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PRIORITY SECTOR LENDING IN INDIA: FROM INCEPTION TO TILL DATE

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ABSTRACT

After outlining the course of priority sector lending policy from its inception to its present form, we can say that the policy has been made flexible in terms of the definition and delineation of targets for priority sector lending. The broadening of the definition of priority sector lending along with interest rate deregulation has made the policy far more flexible than before.

KEYWORDS: *Priority Sector Lending, Directed Credit, Mandatory Lending Requirement*

***JEL Classification codes*: G21, G28, O10, O47**

INTRODUCTION

This article covers the evolution of priority sector lending in India from its inception to till date. We can divide the evolution of India's priority sector lending policy into four broad phases depending on the striking features of the policy as it evolved over time. Phase I (1967 to 74) when there were no targets fixed for the level of priority sector lending and when only public-sector banks were required to adhere to the policy. Phase II (1974 to 1991), was the period when both private and foreign banks along with public banks were required to adhere to the priority sector lending policy and the minimum lending requirement for the level of priority sector advances was imposed on banks. By the end of this phase, one important change was that concessionary interest rates were removed on specific sectors or programmes with the beginning of liberalization of the financial system and were completely eliminated in 1990. One major change in phase III (1991 to 2005) was the introduction of penalty on non-achievement priority sector lending targets on the bank, as many banks, especially foreign banks, were not fulfilling the minimum lending requirements.

Finally, phase IV (2005 till date) is the phase of expansion of priority sector as more sectors were included in the policy with the same overall minimum lending requirements. The most significant changes during this phase include the securitization of the priority sector lending and the concomitant orientation of it towards market regulation. In the following sub-sections, we explore the main features of each phase in some detail. Section 3.6 outlines the present form of priority sector lending policy.

Phase I (1967 to 1974)

The need to allocate loans to the neglected sectors of the economy in India was first realized in July 1961 thus, initiating the first phase of the priority sector lending policy (RBI, 2008). At this time, a large percentage of bank credit

was directed to the big industrialist, commerce sector and established business houses (see Table 1).

Table 1: Sector-Wise Advances of Scheduled Commercial Banks

	1951 (March)		1967 (March)	
Sectors	**Total Credit (in Rs. Million)**	**Percent in Total Credit**	**Total Credit (in Rs. Million)**	**Percent in Total Credit**
Agriculture	120	2.1	570	2.2
Industry	1990	34	17470	64.3
Commerce	2110	36	5270	19.4
Personal	400	6.8	1150	4.2
Others	1230	21	2730	10
Total	5850	100	27160	100

Source: RBI (2008), Report on Currency and Finance, 2006-08, Reserve Bank of India, Mumbai

Table 1 clearly shows that banks were advancing large percentage of credit to industry and commerce sector in 1951 and it increased by around 30 percent for the industrial sector in 1967 and reduced for commerce sector by 17 percent in 1967. In contrast, advances to agriculture sector remained at a mere 2.2 per cent throughout the entire decade.

Thus, banks were more urban-oriented, tended to advance selective credit to big industries, and less transparent (RBI, 2008). This had resulted in a lack of credit supply to many important sectors of the economy, especially agriculture and small-scale industries. During the 1950s and 1960s, there was a nexus between banks and big industrialists in order to break this nexus, social control on banks was intended to ensure credit to all sectors of the economy and not only to particular customers or group of clients. This necessitated some social control over banks.

In the year 1967, Finance Minister Morarji Desai introduced the term 'priority sector' to describe the critical sectors of economy viz. agriculture, exports and small-scale industries, which were not getting the sufficient amount of credit.[1]This period was also witnessing shortage in agricultural productivity and an industrial downtrend that caused a severe deceleration in the growth of the economy. In the year 1967-68, the RBI undertook the policy of directing credit supply to priority sectors of the economy such as agriculture and small-scale firms. However, there was no comprehensive definition of these sectors and no targets were fixed for such sectors. Advancing credit to the priority sector was left more or less on the discretion of the banks.

In addition to the priority sector lending policy, the National Credit Council was set up in 1968 to assist the RBI in estimating the demand for credit which emphasized that commercial banks should be involved more in granting loans to the priority sectors especially agriculture and small-scale industries.

Due to the nationalisation of 14 banks in 1969, there was a considerable shift of credit pattern by banks especially crucial sectors which had previously been neglected by the commercial banks.[2] Thus, the policy of priority sector lending was expanded further to meet the credit requirements of crucial sectors as per national priorities. Other policies which were introduced during this phase to promote the social objectives through banking system were: Credit Guarantee Corporation of India Limited and the Differential rate of interest (DRI). Credit Guarantee Corporation of India Limited was set up in 1971 by RBI for making provisions for the incentives to banks for lending to various categories of small borrowers under

[1]RBI (1967),Social Control Over Commercial Banks, Reserve Bank of India Bulletin, 21 (12): 1653-1654.
[2]RBI (2008), Report on Currency and Finance, 2006-08, Reserve Bank of India, Mumbai

priority sector lending and providing guarantees against the risk of default in payment; the DRI was actuated in 1972 to provide aid to the weaker sections of society by allocating credit at the lower rate of interest. The targeted groups under DRI were landless laborer, physically handicapped persons, women, orphanages, scheduled caste and Scheduled tribes who did not have any collateral to offer to banks for credit. The minimum lending requirement for each bank under this scheme was one percent of its total advances of the previous year.

Configuration of priority sector was formalized in 1972; constituents of it were identified on the basis of the report submitted by the 'Informal Study Group on Statistics' relating to advances to priority sector constituted by the Reserve Bank of India (RBI). According to the report, in addition to the agriculture sector, the sectors notified as priority sectors were: Small-scale industries, Industrial Estates, Road and Water Transport Operators, Professional & Self-Employed Individuals, Retail Traders & Small Business and Education. However, there were no specific targets for banks, but these sectors were made to get priority in the approval of loans, concession in the interest rate and other terms and conditions.

Hence, priority sector lending policy in this phase was only a directed credit policy with interest rate subsidy without any minimum lending requirement for banks. Till 1969, only public-sector banks were required to lend to priority sectors. It was only in the late 1970s that the private sector banks were directed to engage in mandatory priority sector lending, along with public sector banks.

The share of priority sector advances in total credit by public sector banks increased from 14 percent in 1969 to 23.8 percent in 1973 (RBI, 2008). Thus, due to the formalisation of priority sector lending, there was a steady increase in the credit supply to priority sector. Even though priority sector lending was formalized, banks were not clear about the definition of priority sector particularly about the precise scope of agricultural lending (Joshi, 1972). Thus, there was a need for a clearer definition of priority sectors and in later phases from time to time RBI has issued a clear definition of priority sectors and targets for different sector/sub-sectors.

To sum up, during the first phase priority sector lending policy was aimed at delimiting the definition of priority sectors, and encouraging public-sector banks to lend to these sectors voluntarily- as there was no target proportion for banks. During this phase, despite the absence of targets fixed in terms of minimum lending requirements, these sectors got priority in approval of loans and concession in interest rate.

Phase II (1974 to 1991)

The two striking features of this phase were, private and foreign banks were also incorporated in the purview of priority sector lending policy and minimum lending requirements were stipulated for the banks. Private sector banks were directed to provide credit to priority sectors from the late 1970s. Percentage targets for priority sector lending were first introduced in 1974 for the public banks, its lower limit was one-third of overall credit of banks which was to be achieved by March 1979. In November 1978, same targets were imposed on private banks operating in India to be achieved by the end of March 1980. In 1988-89, foreign banks functioning in India were also brought under priority sector lending policy and were mandated to attain a minimum lending requirement of 15 percent of their net total credit by the end of March 1992 (RBI 2005). Thus, the priority sector lending was no more a voluntary affair for banks, and all banks were obliged to give credit to priority sectors as minimum lending requirement was imposed on them.

Various measures undertaken by the RBI, like branch licensing policy[3], nationalization of banks, lead bank scheme[4], priority sector lending, and DRI had a positive impact on the supply of credit to the agriculture sector. The proportion of agricultural credit to total credit by banks increased from 2.2 percent in 1967 to 9.1 percent in 1974-75 (RBI 2008). However, it was less than expected and there was need of separate banking structure as commercial banks were not able to meet the requirement of small and marginal farmers and on the other hand cooperative banks lacked resources for it. As a result, Regional Rural Banks (RRB) was set up in 1976 with a view to developingtherural sector by allocating loan for the purpose of agriculture development, industrialization, trade and other facilities in the rural economy. In 1978, commercial banks and RRBs were mandated to give credit to all priority sector loans at an interest rate of 9 percent irrespective of loan size, for it was felt that lending rate instead of access to credit was the reason behind credit constraint faced by the rural economy (RBI 2008). However, RRBs were allowed only to give credit to target groups such as landless laborer, small and marginal farmers, rural artisans and weaker sections. Later on, in 1997, RRBs were mandated to give 40 per cent of their total credit to priority sectors as in case of commercial banks. Within the overall target of 40 per cent, a sub-credit of 25 per cent was fixed for credit to the weaker sections.[5]

The standing advisory committee for urban co-operative banks (UCBs) by RBI in 1983 examined the need for primary co-operative banks for allocating credit to priority sectors.[6] The recommendation was accepted by RBI and accordingly to minimum lending requirements for priority sectors and weaker section were stipulated. The UCBs were mandated to give 60 per cent of their credit to priority sector and within an overall target of 60 per cent, the credit to weaker sections was fixed at 25 per cent of total priority sector advances. Earlier UCBs were not allowed to give loans to agricultural activities except those activities allied to agriculture. After RBI's decision to allow UCBs to extend their geographical area of operation to the entire district of registration including rural areas, the RBI issued a circular in December 1996 that allowed them to give credit to agricultural activities also. The loan given for agricultural activities would be eligible for counted as the priority sector advances for UCBs. However, there were no separate targets for agricultural lending by urban co-operative banks.Thus, besides commercial banks, regional rural banks and urban co-operative banks were also included in the priority sector lending policy.

During this phase, two important committees led by Krishnaswamy (1980) and Ghosh (1982) recommended major changes in terms of sectors, subsectors, and target proportion. The major contribution of these two committees was the inclusion of weaker section as a sector under priority sector lending and setting up separate targets for it. Since a substantial portion of the country was poor there was the need to provide financial support to these poor and weaker sections of the society through priority sector lending. (Vadilal**,** 1975; Patel, 1979).

[3]Branch licensing policy was imposed in 1971 to equalize population per bank branch across India States. The policy required banks to open 4 branches in unbanked (rural) areas for every branch opened in banked (Urban) areas. However, the policy was discontinued in 1990, with onset financial liberalisation.
[4]Lead bank scheme was introduced in 1969 as part of social banking. Under the scheme banks was given districts in which bank had play a lead role to make aware about benefits of banks and provide financial services.
[5]This information is taken from RBI (2013), Master Circular-Lending to Priority Sectors-RRBs, Reserve Bank of India, Mumbai. This circular consolidated all master circulars related to lending to priority sectors-RRBs, prior to 2013.
[6]This information is taken from RBI (2004), Master Circular-Lending to Priority Sectors-UCBs, Reserve Bank of India, Mumbai. This circular consolidated all master circulars related to lending to priority sectors-UCBs, prior to 2004.

Based on the recommendations of the working group headed by Krishnaswamy (1980)[7], RBI increased commercial banks' priority sector lending target to 40 percent with the sub-target for agriculture increased to 16 percent by March 1985. Separate sub-targets for lending to weaker sections in the agriculture sector were fixed, as suggested by the Working Group. Direct loans to weaker sections within the agriculture sector was fixed at a minimum of 50 percent of total direct advances to agriculture and allied activities by 1983. In small scale industries sector advances to rural artisans, village craftsman and cottage industries were to constitute 12.5 percent by 1985. In terms of the definition of priority sectors, housing and consumption credit for scheduled castes, scheduled tribes, and weaker sections were added to be eligible for priority sector lending.

The various segments of the priority sector lending were further modified on the basis of the report of the 'working group on the role of banks in the implementation of new 20-point programme' led by A. Ghosh in 1982. The guidelines on priority sector lending for banks based on Ghosh committee issued by RBI in February 1983 were:

The separate target for direct advances under the agriculture sector, with the overall target remaining the same at 40 per cent. Banks should increase lending to direct advances under agriculture sector to 15 percent of total credit by March 1985, 16 percent by March 1987, 17 percent by March 1989 and 18 percent by March 1990 i.e. one percent increase in every two years from 1985 to 1990. Banks were directed to increase lending to the weaker section at least 25 per cent of the total priority sector lending by March 1985. However the definition of weaker section was also revised to include (1) small and marginal farmers with land holding of less than or equal to five acres, landless laborers, sharecropper and tenant farmer, (2) Integrated Rural development Program Beneficiaries, (3) Scheduled Castes and Scheduled Tribes, (4) Differential Rate Interest beneficiaries and (5) Artisans irrespective of location or small industrial activity in villages and small towns with a population of not exceeding 50000 involving utilisation of locality available resources and/or human skills, where individual credit requirement does not exceed Rs 25000.

One striking feature of this phase was the removal of concessionary interest rates during the late 1980s which were on specific sectors and programmes which were completely eliminated in 1990, except in some sectors or programmes such as export, agriculture, small-scale industries, and DRI scheme (RBI, 2008). Thus, priority sector lending policy after 1990 had no interest subsidy except in a few sectors.

Inclusion of private sector banks and foreign banks in this phase led to an increase in the share of priority sector advances in total credit of scheduled commercial banks. The share increased from 23 percent in 1973 to 40.7 percent in 1990. Table 2 shows the share of priority sector advances in total credit of scheduled commercial banks.

The percentage of priority sector advance in total credit in June 1973 was only 23.8 per cent, as there were only public-sector banks operating under the priority sector lending policy and there were no minimum lending targets fixed for them. However thereafter, the share of priority sector advance in total credit increased sharply in 1983 due to the changes in the basic structure of the policy like the inclusion of private banks and foreign banks, fixing up the minimum lending requirement for banks. A fall in the share of priority sector advances was recorded after 1989 and it was around 40.7 of total credit in the financial year 1990, however, it remained above the stipulated overall minimum lending requirement, i.e. 40 percent, when all scheduled commercial banks are taken together.

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[7]This working group was setup by RBI in 1980 and was known as Working Group on the 'Modalities of Implementation of Priority Sector Lending and 20-Point Economic Programme'.

Table 2: Share of Priority Sector Advances in Total Credit of Scheduled Commercial Banks (Excluding RRBs)

Year	Priority Sector Advances (in Rs. million)	% of Priority Sector Advances in Total Credit
June (1973-74)	12710	23.8
June (1983-84)	127830	36.1
June (1984-85)	163030	38.1
June (1985-86)	198290	39.9
June (1986-87)	228440	41.0
June (1987-88)	267430	42.9
June (1988-89)	306930	43.8
June (1989-90)	380860	42.6
March (1990-91)	414970	40.7

Source: *Basic Statistical Returns of Scheduled commercial Banks in India*, RBI, various issues

Thus, the second phase was marked by the inclusion of private and foreign banks in the policy purview and a minimum lending requirement was imposed on public and private banks at 33.33 percent, which was increased to 40 percent in 1980 to be achieved by 1985. Lending targets for foreign banks were fixed at 15 percent of net bank credit. There was a separate target for direct advances under the agriculture sector, with the overall target remaining the same at 40 per cent. Moreover, in terms of the list of sectors under priority sector lending, many new sectors and sub-sectors were added to earlier ones. By the end of this phase, concessionary interest rates were removed on specific sectors or programmes with the beginning of liberalization of the financial system and were completely eliminated in 1990.

Phase III (1991 to 2005)

Till 1991 Indian banking sector focused only on the objective of increasing supply of credit through various programmes like a wider network of banks' branches to neglected areas, priority sector lending, DRI, etc. Thus, asset quality was not a prime concern prior to 1991. Since priority sector lending accounted for 40 percent of banks total credit and it included more risky borrowers who lack collateral for the credit. The issue of non-performing assets(NPA) was considered to be of great concern in the priority sector lending policy.

In 1991, a committee on financial reforms, as part of economic reform, known as first Narasimham Committee was set up by government of India to study the problems faced by the Indian banking sector and to suggest measures to re-energize the banking sector. The committee identified the issue of NPA[8] as the major threat to the Indian banking sector and suggested measures for asset classification, income recognition, and provisioning requirement. On the account of priority sector lending policy, this committee appreciated the role of priority sector lending in achieving its social objective i.e. providing credit and reaching to neglected sectors of the economy. However, the committee also blamed priority sector lending policy as one of the main responsible factors which had affected the banks' income negatively through interest rate subsidy and high monitoring costs of such loans. The committee recommended the reduction of the targeted proportion to 10 percent from 40 percent for banks and at the same time narrowing down the definition of priority sectors to give attention only to the low-income target sector. Thus, the committee tried to phase out priority sector lending by reducing the targeted proportion and focusing only on lower-income borrowers such as marginal farmers, small sector and small business, transport sector, village and cottage industries as there were problems of declining profitability and efficiency of banks due to priority sector advances. In this connection, prominent economist D. N Ghosh opined that the proposed cutback of the target of priority sector lending to 10 per cent would send an unfortunate signal to the dispenser of credit

[8]Non-performing assets is an asset that ceases any return on loans disbursed by the banks.

which in turn will dilute the prime objectives of priority sector lending.[9]This might have constituted a possible factor because of which the committee recommendations were not accepted by the government, and priority sector lending policy continued unchanged.

One important change in the priority sector lending policy during this phase was the introduction of penalties in the event of a failure in achieving targets imposed by RBI under priority sector lending. Foreign banks were mandated to increase their priority sector lending to a level of 15 percent by the end of March 1992. Priority sector lending by foreign banks was only 7.2 percent of their net bank credit at the end of March 1992 (RBI 2005). The non-achievement of priority sector lending targets by foreign banks was taken seriously by RBI and foreign banks were advised in April 1993 to achieve the target by June 1993. In the event of failure to attain the minimum lending requirement, foreign banks were required to deposit the shortfall for a period of one year with the Small Industries Development Bank of India (SIDBI) at 10 percent interest rate per annum. Thus, penalties for non-achievement of priority sector lending requirement were first imposed on foreign banks in 1993. In April 1993, it was also decided to increase percentage targets for foreign banks to priority sector lending from 15 percent to 32 percent of their net bank credit. Accordingly, from March 1994 composition of priority sector lending for foreign banks was widened to include the export sector from July 1993(RBI 2005). The sub-target for exports and Small-Scale Industries (SSIs) within the overall targets of 32 percent for foreign bank stipulated to be at least 10 percent of net bank credit.

Although minimum lending requirements to the level of priority sector advances for public and private banks were imposed in 1974 and 1978, there was no provision of penalties on these banks in non-achievement of targets. In 1995 after setting up Rural Infrastructure Development Fund (RIDF) with NABARD, by the Central Government, private and public banks were also required to deposit funds equivalent to the amount shortfall in agricultural lending, with RIDF.[10]As per the penalty clause, the RBI would decide the periods of such deposits and interests on the shortfall amount deposited by banks to such funds. In 1998, Narasimham II committee recommended to include, deposit funds equivalent to the amount shortfall in total priority sector lending, with RIDF. Thus, the concept of giving the shortfall as a penalty to (RIDF) in the case of not achieving the minimum lending requirement presses banks to achieve the targets directly or indirectly. Since it will not help in increasing credit to priority sector thus this recommendation was not accepted. However, it was introduced in 2004 in some sectors such as agriculture, small-scale industries, and housing.

After Gosh committee (1982) recommendations, sub-target for the agricultural sector was fixed at 18 percent of the net bank credit (NBC). In 1996, a high-level committee, on agricultural credit through commercial bank under the chairmanship of R.V. Gupta, found that the 18 per cent target fixed for agriculture sector was too low if considered in relation with the reserve requirements which was very high at 63 per cent. However, the total credit resources of banks have increased due to a reduction of reserve requirements over the years. The committee recommended that in order to maintain the same share banks should double their credit to agriculture sector because the base on which the target had been fixed doubled. The committee also suggested banks have self-set targets for agriculture sector credit based on their flow of credit. In order to have self-set targets, the committee suggested to preparing Special Agriculture Credit Plans

[9]Ghosh, D. N (1992), "Bank Profitability and Priority Sector Lending from Populism to Impressionism," *Economic Political Weekly*, 27(8), February 22, pp. 387-388.

[10]RIDF was established by union government to provide funds to state governments for rural infrastructure development.

(SACP) with RBI specifying current year expected an increase in the flow of credit over the preceding year. Based on the above recommendations Special Agriculture Credit Plans (SACP) was introduced for Public sector banks but sub-target for agriculture sector remain unchanged at 18 percent.

The committee on banking sector reforms, Narasimham Committee II (1998), again focused on the issue of priority sector lending and noted the reasons why the earlier recommendations of Narasimham Committee I were not accepted by the government. The committee found that priority sector lending led to an increase in non-performing credits and had an adverse impact on banks' performances concerning profitability and efficiency. The committee observed that 47 per cent of total NPAs were due to priority sector advances. The committee also acknowledged that reducing the targeted proportion could have an adverse impact on the flow of credit to the priority sectors. The second Narasimham Committee recommendations could be illustrated as, encouraging lending to marginalized farmers, small farmers and other small sectors such as small business, which otherwise had difficulty in obtaining loans. In addition to that, the committee also realized that it would be beneficial to redirect credit to employment generating sectors of the economy. In addition to that, the removal of discounted interest rate on credit up to Rs 0.2 million and a phased moving away from overall targets and sub-targets was recommended.

Finally, there was an encouragement of debt-securitization which would allow smaller banks that were not able to meet the minimum lending requirements to buy debt from other financial organizations. Narasimham Committee II was the first committee to recommend debt securitization for banks which were not able to meet the minimum lending requirements by buying the debt from other financial institutions. But the recommendation was not accepted by the government, although in the later period securitization of the priority sector advances were recommended by various committees (which have been discussed in the following sections) and it is part of the present form of priority sector lending policy.

Based on the recommendations of the Narasimham Committee II, the following major changes were made by the RBI in the guidelines of the priority sector policy. The scope of priority sector was increased by adding employment generating activities like food processing, related services activities in agriculture, poultry, fisheries and dairying in 1999, to the list of priority sectors. The rate of interest was not supposed to exceed the prime lending rate of the banks for loans up to Rs 0.2 million, and banks were allowed to choose their prime lending rate subject to the approval of their boards.

In the year 2000, Technical Group on Computation of Priority Sector Lending Targets led by B.R. Verma recommended that targets could be linked to the last year's net bank credit (NBC)[11] and up-scaled by the estimated growth in the credit. The Group also recommended withdrawal of exclusion of Foreign Currency Non-Resident (FCNR (B)/ Non-Resident Non-Repatriable (NRNR) deposit from NBC for computation of targets in a phased manner.[12] The recommendation was re-examined in 2004 and was decided that the current definition of NBC may not be changed (RBI, 2005).

[11]Net bank credit of any bank is measured by deducting its bills rediscounted with RBI and other approved financial institution from its total credit in India

[12]Both FCNR(B) and NRNR deposits are the scheme through which non-resident Indian's(NRIs) can invest in India. However, FCNR(B) is denominated in foreign currency and B stands for banks, before 1993 it was known as FCNR(A) where A stands for account and NRNR is denominated in Indian rupee. FCNR(B) loans are thus loans raised by Indian corporates in foreign currency as per the guidelines issued by RBI. NRNR loans are loans from NRNR deposit in Indian currency as per guidelines issued by RBI.

Another important change during this phase was the inclusion of micro-finance institutions and bank credit to Self Help Groups(SHGs) and Joint Liability Groups(JLGs) as part of priority sector lending since 2000 (RBI 2008).[13]In 2002, targets for RRBs were reviewed in and it was decided that RRBs should achieve a minimum lending requirement of 60 per cent of their total priority sector advances as against 40 per cent earlier.[14] Further, out of the overall target of 40 per cent at least 25 percent should be allocated to weaker sections. The revised targets were made effective from the year 2003-04. As per RBIs master circular on lending to priority sectors relating to co-operative banking 2008, urban co-operative banks were mandated to give 40 per cent of their credit to the priority sector as against 60 per cent earlier and within overall target 60 per cent, the credit to weaker sections should be 10 per cent of total priority sector advances.[15]Thus during this phase (1991 to 2005) targets for RRBs increased and that of UCBs decreased. These targets for RRBs and urban co-operative banks continued to be part of the present form of priority sector lending by RRBs and urban co-operative banks.

Expert Committee on Rural Credit (Vyas Committee, 2001) appointed by NABARD in the year 2000 recommended in its report that a minimum lending requirement of 18 percent for the agriculture sector and 40 percent for priority sectors should be reviewed after every five years.[16] It also suggested for retaining the minimum lending requirement of 4.5 percent on indirect finance to agriculture and 18 percent for overall agricultural loans. The committee also recommended a major reduction in RIDF interest rate to a level just enough to cover the interest cost of the deposit. Although, RBI has not formally reviewed agricultural lending requirement in the intervening period, , much in the line with the Vyas Committees recommendations, it has suggested that banks shall meet the targets of 18 percent credit to the agricultural sector in a time-bound manner. RIDF interest rates had been reorganized and a system of graded rates was introduced as per which the banks having higher shortfall would be paid lesser interest rates.

Another committee led by V. S. Vyas –'Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System', (2004), recommended the following changes under priority sector lending. There should be a comprehensive review of the minimum lending requirements under the priority sector lending, and following that, if such a review was pending the current lending of 18 percent for the agriculture sector should be enforced. Banks were recommended to raise their direct credit to agriculture to 12 percent of NBC within a span of two years and furthermore to 13.5 percent even after that. Those banks who were already in this position were supposed to continue with this. Indirect lending to agriculture for the first two years was set at 6 percent for judging the performance of the banks in the face of 18 percent minimum lending requirement for the agriculture sector and ceiling of 4.5 percent.

Recommendations for the continuation of the Special Agricultural Credit Plan (SACP) was also included, which was recommended by the Gupta Committee (1996). In addition to that, the inclusion of private banks along with the public sector was encouraged which was based on the disbursement during the year rather than on the outstanding. Shares of small and marginal farmers were supposed to be calculated on the basis of their land holdings. The committee also recommended the increase of credit disposal under the SACP to be increased to 40 percent by the end of the Tenth Five

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[13]Microfinance was introduced in 1992 to allocate credit to poor section of the economy, particularly poor women with help of non-governmental organisation and non-banking institutions. Microfinance was elevated under two major approaches: *First* the Bank-Self Help Group Linkage programme under which SHGs were given credit by non-governmental organisation or by banks themselves and *Second* Bank-MFI Linkage Model under which bank lent to MFIs, Non-Banking Financial Corporations (NBFCs) registered with RBI, and these MFIs and NBFCs further lent to SHGs and Joint Liability Groups (JLGS) (RBI 2008).

[14]RBI (2013), Master Circular- Lending to Priority Sectors-RRBs, Reserve Bank of India, Mumbai

[15]RBI (2008), Master Circular-Lending to Priority Sectors-UCBs, Reserve Bank of India, Mumbai

[16]In order to make rural population of the country financially inclusive National Bank for Agricultural and Rural Development (NABARD) was set up in 1982 under the recommendation of the internal working group chaired by B. Sivaram.

Year Plan, 2007. Credits for storage facilities irrespective of their location were supposed to be treated as indirect advances to agriculture and banks investment in securitized assets was supposed to be treated as direct (Indirect) advance to agriculture if the assets comprise only direct (Indirect) advances.

Based on these recommendations which were made by the Vyas Committee, the RBI issued the following changes in agriculture which were under the priority sector, such as credits were supposed to be awarded to storage facilities which were not dependent upon the location and these would be treated as indirect advances to agriculture. Investments of banks in securitized assets were supposed to be treated as direct (indirect) advances for agriculture in case the assets only comprised of direct (indirect) advances to agriculture. In a further modification, NPA norms were tweaked which led to the association of repayment period of loans with the harvesting of crops.

Table 2 and 3 show that priority sector lending as a percentage of total bank lending reached its highest point at around 40% in late 1990, and steadily declined after 1991. This fall in the proportion of the priority sector advances has been widely linked to the RBI's focus on bank profits as the main performance indicator after 1990 (Nair 2000). During this phase(1991-2005), the share of priority sector lending in total credit by scheduled commercial banks remained around 35 to 38 per cent. As we can see from table 3.2 the share of priority sector advances in total credit by scheduled commercial banks was 37.7 percent in 1991; it then, started decreasing and in 2004-05, end up with the same percent as in 1991. However, from 1993, the performance of priority sector lending policy has been improving significantly as concessions on interest rate were reduced for loans above Rs 0.2 million (Sarkar & Agrawal, 1997).

Table 4: Share of Priority Sector Advances in Total Credit of Scheduled Commercial Banks (Excluding Regional Rural Banks)

Year	Priority Sector Advances (in Rs. Million)	% of Priority Sector Advances in Total Credit
1991-92	445720	37.7
1992-93	473180	37.1
1993-94	517390	34.4
1994-95	59097	36.5
1995-96	692090	33.7
1996-97	808310	32.8
1997-98	938070	34.8
1998-99	1089050	34.6
1999-00	1263090	35.3
2000-01	1557790	35.4
2001-02	1822550	35.5
2002-03	2056040	34.8
2003-04	2546480	35.1
2004-05	3168080	37.7

Source: *Basic Statistical Returns of Commercial Banks in India*, RBI

To summarize, in this phase (1991-2005)the issue of increasing NPA, particularly due to priority sector advances were given importance by RBI. An important change in the policy was the inclusion of micro-finance institutions and bank credit to SHGs and JLGs as part of priority sector lending and introduction of penalties on banks in the event of failure of achieving target imposed by RBI under priority sector lending.

Phase IV (2005 to Present)

This phase for Indian banking sector can be characterized as the phase of financial inclusion as RBI focused on

extending banking services to all sections of the society. However, for priority sector lending, the period starting from 2005 is the phase of expansion of the policy as many new sectors were added in it. Apart from broadening of the definition of priority sectors, securitization of priority sector lending made it more market based during this phase.

An internal working group set up by RBI under the chairmanship of C.S. Murthy (2005)focused on reviewing important issues on priority sector lending like whether priority sector lending. These issues revolved around whether priority sector lending norms were still necessary and whether priority sector lending policy needed to review in terms of the definition of priority sector, overall targets and sub-targets for domestic and foreign banks, the concept of Net BankCredit (NBC) and method of calculation of minimum lending requirements of priority sector lending. According to the committee, even after 36 years of priority sector lending policy, credit allocation to priority sectors had not been to the desired extent. Thus, the committee viewed that the priority sector lending policy needed to continue. The committee revised the priority sectors to include those sectors that were employment generating, beneficial to small borrowers and would affect a large section of the economy. In small-scale industries sector, the committee suggested a separate classification of finance into direct and indirect for fixing targets.

According to the above committee, use to Net Bank Credit (NBC) to fix the target for PSL had its shortcomings as Net Bank Credit is based on outstanding advances of banks at a particular point of time. Outstanding advances generally tend to decline in the case of write-offs and better recovery of loans. Further, outstanding advances comprise NPAs, which are reflected in banks credit to priority sectors. Thus, the committee recommended linking of priority sector lending targets to total disbursement by banks during the previous year.

The committee also focused on the consequences of using Inter Bank Participation Certificates (IBPC) for meeting minimum lending requirement posed by priority sector lending policy.[17]As per RBI guidelines, IBPCs are non-transferable and allowed to the level of 40 percent of underlying advances, thus, IBPCs have not been widely used by banks in India. But Banks, especially foreign and private banks, have used IBPC as an alternative source of lending. They have also used this to meet the lending requirement posed by priority sector lending from priority sector lending surplus bank, although on a limited scale (RBI 2005). Banks having a comparative advantage in disbursing loans to the priority sectors may have higher targets than the prescribed minimum lending requirements and may issue certificates, which can be bought by banks which are short of targets to meet the lending requirements prescribed by the priority sector lending policy. However, according to RBI master circular on lending to priority sector lending till 2007, does not include investment in IBPCs to be eligible for priority sector lending. Thus, banks should be more involved in lending directly to the priority sector.

Thus Committee (C S Murthy, 2005) reported that IBPC existed in India although it is thin in size and some banks have used IBPCs to meet targets posed by priority sector lending policy. The committee recommended investment in priority sector lending based IBPCs can be allowed to trade among banks, which will provide a short-term funding instrument at market-based interest rate. Thus, the committee wanted to make the priority sector lending more-market

[17]The IBPC scheme was introduced in 1988 in order to provide banks an instrument, for evening out short-term liquidity usually for 91 days or 180 days within the banking system. Under this scheme there are two types of participations certificates; Inter-bank participation with risk sharing and Inter-bank participation without risk sharing. However out of the two participations most commonly used is IBPCs with risk sharing as it reduces the banks credit portfolio size due to reduction in their capital requirement and there is no reserve requirement on such IBPCs. The interest rate on IBPCs are market based, bilaterally determined between the participating banks and also depend upon the purposes like weather it used for meeting regulatory obligations. The rates are also quoted in accordance with prevailing short-term money markets. IBPCs have not been widely used by banks in India as they preferred their own assets portfolio.

oriented by allowing such type of securitization of priority sector lending.

Moreover, the committee recommended that investment by banks in special bonds of a specialised financial institution to be considered as priority sector advances subject to condition (see RBI, 2005).

The committee submitted its report in 2005 and based on the recommendation of the committee priority sector lending policy guidelines were revised from 30th April 2007. Major changes suggested were such as the overall lending requirement was to remain unchanged and stood at 40 percent for all domestic and 32 percent for all foreign banks. In addition to that priority sector lending were to be linked to the credit equivalent to the off-balance sheet exposure of some banks which were showing negative or zero Net Bank Credit on their balance sheets. The targets and sub-targets under the priority sector lending were supposed to be linked to the Adjusted Net Bank Credit (ANBC) or Credit Equivalent of off-balance Sheet Exposures (COBE), whichever was higher, as on the 31st of March of the previous year. As per the revised definition of micro, small and medium enterprise development (MSMED) Act 2006, small scale industries were too brought under the ambit of priority sector lending. Investment of bonds of financial institutions was not supposed to be considered as priority sector advances. On the other hand, outright purchases of any loan assets by banks, investments by banks in securitized assets and Inter Bank Participation Certificates (IBPCs) on a risk-sharing basis were supposed to be eligible for classification under respective categories of priority sector.

Thus, besides direct loans under priority sector lending policy, outright purchases of any loan asset by banks, investments by banks in securitized assets and Inter Bank Participation Certificates (IBPCs) on a risk-sharing basis was also eligible for classification under respective categories of priority sector. Thus, the priority sector lending policy in 2007 was more market-determined that the earlier practice wherein banks directly gave loans to priority sectors.

The committee on the financial sector reforms led by Raghuram Rajan (2009) recommended that although there is broadening in the definition of priority sector lending from time to time, certain sectors such as direct advances to agriculture and weaker section which, in real sense, are affected due to credit constraints should be preserved in the priority sector lending. The committee suggested that with the increase in rural to urban migration and increasing share of urban poor, these borrowers should be included in the overall agriculture share. The committee also recommended that all commercial banks, whether domestic or foreign, must have the same lending requirement under priority sector lending. According to the committee, Inter Bank Participation Certificates (IBCP) scheme under priority sector lending were such type of securitization in which borrower takes on the credit risk, and these credit risks are high in case of neglected sectors. Another issue highlighted by the committee was of the securitization of the priority sector lending that poses problems in getting credit for neglected sectors as it has to be well documented, standardized and serviced. Thus, the committee proposed a new scheme of Priority Sector Lending Certificates (PSLC) for making the priority sector lending policy more cost effective for banks.

Under the PSLC scheme, any registered lender such as money lenders, MFIs, NBFCs, cooperatives, who have made credits to eligible sectors and any bank that surpass priority sector targets would receive PSLCs equal to the amount by which the requirement is surpassed. A market would then be opened up for these certificates, along the lines of the IBPCs, where deficient banks can purchase certificates to make up for their deficit in targeted credit. However, loans would still be on the books of the original lender and if the loans default, no loss would be borne by the certificate buyer. According to the committee, such type of certificates would encourage small financial institutions that specialize in priority

sector lending, much like the impact of the US CRA policy on Community Development Financial Institutions.

Later on, some recent committees such as (Nair (2011); Vadera (2015)) also recommended PSLCs to be eligible for priority sector lending under the respective categories of priority sectors. On the recommendation of these committees, the PSLCs scheme introduced by RBI in April 2016 provided for the purchase of these certificates, in the event of a shortfall in meeting their priority sector lending minimum requirement for the sector as well as for the sub-sectors (RBI 2015).

In its report on the priority sector lending, Nair Committee (2011) suggested not to change the existing basic structure of priority sector lending regulations, but to understand as to why the priority sector lending system had not been satisfactory. On the other hand, the recommendations also stated that merely forming guidelines could not guarantee success in this regard. It advocated the introduction of appropriate structural changes in the domain of policymaking as per changes in the economic scenario, both national and international, and the consequent variations in the structure of the priority sector lending.

Major recommendations of Nair Committee were, the minimum lending requirement for the domestic banks were set at 40 percent of the ANBC or the CEOBE, whichever stood higher, and in addition to that, a minimum 40 percent lending requirement was also proposed for foreign banks. It was also recommended to have an 'agriculture and allied activities' as a composite sector for which the targets were fixed at the same 18percent. It also suggested a sub-target of 9 percent for small and marginal farmers within the agricultural sector and other allied activities which were to be attained by the banks by the year 2015-16. Other recommendations such as a sub-target under Medium and Small Enterprises (MSE) to a level of 7 percent of the ANBC or the CEOBE was to be attained by the year 2013-14. Credit sanctioned to women could also be extended to the weaker sections of the society, and the minimum lending requirement for foreign banks was supposed to be increased to 40 percent with sub-targets of 15 percent each for MSE and exports. PLSCs were allowed to function on a pilot basis with scheduled commercial banks including regional banks as the main market players. Finally, credit given by banks to the Non-Banking Financial Institutions (NIBF) was to be eligible for priority sector lending up to a level of 5 percent, if given to a specified segment with due diligence and standards of documentation.

According to the recommendations laid down by the Nair Committee in 2011, RBI issued following guidelines in 2012, domestic banks with more than 20 operating branches should ensure at least 40 percent of its ANBC or credit equivalent amount of off-balance sheet exposure, whichever is higher should go to the priority sector, of which around 18 percent should be allocated towards the agricultural segments and around 10 percent to the weaker sections. Foreign banks with more than 20 branches should ensure 40 percent of its adjusted net bank credit or credit equivalent amount of off-balance sheet exposure, whichever is higher should go to the priority sectors with a minimum lending requirement of 18 percent for agriculture. Foreign banks with at most 20 branches, however, continue to the target of 32 per cent of their ANBC to the priority sectors with no minimum lending requirement for agriculture.

Recently in the year 2015, an internal working group appointed by RBI under the chairmanship of Lily Vadera to revisit the existing guidelines of priority sector lending and recommended the following major changes. The minimum lending requirements of all domestic and commercial banks were to be continued at 40 percent of the ANBC or the CEOBE, whichever is higher and all the scheduled commercial banks excluding RRBs irrespective of their number of branches should have the same targets or sub-targets. This committee recommended that the priority should be credit for

agriculture, which was to be fixed at 18 percent including farm credit, credit for short term crop loans and medium and long-term investment credit to farmers. Taking into consideration of the small land holdings of farmers, it was recommended that the minimum lending requirement credit of 8 percent should be fixed or the small and marginal farmers out of the total 18 percent for the agricultural sector.

A status of priority sector lending was recommended for medium enterprises under the Medium and Small Enterprises (MSE). A credit of up to 100 million was to be also included and in addition to that the committee suggested that a microenterprise target of a level of 7.5 percent of ANBC and CEOBE whichever was higher, was to be achieved in stages. In order to ensure that the micro and small enterprises move out of the priority sector after achieving their targets, the committee recommended that the MSMEs should remain only for 3 years. A separate category for the export loan under priority sectors, with a limit of 2 percent of ANBC in order to make sure that the other sectors are not crowded out. House loan limit was fixed at 0.5 million and the credit up to 100 million to the borrower's other than the households. These included activities such as solar and biomass-based power plants. It also extended the recommendations to linking the borrower's Aadhar number for the identification of borrowers and also suggested that accounts of Self-Help groups and Joint Liability Groups should be reported to the credit offices for verifying their eligibility for obtaining credit under priority sector lending. Finally, the recommendations also reached out to the introduction of PLSCs to enable banks to meet their minimum lending requirements under priority sector lending, in order to leverage their comparative advantage. This model would therefore lead to surplus which would be issued and which could also be acquired on the electronic platform at a market based free, enabling the banks to undershoot the priority sector lending targets or the declared volume of PSLCs.

Present Form of 'Priority Sector Lending' Policy

There have been several changes in the definition as well as targets of priority sectors over the years. At present priority sector broadly include the following sectors:

- Agriculture: this includes Farm Credit (which will include short-term crop loans and medium or long-term credit to farmers), Agriculture Infrastructure and Ancillary Activities.
- Micro, Small and Medium Enterprises(MSMEs): Banks credit to micro, small and medium enterprises based on the limit on investment notified by Ministry of MSMEs for manufacturing and servicing are considered as a priority sector.
- Export: includes pre-shipment and post-shipment export credit (excluding off-balance sheet items).
- Education: loans for educational purposes and vocational training up to Rs 1 million irrespective of sanctioned amount are considered.
- Housing: contains credit to an individual for construction or purchases of houses, loan to the government agency for construction of dwelling unit or for slum cleaning and rehabilitation of slum dwellers, credit for housing exclusively for low-income group and weaker sections and a bank loan to housing finance companies. However, the credit limit is different for different borrowers and different locations.
- Social Infrastructure: bank credit up to a ceiling of Rs 5 crore per borrower for construction of social

infrastructures such as schools, health care, and drinking water facilities, and sanitation facilities including construction/ refurbishment of household toilets and household level water improvements. In addition to that, this includes credit to microfinance institution extended for on-lending to individuals and also to members of Self Help Groups or Joint Liability Groups for water and sanitation facilities.

- Renewable Energy: forms up with bank credit to borrowers and individual household for purposes like solar based power generators, biomass-based power generators, wind-mills, micro-hydel plants and for non-conventional energy based public utilities viz. Street lighting systems, and remote village electrification. For borrowers, other than individual household the credit limit is Rs 150 million and for individual households, the loan limit will be Rs1 million per borrower.
- Others: loans up to Rs 50,000 per borrower provided directly by banks to individuals and their SHG or JLG, provided the individual borrower's household annual income in rural areas up to Rs100,000 and for non-rural areas up to Rs1,60,000, Loans to distressed persons up to Rs 100,000 per borrower to prepay their debt to informal lenders and credit sanctioned to State Sponsored Organisations for SC or ST for the specific purpose of purchase and supply of inputs and/or the marketing of the outputs of the beneficiaries of these organisations.

Thus, at present, the priority sector lending policy covers many new sectors and sub-sectors as compared to its initial phases. Inclusion of new sectors and sub-sectors may cause some amount of dilution in the policy since the overall target remains at 40 percent while the number of sector and sub-sector has gone up.

Along with bank loan extended to these sectors, the investment made by banks in securitized assets, representing loans to various categories of priority sectors except 'others', IBPC and outstanding PSLC certificates bought by banks are eligible for classification of priority sectors under respective categories of priority sector lending. Bank loans to MFIs for on-lending to individuals and also to members of SHGs or JLGs are eligible for categorization as priority sector advance under respective categories viz., Agriculture, Micro, Small and Medium Enterprises, Social Infrastructure, and Others, provided not less than 85 percent of total assets of MFI. The rates of interest on bank loans on priority sector lending would be as per directives issued by our Department of Banking Regulation from time to time.

The present minimum lending requirements for banks for the above-mentioned sector are listed in table 3.1.

In non-achievement of priority sector targets and sub-targets, scheduled commercial banks shall be allocated shortfall amounts for contribution to the Rural Infrastructure Development Fund (RIDF) established with NABARD and other Funds with NABARD/NHB/SIDBI/ MUDRA Ltd., as decided by the Reserve Bank from time to time. It will also be taken into account while granting regulatory clearances and approvals for various purposes.

The interest rates on banks' contribution to RIDF or any other Funds, tenure of deposits, etc. shall be fixed by Reserve Bank of India from time to time. The misclassifications reported by the Reserve Bank's Department of Banking Supervision would be adjusted/ reduced from the achievement of that year, to which the amount of declassification/ misclassification pertains, for allocation to various funds in subsequent years.

Table 1 Targets/ Sub Targets for Banks under Priority Sector Lending

Sectors	Domestic Commercial Banks/Foreign Banks (20 Branches and above)	Foreign Banks with Less than 20 Branches

Total Priority Sector	40 percent of ANBC* or CEOBE, whichever is higher Foreign banks have to achieve the minimum lending requirement of 40 percent of ANBC within a maximum period of five years starting from April 1, 2013, and ending on March 31, 2018	40 percent of ANBC or CEOBE, whichever is higher to be achieved in a phased manner i.e. 32 percent by March 2016 and then the target of 2 percent of ANBC every year from 2016-17 to 2019-20.
Agriculture	18 percent of ANBC or CEOBE, whichever is higher (Direct: 13.5 percent and Indirect: up to 4.5 percent) Out of the 18 percent target, 8 percent is prescribed for Small and Marginal Farmers, to be achieved in a phased manner i.e., 7 percent by March 2016 and 8 percent by March 2017. Foreign banks have to achieve the Agriculture Target within a maximum period of five years starting from April 1, 2013, and ending on March 31, 2018.	No specific target
Micro Enterprises	7.5 percent of ANBC or CEOBE, whichever is higher to be achieved in a phased manner i.e. 7 percent by March 2016 and 7.5% by March 2017. The sub-target for Micro Enterprises for foreign banks would be made applicable post-2018 after a review in 2017.	No specific target
Weaker Sections	10 percent of ANBC or CEOBE, whichever is higher Foreign above have to achieve the Weaker Sections Target within a maximum period of five years starting from April 1, 2013, and ending on March 31, 2018.	No specific target
Exports	Incremental export credit over the corresponding date of the preceding year, up to 2 percent of ANBC or CEOBE whichever is higher, effective from April 1, 2017. However, for domestic banks, it is subject to a sanctioned limit of up to Rs 25 crore per borrower to units having a turnover of up to Rs 100 crore.	Export credit will be allowed up to 32 percent of ANBC or CEOBE, whichever is higher.

Source: RBI (2015), Master Circular, Priority sector Lending-Targets and Classification, Reserve bank of India, Mumbai

CONCLUSIONS

After outlining the course of priority sector lending policy from its inception to its present form, we can say that the policy has been made flexible in terms of the definition and delineation of targets for priority sector lending. The broadening of the definition of priority sector lending along with interest rate deregulation has made the policy far more flexible than before.[18] Many new sectors have been added like social infrastructure and renewable energy, at the same many new sub-sectors have also been included in existing sectors. However, the minimum lending requirement has remained the same since 1985. Like, the agriculture sector has been divided into two sub-sectors- direct agriculture and indirect agriculture with many new activities have been made eligible for agriculture credit under priority sector lending. Thus, the policy seems to have diluted from its original form, when there were only three or four sectors with a lending requirement of around 33.3 percent.

With regard to the method of Computation of Priority Sector Lending Targets, earlier targets were based on net bank credit but presently they are calculated on the basis of previous year's Adjusted Net Bank Credit or Credit Equivalent of Off-Balance Sheet Exposure. One important study by Jain et al. (2015) on the basis primary survey of 100 bank

[18]RBI (2004), Report on Trends and Progress of Banking in India 2004-05, Reserve Bank of India, Mumbai

branches found that most of the bankers do not prefer calculation of targets on ANBC, since, the credit given by banks is directly proportional to Net Lendable Resources, so bankers prefer calculation of PSL targets to be based on net loanable resources i.e. total deposit minus cash reserve requirement and statutory lending requirements.

One important change which makes the policy more favourable to banks is the inclusion of investment made by banks in securitized assets, representing loans to various categories of priority sectors except those falling in the category of ‘others’, IBPC and outstanding PSLC certificates bought by banks are eligible for the classification of priority sectors under respective categories of priority sector lending. However, the inclusion of these types of instruments is necessary because of rising NPAs in priority sectors, which is generally due to lack of monitoring and supervision. Since these types of the instrument allow banks to meet their lending requirement by using credit given by priority sector lending surplus banks. At the same time with the introduction of penalty in non-achievement of priority sector targets and considering it while granting regulatory clearances and approvals for various purposes, the policy has been made stricter for banks operating in India.

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