1. **Discuss whether priority sector lending norms need to be done away with? (250 words)**

Answer:

<u>Background:-</u>

- In a recent report the IMF, raised concerns regarding the role of the public sector in the financial system and has advised the RBI to review its PSL policy to allow for greater flexibility in meeting targets

Priority sector lending norms:-

- Currently, all domestic and foreign banks with at least 20 branches are required to lend a minimum of 40 per cent of their total loans (Adjusted Net Bank Credit (ANBC) or credit equivalent amount of off-balance sheet exposure (whichever is higher)) to the priority sector (agriculture, micro enterprises, education, social housing, etc).
- They are also required to meet sub-targets, such as 18 per cent for agriculture (8 per cent for small and marginal farmers), 7.5 per cent for micro enterprises and 10 per cent for weaker sections.
- Those with less than 20 branches will also need to fulfil the overall PSL norms of 40% of adjusted net bank credit (ANBC) in a phased manner by 2020

PSL norms are needed because:-

- Those who are directly affected comprises of mainly weaker sections of society like farmers and small scale industries.
- PSL was created to ensure support for sectors of the economy that do not receive adequate credit or support from financial institutions due to questions of profitability.
- It is also claimed that PSL results in social returns and improved lending portfolios of the banks.
- The directed lending promotes social equity and facilitates increase in employment and investment in less developed regions and the vulnerable sections of the society.
- Average PSL ratio overall is well above the target over the entire period, with some degree of variation. However, the average lending to agriculture and weaker sections is much below the RBI target. All banks have defaulted on their sub-sectoral targets, especially that of 18% for agriculture, in most years.
- Priority sector loans have contributed far less to the gross non-performing assets (NPAs) .priority sector lending may not be responsible for compromising banks' credit risk minimization strategies, or risk accumulation.
- Removal of existing loan limits of up to ₹5 crore to micro and small units and up to ₹10 crore to medium enterprises, will help banks make good the shortfall in MSME loans that qualify as priority sector lending.

They need to be done away with:-

- It diverts funds from the productive sectors, imposes economic burdens on the banks in the form of loan losses and payment defaults and also imposes opportunity costs of lending to non-priority sectors of the economy.
- These negative effects are increased transaction costs, increased NPAs and the decreased deposit mobilization. Since the subsidized nature of loans under the directed credit forces the banks to pay lower interest rates on deposits, this makes the deposits a less attractive avenue for the people which ultimately impacts the banks.
- **Foreign banks**
- They have cited their lack of knowledge, and fear of stressed assets, as reasons for their reluctance to lend to these sectors.
- A foreign bank, desirous of opening a bank branch in some remote area to service agricultural borrowers, neither understands its borrower, nor is clearly aware of the legal provisions to recover stressed assets.
- **Agriculture and credit risk:-**
  - Problem with priority sector loans is the lack of understanding of the sub-sectoral target groups, especially agriculture and the small and medium sector, as also weaker sections.
  - Further, given the vagaries of the monsoon that agriculture is susceptible to and the undiversified risk portfolios in such rural areas, the credit risks for such banks from such PSL would be extremely high.
  - The guidelines for agricultural credit and lending to weaker sections are extremely complex the commercial banks may not be the best equipped to handle beneficiary identification, credit risk assessment and loan disbursement to these sectors.
- Same would be the case for PSL to the micro, small and medium enterprise (MSME) sector. The sector, with its unorganized operations and lack of proper accounting records and financial statements, poses higher costs and greater risks in credit disbursement.
- **IMF recommendations:-**
  - It also suggests a gradual reduction in PSL as a means to move funds into more productive activities and greater participation of the private sector in capitalizing public sector banks, together with full capitalization.
  - Since all banks need to follow guidelines and meet targets on PSL, it compromises their independent, risk-based credit allocation policies and strategies.
  - At a time when non-performing assets (NPAs) are weighing heavily on banks' balance sheets, this poses a challenge to attract credit to productive sectors and enterprises that the economy desperately needs.
  - As the IMF report suggests, sectoral lending targets should be in the exclusive domain of specialised institutions such as NABARD, regional rural banks, small

finance banks and other development finance institutions, and not general commercial banks as is currently the case.

Way forward:-

- Banks should be allowed to choose the category they wish to lend to. Foreign banks may then choose to lend in the form of export credit rather than to agriculture.
- Creation of a development finance institution that would provide a mix of grants and loans to under-served sectors and geographies.
  - The new institution can raise capital from commercial banks through existing innovative instruments like the PSL certificates, specify minimum sectoral disbursement targets and choose projects based on independent risk assessment and intended outcomes.
  - This will support the policy objectives of increased credit and reduce systemic risk, making PSL work in the long run
- Similarly, private sector banks may choose to lend housing credit in urban areas, rather than being forced to lend agricultural finance. The government may rely on specialized institutions such as the National Bank for Agriculture and Rural Development (Nabard) to fulfil sectoral lending targets, while at the same time ensuring structural reforms in these sectors to make lending to them more viable.

PRACTICE QUESTIONS

Answer the following Questions

1. Examine how organisational barriers and court processes that contribute to case delay in India, could be resolved. (250 words)
2. Multiple rate structure of GST makes the tax structure more flexible and not complex. Discuss citing global experiences. (250 words)