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Priority sector lending and non-performing assets: Status, impact & issues

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Abstract

Priority sector lending has become an important component of national agenda after the nationalization of banks. Priority sector lending quota for the commercial banks has provided a major tool for allocation of financial resources to agriculture, small scale enterprises and to the schemes for self-employment. According to priority sector standards, scheduled commercial banks have to give 40% of their loans to the identified priority sectors by the RBI directions. sector-wise NPAs of public sector banks for twelve years from 2005 to 2016 depicts that percentage of priority sector NPAs increased from FY 2005 till FY 2011, and it witnessed fall in FY 2012 and it continued to fall till FY 2016. In case of Non-priority sector NPAs, it continued to fall from FY 2005 to 2009 and it was observed to be stable form FY 2009 to FY 2011 and from FY 2011 onwards it continued to increase substantially from 45.85 in FY 2011 to 76.7 in FY 2016. Both Priority Sector and Non-Priority Sector NPAs are contributing total NPAs of public sector banks. Compound growth rate of nationalized and private sector banks for Outstanding Credit to Priority Sector was calculated and found that private sector banks having more credit to priority sector (26.64215). Resetting PSL targets for banks based on their underlying business models will certainly enable them to meet their targets efficiently. However, considering the costs of PSL for banks, credit availability to priority sectors in the long run can be sustained by making these sectors, especially agriculture, attractive for private sector investment and by strengthening specialized financial institutions like RRBs, cooperatives and MFIs to meet the credit needs of these priority sectors and stimulate positive feedback effect on the growth of these sectors.

Keywords: Priority sector lending, non-performing assets, Indian agriculture, t-test, compound annual growth rate (CAGR), correlation

Introduction

Banking system always played a crucial role in the growth of Indian economy. The economic performance of the country is positively related to the working of different sectors banks. The key players in the development of the economy are different nationalized/commercial banks. Priority sector lending and social banking concepts have been developed and adopted for the purpose of credit deployment. Priority sector lending quota for the commercial banks has provided a major tool for allocation of financial resources to agriculture, small scale enterprises and to the schemes for self-employment (Rani et. al. 2015) [9]. A large number of formal institutional agencies like Co-operatives, Regional Rural Banks (RRBs), Scheduled Commercial Banks (SCBs), Non– Banking Financial Institutions (NBFIs), and Self-help Groups (SHGs), etc. are involved in meeting the short- and long-term needs of the farmers (Kumar *et al*, 2010) [4]. Under this program, the RBI stipulated that at least 40% of average net bank credit (ANBC) or of credit equivalent amount of off-Balance sheet exposures (OBE), whichever is higher, must be given to certain select sectors (Kumar *et al.*, 2016). The scope and extent of priority sector lending has undergone a significant change in the post-reform period with several new areas and sectors being brought under its purview while there had been demands to include new areas, such as infrastructure, within the ambit of priority sector, there is apprehension that it will dilute the definition of the priority sector with the focus on the needy sectors of the economy and weaker section of society getting completely lost (Uppal, 2009) [10].

I. Categories under priority sector (i) Agriculture (ii) Micro, Small and Medium Enterprises (iii) Export Credit (iv) Education (v) Housing (vi) Social Infrastructure (vii) Renewable Energy (viii) Others.

II. Targets /Sub-targets for Priority sector (i) The targets and sub-targets set under priority sector lending for all scheduled commercial banks operating in India are furnished below:

The Total Priority Sector target of 40 percent for foreign banks with less than 20 branches has to be achieved in a phased manner as under:

Table 1: Achievement of Total Priority Sector target

Financial Year	The Total Priority Sector as percentage of ANBC or Credit Equivalent Amount of Off Balance Sheet Exposure, whichever is higher
2015-16	32
2016-17	34
2017-18	36
2018-19	38
2019-20	40

Sources: Master Direction FIDD.MSME & NFS.12/06.02.31/2017-18

The most important factor which measures the health of the banking industry is the size of NPAs. Non-Performing assets have direct impact on the financial performance of banks i.e. their profitability. It denotes the efficiency with which a bank is optimizing its total resources and therefore, serving an index to the degree of asset utilization and managerial effectiveness. NPAs affects the profitability of the banks in terms of rising cost of capital, increasing risk perception thereby affecting liquidity position of banks (Mittal, *et al.*, 2017) [6]

Research Methodology

The secondary data collected from RBI trends, reports and annual reports has been considered for the purpose of this study. The performance priority and non-priority sectors were analysed with the help of few variables like sector wise growth of priority sector advances, sector wise performance of priority sector advances, share of NPAs in overall priority sector advances. For analyzing secondary data, tools like simple percentage, annual growth rate and compound growth rate followed by Correlation analysis and Paired t-test were used.

Results and Discussions

Table 2: NPAs in Priority and Non-Priority Sectors and Public Sector Banks (Amount in Billion)

Years	Priority Sector		Non-Priority Sector		Public Sector		Total
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount
2005	215.36	45.22	254.94	53.53	5.92	1.24	476.22
2006	222.36	53.75	182.79	44.18	8.55	2.07	413.70
2007	225.19	57.96	156.03	40.16	7.32	1.88	388.54
2008	248.74	61.48	150.07	37.10	5.74	1.42	404.56
2009	242.01	53.75	205.28	45.59	2.97	0.66	450.26
2010	304.96	50.89	291.14	48.58	3.14	0.52	599.24
2011	401.86	53.82	342.35	45.85	2.43	0.32	746.64
2012	557.80	47.57	588.26	50.17	26.56	2.27	1172.62
2013	672.76	40.91	960.31	58.39	11.55	0.70	1644.61
2014	798.99	35.16	1472.35	64.79	1.30	0.06	2272.64
2015	966.11	34.69	1815.98	65.21	2.59	0.09	2784.68
2016	1258.09	23.30	4141.48	76.70	34.82	0.64	5399.57

Source: Handbook of Statistics on the Indian Economy, 2016-17

It has been depicted from the tables 2, which from 2005 till 2011 percentage of priority sector NPAs increased, and it witnessed fall in 2012 and it continued till 2016. In case of Non-priority sector NPAs, it continued to fall from 2005 to 2009 and it was observed to be stable form 2009 to 2011 and from 2011 onwards it continued to increase substantially from 45.85 in 2011 to 76.7 in 2016.

Table 3: Comparison of Priority and non-priority sector in nationalized banks (Amount in Billion)

Nationalized banks	Priority Sector		Non Priority Sector	
Years	Amount	Percentage	Amount	Percentage
2017	1257.29	24.80	3811.93	75.20
2016	969.03	23.18	3210.85	76.82
2015	709.34	34.61	1337.67	65.26
2014	537.50	36.45	935.67	63.46
2013	408.34	40.16	599.01	58.91
2012	324.24	46.96	355.55	51.49
2011	246.20	55.61	194.10	43.84
2010	195.67	53.76	165.23	45.40
2009	157.54	59.35	106.68	40.19
2008	159.72	63.96	85.63	34.29
2007	153.44	58.63	103.40	39.51
2006	149.22	51.78	132.27	45.90
2005	153.36	46.75	170.62	52.01
Correlation analysis of Priority and Non Priority Sectors				
Priority Sector	Pearson Correlation		1	.977**
	Sig. (2-tailed)			.000
	N		13	13
	Bias		0	.000
	Std. Error		0	.000
Non Priority Sector	Pearson Correlation		.977**	1
	Sig. (2-tailed)		.000	

	N		13	13
	Bias		.000	0
	Std. Error		.000	0
**. Correlation is significant at the 0.01 level (2-tailed).				
b. Unless otherwise noted, bootstrap results are based on 1000 stratified bootstrap samples				

Table 4: t-Test of Priority and Non-priority sectors

Paired Samples Test								
	Paired Differences					t	df	Sig. (2-tailed)
	Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
				Lower	Upper			
Pair 1 Priority Sector-Non Priority Sector	-445.20	893.526	247.819	-985.161	94.743	-1.79	12	.098

From the table it has inferred that from 2006 to 2011 the priority sector has shown growth form 51.78 to 55.61 billions and in non-priority sectors it has uneven growth in the same period. From 2012 to 2017 it has shown a decreasing rate in priority sectors from 46.95 to 24.80 billions and similarly an increase in non-priority sectors from 2012 to 2017 as 54.49 to 75.20 billions. From the statistical test, correlation between Non-Priority Sector NPAs and total NPAs was found to be 0.977; this indicates a higher degree of positive relationship between Non-Priority Sector and priority sector. Mean differences between the two variables was -445.20 and paired sample t test calculated values was -1.79, and the p value was 0.098.

Table 5: Deployment of bank credit by major sectors (Rupees Billion)

S. No.	Major Sectors under Priority Sector Lending	2015	2016	2017	Compound Annual Growth Rate (CAGR)*
1.	Priority Sector	20103.24	22259.07	24356.53	10.07145
2.	Agriculture & Allied Activities	7658.80	8825.90	9909.22	13.74685
3.	Micro & Small Enterprises	8003.43	8475.87	9019.75	6.159576
4.	Manufacturing	3800.28	3714.67	3697.32	-1.36394
5.	Services	4203.14	4761.20	5322.43	12.52993
6.	Housing	3223.86	3422.76	3683.44	6.890403
7.	Micro-Credit	177.01	188.46	188.94	3.314923
8.	Education Loans	591.84	601.37	604.36	1.052183
9.	State-Sponsored Orgs. for SC/ST	3.48	5.14	6.38	35.40064
10.	Weaker Sections	4048.84	4773.97	5545.99	17.03728
11.	Export Credit	426.26	423.82	425.02	-0.14556

Data Source: Handbook of Statistics on the Indian Economy, 2016-17 and *Authors Calculation

An annual compound growth for calculated for different priority sectors. It was observed that priority sectors have growth rate of 20103.24 in 2015 and in 2017 it was 24356.53 billion with and growth rate of 10.07. Similarly in agriculture and allied sector it was found that amount 7658.80 was deployed and in 2016 it was 8825.90 whereas in 9909.22 billion with an compound growth rate of 13.47 from 2015-2017. For manufacturing and export credit sector has shown a negative growth rate of -1.3 and -0.14 respectively.

Impact of NPAs on Banks

According to Mittal *et al.*, 2017 [6], NPAs directly affect the profitability of the banks. Below mentioned are the ways through which banks profitability is affected:

(i) Liquidity position: NPAs affects the liquidity position of the banks, thereby creating a mis-match between assets and liability and force the banks to raise resources at high cost.

(ii) Effect on funding: Increasing level of NPAs in banks results in scarcity of funds in the Indian capital market as there will be only few banking institutions who will lend money.

(iii) Higher cost of capital: It shall result in increasing the cost of capital as banks will now have to keep aside more funds for the smooth working of its operations.

(iv) High risk: NPAs will affect the risk-bearing capacity of the banks.

(v) Effect on income: NPAs will reduce the net interest income of the banks as interest is not charged to these accounts.

(vi) Declining productivity: It will also cost in terms of time, money and manpower which will ultimately results in declining profitability, since the staff is primarily engaged with preparing papers for filing law cases to recover principal amount and interest rather than devoting time for planning mobilization of funds.

Issues and Problems

Low Profitability

There is an increasing proportion of deposit resources under statutory liquidity pre-emption at lower rates which is due to shift of the savers' preference to long term deposits and the incidence of the non-performing assets and Increasing involvement of banks in providing mandatory credit entailing rigid target setting has become one of the important reason for declining profitability.

High NPAs

People who borrow from the bank do not repay the loans in time which increase non-performing assets of the banks. The sustainability of priority sectors depend upon the efficient use of the credit of the priority sector lending and the later is directly related to the issue. Thus priority sector lending has created anxiety among Indian banks which discourages them to go slow in disbursement of credit to these sectors.

Quantitative targets
An erosion of quantitative aspects of lending has been caused due to the concern for achieving quantitative targets within stipulated frame of time despite of assessed potential or demand which affects viability of lending institutions.

Transaction cost
Sanctioning and monitoring of large number of small loans is time consuming and manpower intensive thus, increases the transaction cost. Deficiencies in pre-sanctioning of the loan and unlimited application in case of lending under poverty alleviation programmes at the last moment by sponsoring agencies also compound the problem.

Strategies & Suggestions
Rate of interest
Reserve Bank of India issues various guidelines regarding interest rate for priority sectors lending schemes. Banks should follow these following guidelines of RBI; 1) In respect of direct agricultural advances; banks should not compound the interest in the case of current dues, i.e. Crop loan and instalment should not fall in respect of term loan, because the agriculturalist do not have any regular income source other than sale proceed of their crops; 2) Banks can add interest to the principal amount when crop loan and instalment under term loan becomes overdue; 3) Bank should extend the period of loan or reschedule the instalment under term loans where default is due to genuine reason.

Recovery of the NPAs
Bank should follow the following measures for the recovery of NPAs; 1) Debts Recovery Tribunal should implement to recover the NPAs; 2) Banks should be very careful in considering compromise proposal; 3) Bank should try to introduce a system of internal audit before disbursement of the loan.

Qualitative targets
Banks should fix quantitative as well as qualitative target so that feasibility of banks could be enhanced. Jain (2015) [3] & Mittal *et al.*, (2017) [6] proposed the following recommendations for Priority Sector Lending for Banks and NPA in India as follows:

- The overall target for PSL needs to be reducing to 35% from 40% in a phased manner by March 2020.
- The target for agriculture needs to reduce to 15% from 18% with no distinction like direct and indirect agriculture.
- Need to add more sectors (like start-up industries) under MSME target.
- Need to rationalize home loan limits.
- Ceiling of export credit needs to increase from 2% to 5% of ANBC.
- The PSL targets need to be calculate on 'Net Lendable Resource' instead of ANBC.
- Revision of existing credit appraisal and monitoring systems by RBI
- Regular follow-up of customers by the banks to ensure that there is no diversion of funds.
- Review of all loan accounts at fixed interval.

Conclusion
Thus, the study reveals that priority sector lending of public sector and private sector banks have not achieved all over targets. A large number of public and private sector banks are not able to reach the prescribed target of lending to priority sectors during study period. In nutshell, shrinking share of real priority sector, neglect of agriculture, neglect of small scale industries and weaker sections, are some important serious issues which need immediate attention of policy maker. Therefore, it is essential that the priority sector lending behaviour of these banks should be closely monitored in the national interest.

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