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Priority Sector Lending By Public Sector Banks In India : Issues And Challenges

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Abstract

Priority sector lending is an important aspect of the banking sector in India, mandated by Reserve Bank of India to ensure that credit reaches sectors of the economy that are considered vital. The PSL framework was introduced to encourage banks to provide credit to key sectors that directly impact employment generation, poverty alleviation, and overall economic development, particularly in rural and backward areas, but often neglected by Public Sector Banks due to risks of profitability concerns. While PSL is essential for promoting inclusive growth, PSBs often encounter systematic and operational hurdles that can hinder their ability to lend efficiently to Priority sectors. This study made an attempt to examine the difficulties and challenges faced by Public Sector Banks (PSBs) in Priority sector Lending and addressed the measures to be taken by PSBs for effective implementation of PSL including better risk management practices, enhanced financial inclusion initiatives and the use of technology to streamline lending processes.

Keywords: Priority sector lending, Public Sector Banks (PSBs), Economic development, Financial Inclusion

Introduction

Priority Sector Lending (PSL) is essential for fostering economic equity and supporting the growth of key sectors that are pivotal to the Indian economy. This initiative involves lending targets established by the Reserve Bank of India (RBI) for financial institutions, ensuring that critical sectors receive sufficient credit. Launched in the 1970s, PSL is designed to promote inclusive growth by enhancing credit access for sectors such as agriculture, micro, small, and medium enterprises (MSMEs), education, housing, and healthcare, while also addressing regional disparities by directing funds to underdeveloped areas to stimulate economic activity. Banks are required to allocate 40% of their net bank credit to these priority sectors, underscoring India's dedication to inclusive development.

The key features of PSL include:

- 1. Targeted Lending:** Financial institutions must dedicate a specific percentage of their net bank credit to priority sectors.
- 2. Focus on Inclusivity:** The program aims to uplift marginalized communities and foster economic growth in rural and semi-urban regions.
- 3. Sectoral Guidelines:** The RBI outlines the sectors deemed as priorities and establishes the credit limits and lending guidelines.

Review of literature

Selvam N (2013) conducted a study examining customer perceptions regarding the non-performing assets (NPA) of commercial banks. The author discovered that customers also perceive social and political pressures, particularly in the form of priority sector lending (PSL), as significant contributors to the increase in NPAs.

Banerjee Abhijit and Duflo Esther (2014) found in their research that PSL entails higher administrative and labor costs. Their study indicated that PSL offers lower interest rates compared to market borrowing, which directly impacts the profitability of banking institutions.

Dhar Satyajit and Bakshi Avijit (2015) undertook a study to identify the primary determinants of NPAs in Indian banks. Their findings indicated that multiple factors contribute to NPAs, including inadequate infrastructure, ineffective recovery systems, improper appraisal of loan proposals, willful defaults in anticipation of debt relief, lack of initiative from bank officials, and the diversion of loan funds for unintended purposes. Furthermore, the study concluded that PSL does not play a role in exacerbating NPAs.

Objectives:-

- To study the Historical background of Priority Sector Lending in India.
- To identify Challenges and Issues faced by Public Sector Banks (PSBs) in Priority sector Lending.
- To explore the remedial measures taken by PSBs to address the challenges.

Historical background of Priority Sector Lending in India

The recommendations for priority sectors in Indian banking can be traced back to the Credit Policy of 1967–1968, which highlighted the necessity for commercial banks to enhance their involvement in financing key areas such as small-scale industries, exports, and agriculture. The formal definition of the priority sector emerged in 1972, based on a report from the Informal Study Group on Statistics regarding advances to these sectors, established by the Reserve Bank in May 1971. Below is a concise historical overview: .

1. 1972: The Narasimham Committee first introduced the concept of Priority Sector Lending (PSL), emphasizing the importance of bank lending to sectors vital for economic growth.

2. 1974: The Reserve Bank of India (RBI) implemented guidelines requiring commercial banks to allocate a specific percentage of their total credit to priority sectors, initially covering agriculture, small-scale industries, and disadvantaged groups.

3. 1980s: The PSL framework was broadened to encompass additional sectors, including rural infrastructure, education, and housing.

4. 1990s: Banking sector reforms prompted a reassessment of PSL norms, shifting the emphasis towards enhancing credit availability for micro, small, and medium enterprises (MSMEs).

5. 2000s and Beyond: The RBI has regularly updated PSL guidelines, raising targets and incorporating new sectors such as health care, renewable energy, and export credit to align with the changing economic environment.

The activities encompassed by priority sector lending in India generally include the following:

Agriculture: Financial assistance aimed at agricultural activities, covering crop production, livestock management, aquaculture, and related agricultural activities.

Micro, Small, and Medium Enterprises (MSMEs): Loans provided to micro, small, and medium-sized businesses, which support the establishment of new ventures, working capital needs, and business expansion.

Education: Financial support for educational expenses, which includes tuition fees, book purchases, and costs associated with various educational programs.

Housing: Loans designated for housing purposes, including the acquisition, construction, or renovation of residential properties.

Export Credit: Financial resources allocated to exporters to support international trade activities, encompassing pre-shipment and post-shipment financing, export working capital, and other related services.

Renewable Energy: Funding for projects focused on renewable energy sources, such as solar, wind, biomass, and other sustainable energy initiatives.

Healthcare: Financial backing for the development of healthcare infrastructure, which includes investments in hospitals, clinics, medical equipment, and healthcare services.

Social Infrastructure: Financing aimed at social infrastructure projects, including schools, colleges, vocational training centers, and other community development efforts.

Loans to Weaker Sections: A targeted approach to providing financial assistance to marginalized and economically disadvantaged groups, including Scheduled Castes, Scheduled Tribes, and Other Backward Classes.

New Priority Sector Lending Guidelines by RBI

The required PSL objective for all scheduled commercial banks has been increased by the Reserve Bank of India (RBI) from 40% to 40% of adjusted net bank credit (ANBC). ANBC serves as a comprehensive measure of bank credit, encompassing loans, investments, and other forms of advances. Additionally, the RBI has established sub-targets for lending to disadvantaged groups within the PSL framework. According to the new guidelines, banks must allocate at least 15% of their ANBC to these weaker sections. The RBI has also implemented a differential weightage system for lending to specific sectors under PSL. This adjustment allows banks to receive greater credit for financing certain areas, including agriculture, micro and small enterprises (MSMEs), and export credit. Furthermore, the RBI has introduced incentives for banks to extend credit to underserved regions. For instance, banks will earn additional credit for lending in districts that exhibit low per capita PSL credit. Lastly, the RBI has strengthened the monitoring and reporting obligations related to PSL. The RBI now requires banks to submit more thorough information on their PSL lending operations.

Challenges and Issues faced by Public Sector Banks (PSBs) in Priority sector Lending

Public Sector Banks (PSBs) in India are vital to the implementation of priority sector lending (PSL), which encompasses areas such as agriculture, micro, small, and medium enterprises (MSMEs), education, housing, and support for marginalized communities. Despite the significance of PSL in fostering inclusive growth, PSBs encounter numerous challenges in its effective execution. Key issues include:

1. High Non-Performing Assets (NPAs): PSBs frequently grapple with substantial NPAs, particularly within the priority sector, leading to increased caution in lending practices. Elevated default rates, especially in agriculture and MSMEs, adversely affect the financial stability of these banks and deter further lending.

2. Credit Risk and Default Challenge:- A considerable number of borrowers in the priority sector, particularly in agriculture and informal industries, often lack adequate credit histories, complicating the assessment of their creditworthiness.

3. Insufficient Financial Literacy and Awareness:- The intended beneficiaries of the Priority Sector Lending (PSL) initiative, especially in rural regions and among small-scale entrepreneurs, frequently exhibit a deficiency in financial literacy. This lack of understanding regarding loan products can lead to difficulties in repaying loans and effectively utilizing the funds.

4. Operational Inefficiencies:- Public sector banks encounter inefficiencies stemming from bureaucratic processes and protracted loan approval timelines. These delays hinder timely access to credit and may deter prospective borrowers from seeking loans under the PSL framework.

5. Weak Credit Infrastructure:- There is a significant absence of a strong credit infrastructure, including reliable credit assessments, which poses challenges particularly for smaller enterprises and rural borrowers. This issue is compounded by the lack of formal credit ratings for numerous micro, small, and medium enterprises (MSMEs) and farmers.

6. Insufficient Collateral Availability:- A considerable number of borrowers within the priority sectors lack sufficient collateral to secure their loans. This presents a significant challenge for public sector banks, as it hampers their ability to recover funds in the event of defaults. In agricultural sectors, the ambiguity or absence of land ownership titles further complicates this issue.

7. Regulatory and Compliance Challenges:- Public sector banks must adhere to a variety of regulations and guidelines established by the Reserve Bank of India (RBI) and government initiatives. While these regulations are designed to foster inclusive growth, they can create a rigid framework that diminishes flexibility and complicates lending to the priority sector.

8. Geographical and Regional Inequities:- Public sector banks struggle to extend their services to remote and underdeveloped areas, where the demand for credit is significant. Rural regions, in particular, face obstacles in accessing banking services due to limited branch presence, insufficient infrastructure, and low levels of financial inclusion.

9. Lack of Effective Risk Mitigation Strategies:- The absence of adequate insurance and risk mitigation products causes public sector banks to be cautious in their lending practices.

10. Insufficient Capacity and Expertise:- Public Sector Banks (PSBs) frequently lack the specialized teams and knowledge necessary to effectively evaluate and manage loans in priority sectors, particularly in complex

domains such as Micro, Small, and Medium Enterprises (MSMEs) or agricultural lending. This deficiency leads to delays, inefficiencies, and inadequate support for borrowers.

11. Balancing Financial Viability with Social Goals:- Although priority sector lending aims to foster inclusive growth, PSBs often struggle to reconcile these social goals with their need for financial viability. Providing loans to sectors characterized by lower returns and higher risks can adversely impact the banks' profitability.

12. Rising Competition from NBFCs and MFIs: The expansion of Non-Banking Financial Companies (NBFCs), Microfinance Institutions (MFIs), and fintech firms has intensified competition for PSBs in the priority sector, especially in areas like microfinance and agricultural loans. These entities often provide more innovative, adaptable, and customer-focused products, posing additional challenges for PSBs.

13. Influence of Political and Administrative Pressures:- PSBs frequently encounter political and administrative pressures to extend loans to specific groups or regions, which may not always align with prudent banking practices. Such pressures can result in less-than-optimal lending decisions, adversely affecting the quality of their priority sector lending portfolios.

14. Technological Constraints:- Despite the rise of digital banking, many PSBs continue to face challenges in adopting new technologies for managing priority sector lending. The absence of advanced digital tools for efficient loan processing, monitoring, and collection further obstructs effective lending in these sectors.

To address these challenges, PSBs should utilize technology for improved credit assessment and monitoring, enhancing risk management practices, increasing financial literacy among borrowers, and fostering collaboration with other stakeholders, including microfinance institutions and fintech companies.

Measures to address the challenges :- PSBs in India regarding the implementation of PSL policies include risks of defaults, insufficient creditworthiness of borrowers, and elevated transaction costs. To tackle these challenges, both the government and PSBs have initiated several strategies:

1. Financial Inclusion Programs:-

- Jan Dhan Yojana (PMJDY): This initiative aims to deliver essential banking services to the unbanked population, thereby improving access to credit for priority sectors such as agriculture, small enterprises, and marginalized communities.
- Collaboration with Microfinance Institutions (MFIs) and Self-Help Groups (SHGs):- Banks have partnered with MFIs and SHGs to provide credit to rural and underserved regions. These organizations mitigate risk by focusing on smaller loans with shared repayment responsibility.

2. Facilitating Credit Access and Risk Management:-

- Interest Subvention Scheme:- The government offers interest subsidies on loans to farmers, motivating banks to provide financing for agricultural activities, particularly to small and marginal farmers.
- Credit Guarantee Programs:- The Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) and the National Credit Guarantee Trustee Company (NCGTC) provide credit guarantees for loans to micro, small, and medium enterprises (MSMEs), thereby lowering the risk of defaults.
- Kisan Credit Card (KCC):- This program ensures that farmers receive timely and straightforward credit for their agricultural needs, reducing reliance on informal lending sources.

3. Adoption of Digital and Technological Solutions:-

- Digital Lending Platforms:- Banks have embraced digital technologies to lower transaction costs and enhance loan accessibility, especially for MSMEs and rural populations. Mobile Banking and
- Online Services: Public sector banks (PSBs) have enhanced access to credit for individuals and small businesses by broadening their mobile and internet banking offerings, eliminating the need for in-person visits to branches.

4. Revised Targets and Flexibility

- Relaxed PSL Norms for NBFCs: PSBs can now fulfill part of their priority sector lending (PSL) obligations by providing loans to Non-Banking Financial Companies (NBFCs) and microfinance institutions (MFIs), which subsequently extend credit to priority sectors.
- Inclusion of New Sectors: The criteria for priority sector lending have been broadened to encompass sectors such as renewable energy, healthcare, and education, thereby expanding lending opportunities for banks in these emerging fields.

5. Capacity Building and Financial Literacy

- Training and Awareness Programs: PSBs are actively conducting financial literacy initiatives, particularly in rural regions, to inform potential borrowers about available financial products and the processes for accessing them.

- Skill Development Initiatives: To bolster lending to underserved populations, particularly micro, small, and medium enterprises (MSMEs), banks have collaborated with government programs focused on skill development to improve borrowers' ability to repay loans.

6. Enhanced Monitoring and Compliance

- Monitoring Tools and Data Analytics: Banks have implemented advanced monitoring systems that utilize data analytics and technology to oversee the performance of PSL accounts, ensuring that loans are utilized appropriately and repaid punctually.
- Periodic Reviews and Inspections: Regular assessments and audits of PSL portfolios are conducted to pinpoint issues such as non-performing assets (NPAs) and defaults, allowing for timely corrective measures.

7. Support for Women Entrepreneurs and Rural Development

- Women's Credit Schemes: Banks have introduced targeted lending programs for women entrepreneurs, including initiatives like the Stand Up India Scheme, which encourages entrepreneurship among women and individuals from SC/ST communities.
- Rural Development Initiatives: Numerous public sector banks have prioritized lending to rural and agricultural sectors, which includes supporting agri-processing units, enhancing rural infrastructure, and fostering agro-based industries.

8. Incentives and Penalties

- PSL Goals and Rewards:-Banks that surpass their Priority Sector Lending (PSL) goals are granted specific rewards, such as more lenient capital adequacy requirements, which facilitate increased lending to priority sectors.
- Consequences for Non-Compliance:-Banks that do not achieve their PSL goals face penalties and more stringent regulatory actions, motivating them to implement necessary adjustments for compliance.

9. Restructuring and Support for Distressed Borrowers:- Financial institutions have established programs like One-Time Settlement (OTS) schemes and loan restructuring as a part of Debt Restructuring Options to assist borrowers experiencing financial difficulties, particularly in agriculture and micro, small, and medium enterprises (MSMEs).

Conclusion: -

Priority sector lending is an integral part of all Public Sector Banks lending in India to stimulate and develop the weaker sections in the economy. PSBs must embrace a more adaptable, innovative, and customer-focused strategy for priority sector lending. Regulatory frameworks can be refined to enhance flexibility and support for public sector banks (PSBs) while ensuring the integrity of the Priority Sector Lending (PSL) mandate. Through these efforts, public sector banks strive to tackle the challenges of providing credit to priority sectors while ensuring the goals of financial inclusion and sustainable development are fulfilled.

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