IFMR
Finance Foundation

IFMR Finance Foundation's Response to the Nair Committee Report on Priority Sector Lending

Directed credit, with its objectives of growth, employment and equity, has been an important policy tool in India since independence. However, this has not translated into substantively improving access to finance outcomes. This has also created attendant problems of high levels of NPAs associated with priority sector assets originated by banks. A recent Financial Stability Report[1] states that 'the contribution of priority sector to aggregate NPAs of the banking system was 48% as at September 2011, which was higher than contribution to total advances of the banking system of 31%'.

The Committee to Re-examine the Existing Classification and Suggest Revised Guidelines with regard to Priority Sector Lending Classification and related Issues chaired by Shri. M.V. Nair (the Nair Committee) recently submitted its recommendations. The Report makes several important recommendations including creating a level playing field for domestic and foreign banks as well as introduction of new categories such as off-grid energy financing.

Our principal observation on the Report is vis-à-vis the role of non-bank intermediaries in the achievement of priority sector policy objectives. In addition to that, we make some minor observations on biases inherent in the definition and implementation of priority sector rules.

Strong Bias towards Direct Origination/Intermediation by Banks

One of the important terms of reference of the Committee was to "consider if bank lending via financial intermediaries for eligible categories of borrowers and activities could be classified under the priority sector and if so, to lay down the conditions subject to which this classification would be admissible." The background to this is an increasing anxiety about the growth of specialised lenders like Micro Finance Institutions (MFI) and gold loan companies fuelled by access to priority sector funding from Banks. In fact, with effect from April 1, 2011, lending through intermediaries is not considered as priority sector lending.

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[1] RBI, December 2011

The Committee recommends that:

"Keeping in view the role of non-bank financial intermediaries like Primary Agricultural Cooperative Societies (PACS), Cooperative Banks, NBFCs, HFCs and MFIs in extending the financial services to the last mile, bank loan sanctioned to non-bank financial intermediaries for on-lending to specified segments may be reckoned for classification under priority sector, up to a maximum of 5 per cent of Adjusted Net Bank Credit (ANBC), subject to adherence to the terms and conditions stipulated..."

Elsewhere in the report, the Committee also states that

"The ultimate objective for banks is to create last mile connectivity through either opening branches or BCS in a defined time manner. Therefore, it is desirable to phase out in a time bound manner the intermediary channel that banks use for reaching out to diverse priority sector segments"

While the Committee's position on intermediaries is more flexible than current norms, it reinforces the policy direction of strongly disincentivising banks from partnering with specialised originators/intermediaries such as NBFCs while nudging banks to open their own branches and originate through their own staff or agents, despite all the issues noted with this approach elsewhere in the report including sharply rising NPAs. With only 30% of the commercial bank branches being in rural areas and with only 61% of the country's population having bank accounts despite decades of efforts by the banking sector, there is strong reason to question an exclusive reliance on bank-led approaches. In its report, The Raghuram Rajan Committee says: *"The focus should be on actually increasing access to services for the poor regardless of the channel or institution that does this—large banks may or may not be the best way to reach the poor, and while the mandate may initially force them to pay for expanding access, others may be able to offer the service more efficiently".*

This is also a systemically riskier approach. For example, when a bank directly provides farm loans on its balance sheet, it is protected merely by its own capital against potential losses. On the other hand, when a bank lends to a specialised financial intermediary who then provides farm loans on its balance sheet, the bank is buffered by the capital of the intermediary to some extent. By phasing out non-bank financial intermediaries, this additional layer of capital protection for priority sector lending will disappear, thus transferring more risk directly to balance sheets of banks. This in turn will translate into higher capital infusion commitments by the Government into state-owned banks or alternately creating fiscal mechanisms such as the Credit Guarantee Fund, as envisaged by the Committee for lending to small and marginal farmers. This has systemic consequences. We need more institutional heterogeneity in the Indian financial system and room to innovate without directly putting depositor money and fiscal

resources at risk, as implied by pure bank-led approaches. This then implies the urgent need for the growth of non-deposit taking institutions that have the expertise and capitalisation to operate in specialised markets and robust partnerships between these institutions and the banking sector.

Policy must focus on outcomes and be agnostic to the different routes in which it can be achieved or the nature of institutions involved. For example, if the outcome of interest is increasing access to crop loans for small farmers, it should not matter whether this loan was provided by a bank, a non-bank or a cooperative, everything else being equal. The only criteria to determine whether an asset must qualify for priority sector is if the underlying purpose of the loan is consistent with the stated goals of priority sector policy. This implies that if the crop loan is seen as fulfilling policy objectives, there must be no distinction made between a crop loan advanced directly by a bank or a crop loan advanced by a non-bank using wholesale funding from a bank. Making this distinction admits of lack of competitive neutrality. Conversely, if a gold loan is viewed to be not welfare-enhancing, it must not be accommodated in the priority sector framework at all, irrespective of whether the gold loan is advanced by a bank or a non-bank. Current policy places too much onus on the channel, rather than the ultimate outcome.

In addition to this significant design flaw vis-à-vis the role of intermediaries, we want to point out some additional concerns for consideration:

I. Bias against landless labourers

Agricultural credit, in the manner in which it is defined, has certain biases built into it. For instance, borrowing to buy a tractor for one's cultivable land or to purchase feed for dairy cattle is recognised under priority sector as a direct agriculture loan while borrowing to purchase food for own consumption by a landless agricultural labourer is not recognised despite strong productivity links in this case. These biases built into the very definition of eligible assets need to be addressed swiftly and effectively.

II. Income-based targeting for non-bank intermediaries

Policy has also introduced income-based priority sector targeting for specific classes of entities (such as the income-based qualifying assets criterion for NBFC-MFIs), while this feature is absent for other qualifying loans within priority sector. Such income-based evaluation is fraught with operational issues.

III. Discontinuous measurement of priority sector achievements

Commercial banks have exhibited a tendency to achieve a significant portion of their priority sector targets mostly towards the end of the financial year when achievement against targets is reckoned. This refutes the purpose of priority sector as the much needed credit reaches the target segments once a year and at a specified month(s) irrespective of cropping seasons or business cycles. A study[2] by NABARD found that the credit limit of the Kisan Credit Card is being used as a one-shot loan instead of as a cash credit limit, either due to the loan amounts being inadequate or because of operational issues faced by the bank or the PACS. This only adds to the debt burden of the farmer as he would have to service interest on cash that he requires only at a later point in his cropping season. Mandating quarterly priority sector targets will serve to ensure that flow of credit to priority sectors is relatively continuous and not limited to certain times of the year.

[2] http://www.nabard.org/fileupload/DataBank/OccasionalPapers/Kisan%20Credit%20Card.pdf