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CUTS INTERNATIONAL

COMMENTS ON THE REPORT OF RBI INTERNAL WORKING GROUP TO REVISIT THE EXISTING PRIORITY SECTOR LENDING GUIDELINES

1. Background

An internal working group (IWG) was constituted by the Reserve Bank of India (RBI) to revisit the existing priority sector lending (PSL) guidelines and suggest revised guidelines in alignment with the national priorities as well as financial inclusion goals of the country.

The IWG submitted its report on 01 March 2015 (Report), which was released in public domain to enable interested stakeholders to provide comments/suggestions. Set out below are comments from CUTS International on the Report of IWG. CUTS International is a non-government non-profit economic policy research and advocacy organisation working in the areas of consumer protection, competition, and trade for more than three decades (www.cuts-international.org).

2. Need to relook approach to PSL

From time to time, RBI issues guidelines in form of notifications and circulars to scheduled commercial banks, on the issue of PSL. Such guidelines are consolidated on an annual basis in a master circular. RBI derives its power to issue such guidelines from the Banking Regulation Act, 1949 (BR Act). Section 21 of the BR Act empowers RBI to determine the policy in relation to advances to be followed by banking companies. Such policy is required to be guided by public interest, or interest of depositors, or banking policy.

The loosely drafted section 21 provides ample unbridled discretion to RBI to distort the loans and advance market of banks by directing them to conduct business in a particular fashion, and resulting in redistribution of financial services. The market gets distorted as the banks are required to allocate funds in a manner which they otherwise might not, resulting in sub-optimal returns for its shareholders and depositors, and inadequate access to finance to remaining sectors.[1] The PSL is often directly proportional to high default rate,[2] which, at times, is linked to waiver announcements by central and state governments.[3] This results in high non-performing assets and sub-optimal utilisation of available financial resources in the economy, a luxury which country like India cannot afford.

The power under section 21 comes with 'no strings attached' and the RBI is not statutorily accountable for success or failure of its policy.[4]

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[1] It might be recalled that one of the factors which RBI could take into consideration while framing policy under section 21 is interested of depositors, however, this seems to be often overlooked.

[2] "*Since the last decade, the share of priority sector in gross advances averaged at over 32 per cent, while its share in total NPAs remained much higher, averaging at around 45 per cent*", Re-emerging stress in asset quality of Indian Banks, Shashidhar M. Lokare, 07 February 2014

[3] The culture of loan waiver must end: Raghuram Rajan, Hindubusiness Line, November 13, 2014

[4] "*While India has high democratic accountability overall, this is not true of RBI. RBI is a set of unelected bureaucrats who are, in effect, largely unaccountable. Although it is supposed to be held accountable by the Parliament, one cannot see how such accountability can be enforced. At present, RBI pursues multiple, conflicting objectives, which give endless opportunities of offering alibis for non-performance. It is a central*

While not being statutorily accountable, RBI undertakes review of its policy on PSL from time to time. As mentioned in the Report, the current requirement of priority sector lending comprising 40 percent of bank advances has been in place since 1985, with minor modifications from time to time.[5] The Report further notes that despite being one of the largest and longest public policy intervention programmes in the world, empirical evidence of the efficacy of PSL in India meeting its final objectives has been limited. Further, there have been concerns about the distribution of credit and a persistent credit gap in these sectors having national priority.

Failure to meet the objective in 30 years since operation, and consequent need to continue to distort the market, begets a rethink on the approach to PSL. In defense of continuation of current approach on PSL, the Report mentions, '*the issue regarding the need for continuance of priority sector prescriptions was discussed with a representative section of bankers and some of the other stakeholders to get a wider perspective. A general perception that emerged was that if the prescriptions under PSL had not been there, the identified sectors would not have benefited to the extent they have and hence, there is a need to continue with priority sector prescriptions.'*

It is nobody's case that certain sections and sectors of the society do not need special attention with respect to financing. However, the approach of facilitating this through distorting market of loans and advances of banks need to be relooked. The direct and indirect costs to stakeholders, including the depositors, taxpayers, and the economy of the hitherto PSL model might have long outweighed the limited benefits. Lack of statutory accountability on RBI to undertake impact assessment of RBI policies has impeded a comprehensive relook of policies such as bank-led PSL and is a major reason for continuation of such sub-optimal policies for more than three decades.[6]

As indicated in the Report, in addition to bank-led PSL, varied approaches are practiced across jurisdictions to facilitate PSL. These include direct credit facilities by government, regulator and dedicated financial institutions, reimbursement/ incentivisation of commercial banks for fulfilled PSL obligations et al. There is a need to develop, evaluate, and compare costs and benefits of each of such approaches to select such approach which has the potential to provide maximum net benefits to the stakeholders.

3. Need of clear guidance from government

As PSL largely meets political objectives, there is a need for a clear guidance and direction on this from government. It might be recalled that originally the initiative in relation to PSL was taken by government, however, with time, governments have seemed to detach themselves from the responsibility of providing guidance and evaluating effectiveness of PSL guidelnes. The current Report is also a result of RBI taking upon itself the task of revision of PSL guidelines for alignment

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bank, manager of government debt, redistributor (e.g. priority sector requirements), regulator of banks, non-banking financial companies, payments and capital flows. It runs exchange and payments infrastructure. When failing on beating inflation, it can say it was keeping interest rates low on government debt. ***When failing on safety and soundness regulation, it can argue that it was busy ensuring banks lend to priority sectors where they incurred losses.*** *Multiple objectives, and conflicts of interest, has given a loss of accountability."* Ajay Shah et al, Going from Strong as in Scary to Strong as in Capable, March 2015

[5] RBI Master Circular on Priority Sector Lending, July 1, 2014

[6] Handbook on governance enhancing and non-legislative elements of the draft Indian Financial Code, 26 December 2013, prescribes regulators to undertake a cost-benefit analysis of regulatory proposals

with national priorities and financial inclusion goals of the country, as there is a lack of guidance on government in this regard.

Rather than providing clear guidance, governments often acts contrary to interests of PSL lenders by announcing loan waivers. This discourages banks from meeting PSL norms. Better guidance and direction on PSL targets from government and timely coordination with RBI would also aid in selection of optimal approach to achieve the targets.

4. Competitive neutrality between foreign banks and domestic banks

The Report has recommended that PSL targets be applicable to all commercial banks, without any distinction between foreign and domestic banks. While the requirements were made applicable to foreign banks having more than 20 branches since 2012 (to be complied by 2018), the Report recommends making the requirements applicable to remaining banks (less than 20 branches) by 2020. While there have been concerns in the past in relation to utility of applying PSL guidelines to foreign banks, in light of their restricted customer base, such concerns are expected to subside when the increased requirements could be met with the availability of priority sector lending certificates (PSLCs).

While this requirement is expected to impose additional burden on foreign banks with limited Indian presence, the parity of treatment seems to be step in a right direction. However, it must be noted that at present, foreign banks are allowed to open up to 20 branches per year as opposed to unlimited number of branches that can be opened by domestic banks in a year. Further, regulatory oversight over foreign branches is less stringent than for locally incorporated banks.[7] There is a need to ensure competitive neutrality amongst foreign and Indian banks in all matters, thereby enabling foreign banks to compete efficiently with domestic counterparts. This would help foreign banks in meeting PSL targets in reality, and not just rely on PSLCs, thereby ensuring market efficiency.[8]

5. Introduction of PSLCs

The Report recommends introduction of PSLCs to facilitate better implementation of PSL mandate. It mentions that the PSLCs could be issued on the basis expected annual surplus in meeting PSL requirement. Absence of direct linkage of PSLC with achievement of PSL target is matter of concern. The Raghuram Rajan Committee Report[9], recommended direct linkage of PSLs to PSLCs via enabling earning of specific amount of PSLCs by making of PSLs. This ensures a clear of objective in form of making PSL to earn PSLC. This seems to be missing from the Report.

The Report further provides that no bank can issue PSLCs of more than 50 percent of last year's PSL <u>achievement</u> or excess over the last year's PSL <u>achievement</u>, whichever is higher. This alternate

[7] The detailed corporate compliance requirements on matters such as board and management do not apply when entities operate through the branch route as they are not incorporated in India. Further, since capital is fungible the assets of foreign branches in India can be repatriated back to the home country with relative ease which raises concerns of governance and resolution. However, liberalised norms to open branches in smaller cities applicable to domestic banks are not applicable to foreign banks. (Financial Sector Legislative Reforms Commission, Report of the Working Group on Banking , March 2013)

[8] RBI has recently released framework for setting up wholly- owned subsidiaries by foreign banks in India. The policy is guided by principles of reciprocity and single mode of presence.

[9] A Hundred Small Steps, Report of Committee on Financial Sector Reforms, 2010

criteria to limit overall amount of PSL seems confusing as there might not be a situation where the former is higher than the latter.

6. Ensuring compliance

In order to ensure efficient monitoring of PSL targets and prevention of year-end crowding, RBI has proposed setting up and monitoring of quarterly PSL targets of banks. This is also expected to aid in tracking use of PSLCs at quarter end.

Such requirement is expected to put additional costs on banks and RBI, both of which would have to build adequate capacity to ensure effective compliance. The perceived benefits are closer monitoring and thus better compliance with PSL targets. All such proposals which are expected to impose additional costs on stakeholders must be mandatorily reviewed on a periodic basis to ensure that the benefits that accrue outweigh the cost, and to enable mid course correction.

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