Priority sector lending

What is the issue?

In FY16 the Reserve Bank of India (RBI) initiated two significant steps on priority sector lending.

What is priority sector lending?

- Priority Sector refers to those sectors of the economy which may not get timely and adequate credit.
- Priority Sector Lending is an important role given by the Reserve Bank of India (RBI) to the banks for providing a specified portion of the bank lending to few specific sectors.
- The sectors may be agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections.
- This is essentially meant for an all round development of the economy as opposed to focusing only on the financial sector.
- As per the RBI circular released in 2016, there are eight broad categories of the Priority Sector Lending.
- They are: (1) Agriculture (2) Micro, Small and Medium Enterprises (3) Export Credit (4) Education (5) Housing (6) Social Infrastructure (7) Renewable Energy (8) Others.
- The others category includes personal loans to weaker section, loans to
distressed persons, loans to state sponsored organisations for SC/ST.


How is RBI revamping PSL?

The current banking and economic situation demands a fresh round of thinking regarding priority sector lending (PSL) guidelines.

Reserve Bank of India (RBI) initiated two significant steps.

First, it revamped PSL norms by including some new sectors such as social infrastructure, renewable energy and medium enterprises among others.

Second was the introduction of the scheme of priority sector lending certificates (PSLC) to facilitate the achievement of PSL targets by banks.

This is to incentivise banks having surplus in their priority sector lending to sell this surplus to peers that are falling short.

The total volume traded at the end of September 2016 was about Rs 140 billion.


Whether PSL is increasing?

Trends indicate that barring renewable energy and to some extent trade, credit to new sectors has not shown any significant expansionary trend.

During April-December 2016, RBI data indicates that the incremental credit growth to priority sector expanded at a very slow pace of 0.8 per cent.

In FY16, public sector banks (PSB) priority sector loans had registered a strong growth of 13.4 per cent, compared to the overall PSBs’ credit growth of 2.1 per cent (renewable energy and trade contributed most).
On an average, the new sectors have contributed around two per cent to the priority sector lending growth.

Despite this, in the last five years, PSBs have been unable to achieve the PSL targets.

But private sector banks achieved their PSL target in the last three rows in a row.

However, this may not be an appropriate comparison, as PSB PSL loan portfolio is three times higher than their private sector banks’ counterparts.

Further, the Nabard balance sheet for FY16 shows a total of Rs 1,89,420 crore in rural infrastructure development fund (RIDF) and other funds being deposited by banks because of shortfall in their PSL targets over the years.

The amounts deposited in RIDF and other such funds are also counted towards PSL achievement.

However, if these amounts are excluded, the banking system will indeed have an overall shortfall in PSL.

What role does RIDF play?

RIDF came into existence in FY 1996, with the primary purpose of encouraging commercial banks to meet their PSL targets through interest rate policy instrument.

That is, lower interest on investment under RIDF as compared to net returns on priority sector advances.

Currently, the interest rate levied on RIDF varies from two per cent below bank rate to four per cent below bank rate depending on the extent of shortfall in PSL targets.

This directly impinges on the profitability of PSBs.

In a scenario of stressed profitability, PSBs can hardly afford this hit, which has a direct bearing on their profitability and retained earnings as also the need for the government to infuse capital.
How should the PSL be tweaked?

- There should be some clear definitional changes in PSL at least with reference to the quantitative caps.
- MSME lending is an integral part of the priority sector. However, the definition of MSME is very old dating back to 2006.
- Therefore, broadening the definition in line with the current economic conditions is required.
- There needs to be a serious re-look at the cap of Rs 5 crore per borrower for building social infrastructure activities like schooling in Tier II and Tier VI centres.
- The cap of Rs 15 crore for borrowers related to public utilities under renewable energy must be increased manifold to make it a meaningful proposition in accordance with the current vision.
- Another area worth considering is expanding the definition of rural infrastructure to include rural roads, power plants, bridges etc.
- We should also consider including food credit under PSL as such credit is primarily used for procurement of food grains, ensuring food security, especially for weaker sections of society.
- Alignment of priority sector guidelines with the affordable housing definition will incentivise banks to lend more to the affordable housing segment.
- It might be worthwhile to make an objective assessment of whether we should include municipal bonds under PSL norms.
- As it will meaningfully facilitate rising of funds for the necessary improvement in social and economic infrastructure of cities.