The Strategies of Lending for Priority Finance in the SAARC Region

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1. Introduction

The SAARC region--along with a diverse geography--has human and social dimensions which are equally diverse. Total population in the region is large and growing. In addition to its vastness, the region is varied and rich in development experience. Some countries are very large while others are small in terms of size of population, economy and geography. The economies of some countries are growing at high rates; while others are gathering speed.

As a result, development challenges faced by the region are quite diverse. Differences in population dynamics and vulnerability to natural disasters are examples which show stark differences. According to the World Bank, between 1990 and 2013, the poverty headcount ratio at $1.90 a day (2011 PPP) fell from 47.3 per cent to 16.2 per cent in South Asia. The same period also saw maternal mortality and under-five mortality rates fall significantly − along with declines in the prevalence of malnutrition. Over the last decades, the region has experienced unprecedented economic and social transformations.

Despite such commendable progress, poverty is still a major challenge, especially in terms of absolute numbers, in the SAARC region. Further, the region has seen glaring disparities across different sub-regions; many parts and sectors of the region gained, while others were by-passed. The success of the region's continued progress towards prosperity depends on adopting a development model that nurtures inclusiveness, equality and social stability as well as broad-based productivity gains.

At present, South Asia is poised to hold its position as the fastest growing region in the world; and is likely to extend its lead over East Asia and the Pacific within a short time. Further, the sustainable development goals (SDGs) present a historic opportunity for the SAARC region to make development more inclusive, equitable and sustainable and to end extreme poverty and provide a life of dignity to all within a generation. This is of particular relevance to South Asia, a region accounting for about 36 per cent of the world's poor and nearly half of the undernourished children.

The SAARC region's economic dynamism and promising prospects provide confidence in its ability to transform itself and build a sustainable future for all. A determined political will is required if the region is to expeditiously adopt and implement the 2030 agenda for sustainable development. To do so, the region needs to mainstream the SDGs into national development plans and budgets as well as reorient growth frameworks to be inclusive, equitable and promote low-carbon development pathways.

In addition, the SAARC region must promote an industry-oriented structural transformation for creating decent jobs without jeopardising environmental sustainability. As per capita incomes rise and demographic dividends grow, targeting manufacturing sector development will become even more critical to meet the increasing domestic demand. Further, inadequate export orientation may carry the risk of external account vulnerabilities. Structural transformation therefore needs to focus on nurturing higher value-added and new and innovative products and services for domestic, regional and global markets. Sustainability in South Asia must therefore, rest on a core foundation of diversification and competitiveness.

Science, technology and innovation agendas in the region must also be aligned with the new sustainable development paradigm and the countries must strengthen their capabilities and capacities in the sector. This requires conducive policies and legal and regulatory frameworks; supported regionally and globally by favourable technology transfer provisions and a global technology facilitation mechanism. In this respect, regional cooperation would play a critical role.

The region's success in implementing the SDGs, however, hinges on addressing current capacity gaps and strengthening the means of implementation. Mobilising diverse sources of finance is imperative to the region in this respect. This includes, but is not limited to, domestic resource mobilisation, official development assistance, foreign direct investments and public-private partnerships for sustainable development but also through directing credit to the priority sectors.

Given the challenges that the SAARC region faces, the policymakers need to examine the possibilities of lending for priority finance keeping the integrated pillars of the SDGs in view. However, priority financing should not be considered in isolation; rather this should be clearly linked with its purpose. Further, the SAARC policymakers should anticipate and identify the unintended consequences of global financial regulations on the SAARC countries and work with global partners to mitigate them. Recent trends in global financial regulation, such as the increase in anti-money laundering (AML) and combating the financing of terrorism (CFT) standards, have had some unintended consequences in several developing countries. Even

Basel III, with its disincentives for banks to engage in long-term finance, due to more stringent liquidity ratios, can have negative consequences for the SAARC attempts to increase lending for priority finance.

Similarly, illicit financial flows are relatively high in the SAARC region by some estimates, whereby many countries are losing huge amounts predominantly due to tax evasion by commercial enterprises and the undervaluing of services and traded goods, while corruption and organised crime also contribute to illicit flows. This loss in capital has translated to lost opportunities for advancing economic and human development in the SAARC region. New efforts are needed to track and reduce illicit financial flows.

2. Lending for Priority Finance

The collective response of the SAARC region to the major development challenges of today needs to adopt innovative financing mechanisms and explore how specific country approaches affect development policies and outcomes at the country and local levels. One must also recognise the citizen's right to development; and push forward a development agenda that recognises that: 'Economic growth without investment in human development is unsustainable and unethical' (Amartya Sen).

Similarly, there are certain sectors in the economies of these countries that require a regular inflow of credit in the larger interest of the countries. As part of their role in development, the commercial banks are required to extend a committed proportion of their adjusted net credit as loans to these sectors, which are classified as priority sectors. This is called priority-sector lending (PSL) or lending for priority finance (LPF).

Historically, the SAARC governments have used state-directed priority sector lending as a policy tool to improve access to credit for the underserved sectors and groups. Almost all countries implement some form of priority sector lending, whether through lending quotas or interest rate caps. Among the priority sectors, micro, small- and medium-sized enterprises (MSMEs) and agriculture receive preference across the countries.

The lending for priority finance has been adopted by many other countries, in addition to the countries in the SAARC region, as a tool to direct financial resources towards select sectors of the economy, which need special thrust for growth. Although the LPF programmes differ significantly in each country in terms of size, scope, strategy, and focus, still the primary objective of these programmes is to provide credit support to the priority sectors of each economy, so that growth becomes sustainable and inclusive.

The prominent priority sectors identified in most countries under these directed credit programmes include areas like agriculture (e.g. farm credit, agricultural infrastructure and ancillary activities); micro, small and medium enterprises (MSMEs); export credit; education; housing; social infrastructure; renewable energy; and other sectors of national importance; and to the weaker sections in these sectors. It is an active instrument of financial policy which aims to restore sectoral balance within credit disbursement and develop the weaker sections within these sectors. These sectors usually employ a large number of people, are geographically well spread across the entire nation, and involve small size owners.

The governments typically implement priority sector lending programmes based on the theory that the financial sector might otherwise underserve socially beneficial sectors because of underpriced risks, information asymmetries, or high transaction costs that the private sector is unwilling to bear. The policy objectives that usually motivate state-directed lending include:

- Financial inclusion initiatives involve efforts to expand financing for sectors like MSMEs or agriculture, which frequently have a share of credit that is lower than their share of output because large businesses receive preferential treatment. Banks prefer larger clients as economies of scale decrease transaction costs and increase the risk-adjusted return.
- Concerns over income inequality or national security may prompt the governments to encourage lending to priority sectors even if such lending may create other economic distortions.

Currently, the most common form of priority sector lending in the region is the use of lending quotas by banking regulatory authorities. In the case of India, for instance, 40 per cent of all bank loans must go to the priority sectors, which include agriculture, SMEs, and export-oriented industries. In Bangladesh, agriculture and rural finance programmes have boosted up as the private commercial banks (PCBs) and foreign commercial banks (FCBs) along with the state-owned commercial banks (SCBs) and specialised banks (SBs) have come forward to disburse agricultural and rural credit fulfilling their targets. Bangladesh Bank, the country's central bank, also has special refinance schemes for the share croppers and dairy farming, among others. Bangladesh Bank's SME credit policies and programmes involve target based SME lending. Bangladesh Bank also operates refinance for SMEs, agro-based product processing industries, and women entrepreneurs.

The Bank of Bhutan (BOB) has adopted priority sector lending to promote and identify the cottage and small industries (CSI) as a priority sector for targeted lending and increased coordination and efficiency in the delivery of government support schemes and incentives. For the purpose, PSL guidelines have been issued for all financial Institutions.

The Nepal Rastra Bank (NRB) raised the lending requirement for commercial banks towards productive sectors to 25 per cent of their total lending in 2017-18. By increasing productive sector lending requirement, the banking industry is expected to channelise more resources into priority sectors like agriculture, energy, tourism, and small and medium enterprises, which are the major sectors of economic activities, and to support the economic growth target of the government. The central bank has also expanded the definition of productive sectors to accommodate pharmaceuticals, cement, and garments, among other industries, as productive sectors.

The State Bank of Pakistan (SBP) has been making endeavours to enhance the priority sector lending--agriculture credit, micro financing, SME financing, house financing, infrastructure financing and exports. Keeping in view the importance of these sectors, the SBP has created enabling regulatory environment through conducive prudential regulations (PRs) and market development through positive policy measures i.e. issuance of guidelines, setting indicative targets, and promoting capacity building of financial institutions.

The Maldives has progressed remarkably well on economic as well as social indicators in the last two decades. The Maldives Monetary Authority (MMA), the central bank of the Maldives, and the government have taken targeted efforts for the promotion of small and medium enterprises and the development of low cost housing and other activities linked to local economic and social needs with the aim of deepening services to the less developed Atoll regions, especially in the north. Access to finance is a significant issue for the promotion and development of MSMEs in the Maldives and for reducing income disparities between Malé and the atolls. The development of MSMEs has been clearly identified as one of the key solutions towards fostering greater economic inclusion. The policies aim to create a more inclusive and broad-based MSME sector with a focus on enhancing the business environment and supporting infrastructure for doing business with better knowledge, greater access to financing, and expanded business opportunities for MSMEs.

Afghanistan has been taking measures to build institutional capacity to improve access to credit of micro, small, and medium enterprises. Further, developing medium and long-term financing options is a top priority for Afghanistan and part of its plan to increase the size of the formal economy. A rise in lending and business development would boost such sectors as telecommunications, media and banking, reducing agriculture’s prominent role in overall economic activities. Currently, farming accounts for around 35 per cent of the Afghan economy.

The Central Bank of Sri Lanka (CBSL) coordinates, facilitates and implements various refinance schemes, interest subsidy schemes and credit guarantee schemes while delivering credit supplementary services through the Regional Development Department (RDD) of the CBSL. The strategic objectives include enhancing regional growth, reducing poverty, creating income generating activities and employment opportunities, supporting skills development and training, strengthening economic activities in the lagging regions and enhancing production of essential food items including organic food to ensure food security and food safety.

The above policy priorities in the SAARC economies point out that, aside from agriculture, MSMEs are usually significantly underrepresented in the allocation of credit given their relative contribution to GDP and employment. The MSMEs suffer particularly large credit gaps that make the sector a typical target for priority sector lending programmes.

Priority sector lending is generally motivated by a policy goal of increased access to finance, but such lending could affect banking system stability if the recipient sectors suffer asset quality problems. Some statistics indicate higher average NPL ratio for MSMEs compared with large firm loans; while priority lending to the agricultural sector sometimes creates negative impact on asset quality as the banks aggressively expand credit to the sector in meeting the lending quota.

3. Need for Lending for Priority Finance

The priority sector bank lending policy is designed to ensure that vulnerable sectors and sections of the society get access to credit at an affordable rate and also there is adequate flow of resources to those segments of the economy, which have a higher employment potential.

In defense of such programmes, it is argued that there is a case for government intervention in credit markets in most developing countries, in view of market imperfections and structure of the banking system. These sectors may not receive timely and adequate loans in the absence of this special privilege. Usually these include small value loans to farmers for agriculture and allied activities, micro and small enterprises, poor people for housing, students for education, and other low income groups and weaker sections. Hence, these lending bring in issues related to bank ownership, size, performance, lending efficiency and other factors.

Unlike large corporate borrowers, most of the borrowers in the priority areas are by their very nature small in size; may not have verifiable financial statements, sufficient or asset-based collaterals; and may be located in rural areas or small towns. This could lead to their higher probable risk of default if the lending banks' structures are not flexible to adapt to peculiar nature of such lending. Thus, it presents a set of challenges to many banks, especially large and state-owned ones, which have fixed structures and who rely more on transaction based lending technologies. As against this, smaller banks or privately owned ones often have a comparative advantage in relationship-based lending, which may be more suitable for priority sector type of lending. Therefore, it is often seen that smaller banks can lend more to smaller firms.

In terms of bank ownership with market imperfections, state-owned or public sector banks are found to lend more to state-owned and to larger firms. Similarly, factors like probable higher risk of default by borrowers, lower risk absorbing capacity of lenders, and political interventions in lending are important factors adversely impacting such lending. Thus, it is important to understand the determinants of priority lending, challenges faced by the banks and their structures, which can make it easier for them to lend to priority areas.

4. Lending for Priority Finance: Experience and Lessons

The lending for priority finance has a long history in the SAARC region. In India, for example, after the nationalisation of banks in 1969, the government through the Reserve Bank of India (RBI), introduced directed credit programme (DCP) termed as 'Priority Sector Lending' (PSL). Under the programme, RBI stipulated that at least 40 per cent of the 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. These were the ones which were hitherto the neglected sectors of the economy like agriculture, small-scale enterprises, weaker sections, export credit, housing, education, etc. Within this, the targets for lending to agriculture and weaker sections were fixed at 18 per cent and 10 per cent respectively. The PSL guidelines are in place in India for nearly 50 years now.

It must, however, be noted that, under the programme, a substantial sum of the banks' funds (40 per cent) is diverted specifically to these areas, and is not available for lending to other areas. It is, therefore, important that they are actually put to good use to serve the stated objectives.

On the part of the banks, reports suggest that they face regular challenges in complying with the total PSL targets and the sectoral targets. It is seen that banks with specific characteristics may be better equipped to lend to smaller firms, and to PSL borrowers who have special features unlike those of a normal corporate. It is argued that an understanding of the factors impacting PSL by banks may help to frame policy and structural recommendations for better implementation of the PSL guidelines. This is especially valid for PSL since it is a special kind of lending with its own peculiarities, expectations and challenges.

In priority sector lending, the banks often find it difficult to achieve overall targets. This calls for a close monitoring of the priority sector lending behaviour of the banks to identify the challenges and the constraints to install right policies.

5. Lending Strategies and Adjustments

Improving the quantity and quality of priority finance is of course necessary, but this is not sufficient to secure sustainable development for the SAARC region. For instance, FDI still predominantly goes to resource-rich countries although there has been some progress in diversification to other countries with large consumer markets or financial sectors in recent years. The scope of priority finance should take these developments and challenges into consideration.

It is also true that priority finance will not work if the fundamental economics are not right and the intended finance lacks secure streams of positive cash flows. In many cases, the supply of high impact, financially feasible, priority sector projects is thin on the ground in most countries.

For creating the right institutional framework for LPF, it may be worthwhile to consider country-specific options. For example, establishing bank sponsored smaller-sized separate entities, which are privately managed, for lending to priority areas within the LPF programme could be one option. One must recognise that lending to small and rural borrowers in LPF is more aligned with relationship lending. This requires flexibility in organisational structures and policies to cater to the peculiar nature of LPF, where banks may not have a comparative advantage. Smaller, private and distinct entities may be equipped to have greater flexibility in this regard. They may also be able to distance themselves from political interventions as well.

In view of the significance of lending efficiency, it is important to reorient the human resource (HR) policies to make them favourable for LPF. Such redesigning of HR policies which takes into account the special characteristics of LPF can be undertaken by the banks on their own. These policies may permit hiring of local staff, special training for staff, and separate performance review systems, which allow for genuine default rates and built in incentives for better risk adjusted performance of employees.

Given the important policy goal of increasing access to finance for under-banked sectors, the governments might explore alternative mechanisms beyond universal quotas or interest rate caps to encourage lending while minimising economic distortions. In the past, many countries have relied on a variety of other schemes to direct lending to priority sectors, including credit guarantees and loan securitisation. Each of these mechanisms has drawbacks, however. In the case of credit guarantees, moral hazard may lead to excessive lending and additional asset quality stress, while also undermining the effectiveness of interest rates in managing risk.

Loan securitisation may offer banks access to capital market funding to meet priority lending requirements. India, for instance, allows priority sector lending securitisation in limited form, but banks must continue to hold these assets on their balance sheets, thereby retaining the potential negative effect on asset quality and capital. Even if the countries allow the transfer of credit risk to bond or equities markets, many countries of the SAARC region lack capital market depth to support priority loan securitisation. Furthermore, moral hazard and transparency issues may lead to inappropriate risk management by banks or investors, creating broader systemic instability.

One promising innovation in India, which is Asia's largest director of priority credit, contemplates replacing strict quotas with Priority Sector Lending Certificates (PSLCs) in a system where qualified lenders, such as microfinance institutions (MFIs), would lend to priority sectors, earn a PSLC, and then sell the certificate to another banking institution seeking to fulfill a priority sector lending quota. The loans would remain on the books of the originating institution. Banks seeking to meet their quotas via PSLCs would not assume any risk, but instead would subsidise lending by other institutions specialised in priority sectors. The RBI intends to implement such a programme on a trial basis.

In theory, a market for PSLCs would finance system-wide priority sector lending directed by MFIs and other organisations with a comparative advantage in lending to sectors like agriculture and MSMEs. Such organisations would have more specialised credit risk assessment methodologies for these sectors and would better manage credit risks, particularly compared with banks with no prior experience lending—not to mention a physical presence—in less-developed areas. The PSLCs would offer other advantages as well such as: (i) by keeping priority sector loans off banks' balance sheets, regulators would lessen the burden of banks preparing for enhanced Basel III capital requirements; (ii) existence of a PSLC market would allow access to non-financial market participants such as governments, NGOs, and foreign donors interested in supporting priority sectors; and (iii) PSLCs would encourage the creation of financial institutions specialising in priority sector lending.

Regardless of the chosen mechanism to encourage credit to priority sectors, the countries implementing priority sector lending programmes would also benefit from improvements in credit risk assessment infrastructure. Financial institutions would benefit from the expanded presence of credit bureaus in less-developed areas with large priority sectors like agriculture and MSMEs. While the development of specialised lenders will enhance credit risk assessment for priority sectors, centralised credit review and monitoring would help reduce information asymmetry and adverse selection.

For the SAARC region, LPF is, and should be considered as, a viable business proposition which can be lucrative for the banks. Therefore, a conducive culture in banks needs to be built, and appropriate strategies to be drawn to focus on LPF as a viable business proposition. It is evident that while banks have shown commitment to the social cause underlying the LPF programmes, they are facing a number of challenges in their implementation.

It would help if the central banks, commercial banks and the policy makers can make it easier for them to comply with the LPF targets by strengthening the LPF programmes. Such a strengthening can be done, both through policy changes and through process improvements in the banks. This will help make the programmes more effective in contributing to the national efforts of achieving fast, balanced, sustainable, and inclusive growth.

At present, priority sector lending and social banking concepts are crystallised and adopted for the purpose of credit deployment in the region. The term 'priority sector' indicates those activities which have national importance and have been assigned priority for development. Hence, the adoption of priority sector concept for the purpose of bank lending reflects the effort to synchronise the lending activities of each bank with the national priorities. These sectors, in particular agriculture, micro and small industries, and other small businesses are the neglected sectors and, for the purpose of bank credit, they have been categorised as priority sectors. Further, the scope relating to priority sector lending has been modified from time to time and, generally, the eligibility criteria have been enlarged to include new areas.

Moreover, it is important to recognise that the sectors that impact large segments of the population, the weaker section and the sectors which are employment-intensive such as agriculture and micro and small enterprises, are considered as priority sectors in the SAARC countries. However, on the part of the banks, it is often maintained that lending to the priority sectors creates many problems for the banks like low profitability, high nonperforming loans, high transaction costs and others. An important need is, therefore, to find out effective solutions to these problems.

What is important for the SAARC countries is to adopt country-specific strategies to give priority sector lending a greater focus and thrust, without hurting the banks. For the purpose, the countries need to adopt a comprehensive approach to financial inclusion which can address at least three important aspects: (i) access to financial services and products; (ii) usage of financial services and products; and (iii) quality of financial services and products. The key issue is to ensure consumers' ability to benefit from new financial services and products which is closely linked to consumer protection and financial capability.

One important step in this direction is to change the attitude of the banks towards priority sector lending. For the purpose, the banks could train a group of senior- and mid-level officers in the art of lending to the priority sectors; they should also be encouraged to upgrade their skills in the area of lending regularly. Similarly, priority-sector lending facilities may be made available in specialised branches in all potential centres where trained staff would be deployed to facilitate proper sanction and monitoring of these loans and advances. Also the possibility of dispensing with the present system of target-oriented lending to the priority sectors may be explored at the right time in order to give the banks freedom to lend to all deserving and productive enterprises according to their own norms of lending.

The central banks may also explore the possibility of devising an incentive-based system to encourage lending to the priority sectors, which will receive better receptivity at all levels, and this will probably provide the necessary thrust to priority-sector lending by the banks. The incentives may, for example, be linked to branch licensing and the CRR/SLR requirements.

Further, the staff working in the specialised branches lending to the priority sectors may be provided with appropriate incentives based on the level of lending to the priority sectors at these branches. Similarly, a share of the profits may be exempted from corporate taxes for those banks reaching specified levels of lending to the priority sectors. Further, the role of the specialised and development banks may be enlarged in the priority sectors to enhance the momentum of meeting the financial needs of the priority sectors and provide the much-needed thrust to improve the lot of the underprivileged sections of the society. This will also help in improving the rural economy further and provide employment opportunities in the rural areas and smaller towns of the countries.

What is important for the banks is to design and implement economically viable and practically feasible strategies/approaches for improving the outreach on the one hand and managing quality of their portfolios, on the other. Moreover, priority sector lending needs to be seen from the business development angle; and not merely as a target-oriented lending. The central banks, on their part, should encourage the banks for lending to the priority sectors and improve the norms for lending. There is a need to identify high credit potential areas for capital formation in agriculture/agri-business sector for stepping up economic growth, keeping the upcoming challenges and opportunities in view.

Although it is important to recognise that access to finance is crucial for uplifting the priority sectors, priority lending goals should not focus on direct effects of the loans alone. When banks give credit, this has a ripple effect in the economy. Business activity arises not only directly in the sector receiving the finance, but also in related other sectors through spill-over effects covering the supply chain. Thus, priority lending alone should not be the focus in itself. If the countries are concerned with lifting the vulnerable and crucial sectors, the relevant metric should be the impact, both direct and indirect, that banks have on these sections of the economy through their credit interventions.

6. Concluding Remarks

It is true that the SAARC countries face a number of challenges to achieving the goals of poverty alleviation and ensuring better lives for all citizens. But one must also realise that opportunities are plentiful as well; and these countries are well positioned to take advantage of these opportunities.

The SAARC countries should prioritise capacity building, knowledge management and networking along with support for improved coordination among the countries. For the relatively advanced countries, efforts should be directed to meet two major goals: remain prepared to overcome the obstacles that hinder their own development (e.g. tackle the middle-income traps), and support the development efforts of the low income countries through sharing experience and success cases and providing support to move faster in achieving their development agenda.

In reality, economic reforms in the real sectors fail to realise their full potential without parallel reforms in the financial sector. The financial sector reforms in the SAARC countries carried out over the years have led to a general improvement in the functioning and efficiency of the financial system as a whole and the removal of impediments to its long term developments. Consequently, there has been a shift in focus from quantitative to qualitative growth and the banking sector is now subjected to the rigors or prudential norms of operations and competitive environment.

While fixing both quantitative and qualitative goals are important, it is also important to realise that efficiency and equity issues are often difficult to harmonise in a principled way; so that priority lending may appear intellectually confusing. But this does not reduce the importance of the tool as a development weapon in the SAARC countries.

In fact, priority finance presents an exciting opportunity for the SAARC region; but we need to be clear about the problem we are trying to solve, address that, and be realistic about whether it can work for all. Priority finance should increasingly be directed towards promoting inclusive growth in the SAARC region by improving infrastructure and financial services, and by supporting the expansion of smaller enterprises. This should focus on strategic investments and interventions to promote inclusive growth, help address climate change impacts, and encourage regional integration.

Given the importance that the SAARC governments place on financial sector inclusion, state-directed priority sector lending will continue to play a large role in SAARC’s future development agenda. Many regulators’ current reliance on universal loan quotas or interest rate subsidies runs the risk of weakening system-wide asset quality, particularly when lenders, lacking the specialised experience in priority sectors, face a lending mandate. As a result, these lending requirements may also discourage market entry of new banks, particularly the foreign ones. The strengthening of priority lending along with development of alternative mechanisms—such as PSLCs— and improvements in credit risk assessment infrastructure could enhance banking systems' transmission of credit to priority sectors in the SAARC region, helping to expand access to finance while limiting economic distortions.

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