1969, PSL was introduced in 1972 on the basis of recommendations of the Informal Study Group constituted by the RBI. In 1974, RBI advised banks to increase PSL to one third of their overall credit by March 1979. As per currently prevailing norms, every domestic bank with greater than

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20 operating branches should ensure that at least 40% of its Adjusted Net Bank Credit[2] is lent to specific segments that qualify for PSL, of which Agricultural segments should comprise at least 18%, and Advances towards Weaker Sections another 10%. For foreign banks with less than 20 branches, the corresponding norms for PSL are 32% for overall exposure with no specific sub-targets for Agriculture or Weaker sections.

Even after 30-35 years of PSL prescriptions, most banks have struggled to comply. This begs the question as to why is it that despite the regulator's repeated directives, the PSL regime has not resulted in inclusive banking as desired. Today, banks are seen as a commercial entities, and regulation is pushing them towards maximising profits to enhance their viability and the collective stability of the banking system; on the other hand, the PSL regulation is pushing banks to make developmental loans which do not recover their full costs. Is it the case that conflicting prescriptions of being profitable and poor-friendly create confusion in the minds and actions of bankers? In the aftermath of bank nationalisation, the concept of subordinating profits gelled with banking objectives, but that is not the case today. Despite pushing hard the norms of PSL in more or less the same garb for 35 years, if less than 40% of the country is financially served by the formal banking system, the reasons are not hard to see – money will not flow to places where the return path is not obvious or cannot be protected. Legislating behaviour by binding all banks to extend PS loans, irrespective of their capabilities to do so or independent of the credit-worthiness of the borrower, is either likely to result in gross shortfalls or a lot of bad loans or both. The reality is that loans given to marginal borrowers who are not bankable does not reduce poverty or create employment in a sustainable manner as much as making well-appraised loans to borrowers, large or marginal, rural or urban who eventually pay back the loans and seek more for growth. This article talks of three specific points to bring some more clarity to the difficult area of PSL.

1. The Committee[3] which reviewed the PSL regime in 2012, and came up with a comprehensive set of recommendations, did not change the basic existing architecture of PSL regulation. The Committee analysed several facets of PSL, and eventually concluded that the prevailing objectives are relevant to the cause of economic and social development of the country, and essentially made changes to the form rather than the substance of the guidelines. There should be no quarrel on whether PSL is required, but one should deeply think why it has not succeeded in deepening banking activity as much as desired for four decades and therefore, what substantive changes might be in order. When the PSL norms were first mooted four decades ago, they were in line with the then national priorities, such as food shortage, low industrial base, shortage of foreign exchange, under-developed financial system, and so on. Surely, the national priorities have changed over the last four decades, as India has moved up to middle income level status and integrated much more with the global economy. E.g. the emphasis now should be to increase employability and skill upgradation and not as much employment protection of specific set of persons, or to create basic infrastructure and improve competitiveness of the economy, thus creating more jobs. The size of agriculture relative to overall GDP has been shrinking and therefore there is a case for reviewing the share of credit to agriculture in the PS dispensation. The nature of agriculture has also changed significantly in this period requiring re-direction of credit – E.g. there is increasing functional consolidation of landholding (without change of ownership commensurately), contract farming has grown, there is greater application of modern technologies, and there is rising automation in several states. However, the accent of PSL seems to be towards marginal and small farmers who are working under difficult conditions, which make the loans risky and bankers reluctant to lend. Instead, PSL norms should nudge bankers to incentivise marginal farmers to adopt modern methods and viable models of farming rather than direct bankers to lending more to marginal farmers compulsively to maintain an unviable status quo. Another indication of anachronismis that today about 60% of the national economic activity is centred in urban areas, where there is a steady migration of persons and the PSL norms do

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[2] Computation would be based on greater of Aggregate Net Bank Credit or Credit Equivalent of Off-balance sheet exposure.

[3] Chaired by Mr. M.V. Nair, then CMD of Union Bank of India

not do enough here. In many urban centres, a good fraction of the working population is migrant but only a few sub-segments of these qualify for PSL category. Most of them are self-employed or work in the unorganised sector, and banks prefer not to lend to them as they do not fit the traditional borrower's template (lack of collateral or proof of identity etc.), and are therefore targeted by the non-banks, micro finance entities or the local money lenders. Third, most lending to Infrastructure sector is not considered as PSL, while by nature, infrastructure assets enhance social inclusion. Fourth, despite the rightful inclusion and stress on lending to MSME sector, the same has not benefitted from adequate credit from the banking sector. One of the ideas in the Nair Committee was to not encourage banks lending to "medium" sized MSME units, as they were found to be getting sufficient funds for growth. Instead, bank lending to "micro" segment has been made a specific target under the PSL. Again, this kind of regulation incentivises small units not to grow and attain scale and competitiveness as bank funding would be denied to them as they grow larger. Successful entrepreneurs tend to create multiple small units rather than consolidate operations.In turn, the banks are pushed by regulation towards the wrong end of the MSME scale which only increases scepticism towards micro-borrowers. A win-win situation could be created if the PSL regulation could nudge banks to lend to those 'micro' and 'small' units who put in the right governance structures to become bigger ('medium' units) and more competitive. Clearly, directing credit to small units (many of which are unviable with no incentive to get better) cannot be a prescription to deepen inclusiveness.

In essence, the overall objective of the PSL regime of making banking more inclusive is correct, but the rigidities of classification of various sub-segments and a lack of congruence between the targets and banker's interests make it hard to comply.

2. Regulation must recognise that commercial banks are not always the best vehicles to extend all the PSLs that this country requires. Unlike two or three decades ago, today there are several non-banking organisations that have scaled their operations in financial services, including NBFCs, private equity funds, Housing Finance companies, micro-finance institutions, cooperative banks, etc. Surely, their services can be more enlisted by the RBI to deepen financial inclusiveness. Over the years, the emphasis of PSL regulations seems to be that banks should make the loans directly on their balance sheets, and not through other intermediaries. Instead the basic objective of RBI's priority sector lending programme should be to enable all subsegments of economy (in particular, those that would not get commercially lent to) gain access to finance at reasonable rates (again "reasonableness" has to judged from the point of view of affordability to both lender and borrower, and also what the alternative is). It cannot be the case that the best way to reach loans to the under-banked is that each commercial bank should lend 40% of its net bank finance to a set of specified borrowers irrespective of whether it is profitable or cost effective to do so. In the era of specialisation and cooperation between different organisations, it will serve the system better if banks could partner with other entities that are better suited to provide PSLs, and confine their direct lending to their own areas of strength. Bank lending (refinancing) to other specialised entities should be encouraged and such lending should be counted as part of PSL in a more active manner than is the case now.

With regards to the small value loans, especially those made to farmers and rural households, it has been demonstrated over the past two decades that micro-finance institutions have been very successful in both offering and recovering such loans. While the MF sector did have its share of turbulence in the past few years, there are signs that most of the leading players have overcome the problems and with the new regulation stabilising, micro-finance loans are growing again. Clearly, micro-finance calls for expertise of a special kind for indentifying local issues, engaging with borrowers in their language, conducting risk appraisals on the basis of understanding local context, making the disbursements and managing a large number of small ticket loans economically – all

of which most commercial banks are clearly not geared to do for various organisational reasons. Therefore, there is a good argument for banks taking on the portfolios/loans ofMFIs by way of PCs/securitisation on a large scale rather than doing it on one's own balance sheet.

Mortgage finance has world over been accepted as one of the engines of economic growth, and involves specialised operational capabilities. Banks in India have entered this segment only in the last one decade or so. There are more than 50 specialised housing finance companies, some of which have developed deep expertise in this area. Again, this is a case where securitisation can be implemented and encouraged by making such portfolios eligible for PS status. On the other hand, one sees several banks trying their hands at manufacturing mortgage products, and not very successfully at that. It would be better if banks lending to mortgage finance companies can be treated as PSL, provided the finance companies adhere to certain norms and standards. A similar case can also be made for treating bank loans to NBFCs that lend to transport operators as PSL. Clearly, banks are not geared for lending to this segment, and several NBFCs (which are regulated by the RBI) have proven their good standing in this area over decades of successful operations.

3. A related third change required for making PSL regime more effective is that RBI should encourage the use of innovative financial mechanisms that enable the separation of manufacture and distribution of financial products to various priority sector sub-segments, including the informal sector. The Business Correspondent model is a good beginning, but the definition of BC should be wider and include other players in the financial sector. All banks do not have the same capabilities to "manufacture" various types of PS loans. Some banks have developed expertise in evaluating the

needs of specific borrowers and the associated risks, while not having the expertise to structure other types of PS loans. Mandating all banks to achieve the same level of PS norms irrespective of internal capabilities to do so, results in misdirected loans of a high order. Instead, it would be desirable if banks could share portfolios (risk and return) without necessarily sharing the customer relationships with other entities, by use of appropriate instruments (credit derivatives, PTCs, PCs, etc.) and qualifying for PS norms.

Even the Nair Committee while recommending the use of participatory certificates at a pilot level, appears to prefer individual banks to manufacture PSLs themselves rather than take over PSLs from other banks. Non-banks are largely out of contention for creating PSLs on a systemic basis, which is a restrictive use of the capabilities of the Indian financial system. NBFCs onlend a good part of the aggregate credit of the Indian banking system, directing the credit to several segments, such as road transport operators, construction equipment operators, infrastructure assets, micro consumer loans, and small businesses and industries in large measure. Many of these segments can be construed to be priority sector in some manner, although they do not so count, unless lent to directly by banks. One may ask, how do such loans become any less priority just because these borrowers chose to borrow from NBFCs and not banks directly? In more ways than one, these NBFCs bring capabilities that banks do not possess in adequate measure to lend to the concerned segments. Securitisation is an acceptable mechanism for distributing loans created in one bank/institution to other institutions; however, PSL regulations have not consistently recognised securitised loans and second, the securitisation guidelines do not enable viability of securitisation business in India. Another mechanism that has been occasionally discussed is the concept of tradable permits within banks. It is not clear why such a system that is overseen by the RBI cannot be implemented, as it would bring a market-based solution with incentives and disincentives built in to move credit to priority sectors. It will also incentivise a few banks that are better placed in terms of capabilities and networks to originate PSL to get better at this, while for banks that are not so good at it, will be forced to pay a market price for acquiring the necessary amount of permits.

Conclusions:

Given that Basel II (and now Basel III) norms are forcing banks to increase internal profits to cover risks and provide for additional capital towards unforeseen risks, the PSL guidelines should also enable banks to make such loans profitable. Else, it would be better if Government provides for subventions in a transparent manner (e.g. a bulk subsidy to a bank for a given volume of PSL or direct financial transfer to the borrower) so that PSLs are fully priced and banks are not confused with regards to pricing or recoveries. The guarantee funds for MSME units and the proposed fund for guaranteeing agriculture loans are in the right direction, and if implemented well, should yield positive results.

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PSL is a regulatory stipulation of the social banking era of the 1960s. Little has changed in the manner it was conceived and structured and over the years, RBI has largely tinkered at the edges. Indian Banking industry has evolved significantly over the years, and at present, several momentous changes are being contemplated in terms of a new licensing policy for private banks and opening of the sector to foreign banks. Inclusiveness in the Banking industry has gathered significant speed, and several bankers are converting to the view that inclusive banking and profitable banking need not be mutually exclusive. It is in this context, that RBI has to restructure comprehensively the edifice of Priority sector lending by making a more comprehensive use of the Indian financial system rather than just forcing every bank to lend 40% of its ANBC towards PSL.

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