CHAPTER – III

COMMERCIAL BANK CREDIT IN INDIA: THEORATICAL FRAMEWORK

One of the profound American economists, ***Stieglitz***, observed that the financial sector constituents the ‘brain’ of the economy and the banks are major constituents of the financial sector. As banks play the intermediation role between the depositor and the investor, their role in dispensing credit becomes all the more important.

The system of credit dispensation has been found to be working well as it aids in quicker examination of the proposals. There are pros and cons of the centralised and decentralised approaches to credit dispensation. However, it has been observed that Financial Institutions (FIs) are not interested in just adding a few more numbers but are more concerned about the rising level of Non-Performing Assets (NPAs). Another issue before the banks is the need to provide the capital to comply with the Basel II recommendations.

Role of Credit

With declining markets, greater availability of cheaper source of funds, like External Commercial Borrowings (ECBs), and an equally falling capital markets, greater attention is being paid by the corporate borrowers towards the domestic banks for sourcing their funds requirement. Banks provide credit in two forms viz., working capital and term loans.

Historically, banks have been advancing more funds for working capital than for the term loans. For the banking sector as a whole term loans stood at approximately 45 % of total advances at the 50% of total advances at the end of 2009.

Even the regulator, i.e., the Reserve Bank of India (RBI), has taken effective steps, like lowering the required statutory liquidity ratio and cash reserve ratio. It has also revised its credit growth target to 24% from 20% in its monetary policy stance, so that the banks can meet the credit requirements. This upward target was communicated to the banks in the third quarterly review of the monetary policy, 2008-’09, which was announced on January 27, 2009.

Table - 3.1

Bank Group-Wise Credit

Annual Growth Rate (Y-O-Y) (%)

Bank Group	**As on January 4, 2008**	**As on January 2, 2009**
Public Sector Banks	19.8	28.6
Foreign Banks	30.7	16.9
Private Sector Banks	24.7	11.8
Scheduled Commercial Banks (including Regional Banks)	21.4	24.0

Source : Reserve Bank of India

Table 3.1 indicates the growth of credit among various bank groups. Though there have been variations between the groups, the contribution of public sector banks in credit dispensation has been higher compared to that of the foreign banks and private sector banks

Utility of Bank Credit

Loans and advances granted by commercial banks are highly beneficial to individuals, firms, companies and industrial concerns. The growth and diversification of business activities are effected to a large extent through bank financing. Loans and advances granted by banks help in meeting short-term and long-term financial need of business enterprises. The role played by banks in the business world by way of loans and advances are as follows:

- Loans and advances can be arranged from banks in keeping with the flexibility of business operations. Traders may borrow money for day to day financial needs availing of the facility of cash credit, bank overdraft and discounting of bills. The amount raised as loan may be repaid within a short period to suit the convenience of the borrower. Thus business may be run efficiently with borrowed funds from banks for financing its working capital requirements.
- Loans and advances are utilised for making payment of current liabilities, wage and salaries of employees, and also the tax liability of business.

- ❖ Loans and advances from banks are found to be ‘economical’ for traders and businessmen, because banks charge a reasonable rate of interest on such loans/advances. For loans from money lenders, the rate of interest charged is very high. The interest rate charged by commercial banks is regulated by the RBI.
- ❖ Banks generally do not interfere with the use, management and control of the borrowed money. But it takes care to ensure that the money lent is used only for production purposes.
- ❖ Bank loans and advances are found to be convenient as far as its repayment is concerned. This facilitates planning for future and timely repayment of loans. Otherwise business activities would have come to a halt.
- ❖ Loans and advances by banks generally carry element of secrecy with it. Banks are duty-bound to maintain secrecy of their transactions with the customers. This enhances people’s faith in the banking system.

Significance of Bank Credit

Availability of adequate and timely finance is an important pre-requisite for growth. Monetary policy affects economic activity not only through the conventional interest rate channel but also through supply of bank credit. In most developing economies and in some advances regions such as Europe, banks have traditionally been the main source of finance for various sectors of the economy. In contrast, in many advanced economies such as the US, market-based finance systems predominate.

Apart from financing growth, variations in bank credit are an important channel of monetary policy transmission mechanism even for central banks that rely on interest rates to convey their policy stance.

Bank Credit: The Indian Experience

Adequate availability of credit to support investment demand in the economy has been an important objective of monetary policy in India. At the same time, monetary policy had to content with widening fiscal deficits. The higher borrowing requirements of the Centre as well as the State Governments in an environment of administered interest rate mechanism were essentially met through a phased increase in statutory pre-emption of banks' deposits. Not only were the banks' lendable resources to be shared between the private sector and the government, the social concerns of society had also to be taken into account. This took the shape of directed lending in the form of priority sector lending targets/ thus, by the early 1980s, an elaborate and arduous system of credit planning was in place. With credit for procurement operations as the first charge on credit demand, credit planning involved sectoral limits for credit deployment. The broad objective of the credit policy was to meet genuine credit needs for productive purposes without stoking inflation expectations.

Table 3.2: Credit Allocation: Towards a Market-Based System

Features	Directed Credit Paradigm	Financial Market Paradigm
1	**2**	**3**
Problem definition	Overcome market imperfections	Lower risks and transaction costs
Role of financial markets	Promote new technology Simulate production Implement State plans Help the poor	Intermediate resources more efficiently
View of users	Borrowers as beneficiaries selected by targeting	Borrowers and depositors as clients choosing products
Subsidies	Large subsidies through interest rate and loan default Create subsidy dependence	Few subsidies Create independent institutions.
Sources of funds	Governments and donors	Mostly voluntary deposits
Associated information systems	Designed for donors	Designed for management
Sustainability	Largely ignored	A major concern
Evaluations	Credit impact on beneficiaries	Performance of financial institutions

Source: Meyer and Nagarajan (1999)

The focus on credit aggregates implied a reduced role for the interest rate as the equilibrating mechanism between demand and supply although interest rate was used as an instrument of cross-subsidiation (RBI, 1999). Increasingly, it came to be realized that such a system hindered efficient allocation of resources [Chakravary Committee (RBI, 1985); Narasimham Committee (RBI, 1991)].

First, a combination of an administered interest rate regime and directed credit controls prevented proper pricing of resources.

Second, most financial intermediaries remained confined to markets relating to their area of operations because of balance sheet restrictions, leading to market segmentation.

Finally, there was the problem of missing markets, especially at the shorter end, with caps even on the inter-bank rate.

From the mid-1980s onwards, steps were, therefore, taken to liberalise the credit delivery system but these gathered momentum only in the 1990s. Selective credit controls have been dispensed with and micro-regulation of credit delivery has been discontinued providing greater freedom to both banks and borrowers. Although directed lending in the form of 'priority sector' remains at 40 per cent of total bank credit, banks have been provided greater flexibility in the changed milieu to meet the priority sector requirements. Notably, advances eligible for priority sector lending have been enlarged and interest rates deregulated, thus making the system far more flexible for priority sector lending. Arrangements requiring banks to form consortia for loans beyond specified credit limits were phased out by 1997.

Principles of Sound Lending and RBI's Guidelines on Bank Credit

There are three cardinal principles of bank lending that have been followed by the commercial banks since long. These are the principles of safety, liquidity and profitability. Nationalized banks in India, like others, do follow these principles in the employment of their funds. These banks are also required under section 8 of the Banking Companies (Acquisition and Transfer of undertakings) Act, 1970 in the discharge of their function, to be guided by such directions in regard to matters of policy involving public interest as the Central Government give. The Central

Government and the Reserve Bank have issued a number of directions in this regard, highlighting the social purpose, which they have to sub serve. The traditional principles of bank lending have, therefore, been followed with certain modifications. The concept of security has undergone a radical change and profitability has been sub-ordinate to social purpose in respect of certain types of lending.

1. Safety

As the bank lends the funds entrusted to it by the depositors, the first and foremost principles of lending is to ensure the safety of the funds lent. By safety is meant that the borrower is in a position to repay the loan, along with interest, according to the terms of the loan contract. The repayment of the loan depends upon the borrower's capacity to pay and willingness to pay.

The former depends upon his tangible assets and the success of his business. If he is successful in his efforts, he earns profits and can repay the loan promptly. Otherwise, the loan is recovered out of the sale proceeds of his tangible assets. The willingness to pay depends upon the honesty and character of the borrower. The banker should, therefore, take utmost care in ensuring that the enterprise or business it out successfully. He should be a person of integrity, good character and reputation. In addition to the above the banker generally relies on the security of tangible assets owned by the borrower to ensure the safety of his funds.

2. Liquidity

Banks are essentially intermediaries for short-term funds. Therefore, they lend funds for short periods and mainly for working capital purposes. The loans are therefore, largely payable on demand. The banker must ensure that the borrower is able to repay the loan on demand or within a short period. This depends upon the nature of assets owned by the borrower and pledged to the banker. For example, goods and commodities are easily marketable while fixed assets like land and building and specialized types of plants and equipments can be liquidated after a time interval. Thus, the banker regards liquidity as important as safety of the funds and grants loans on the security of assets, which are easily marketable without much loss.

3. Profitability

Commercial banks are profit-earning institutions; the nationalized banks are no exception to this. They must employ their funds profitability so as to earn sufficient income out of which they have to pay interest to the depositors, salaries to the staff and to meet various other establishment expenses and distribute dividends to the shareholders (the Government in case of nationalized banks). The rates of interest charged banks wherein the past primarily dependent on the directives received by the Reserve Bank of India. Now banks are free to determine their own rates of interest on advances of above Rs. 2 lakhs. The variations in the rates of interest charged from the different customers depend upon the degree of risk involved in lending to them. A customer with high reputation is charged a lower rate of interest as compared to an ordinary customer. The sound principle of lending is not to sacrifice safety or liquidity for the sake higher profitability. That is to say that the banks should not grant advances to unsound parties with doubtful repaying capacity, even if they are ready to pay a very high rate of interest. Such advances ultimately prove to be irrecoverable to the detriment of the interests of the bank and its depositors.

4. The purpose of the loan

While lending the funds, the banker enquires from the borrower the purpose for which he seeks the loan. Banks do not grant loans for each and every purpose – they ensure the safety and liquidity of their funds by granting loans for productive purposes only, viz., for meeting working capital needs of a business enterprise. Loans are not advances for speculative and unproductive purposes like social function and ceremonies or for pleasure trips or for the repayment of a prior loan. Loans for capital expenditure for establishing business are of long-term nature and the banks grant such term loans also. After the nationalization of major banks loans for initial expenditure to start small trades, business, industries, etc. are also given by the banks.

5. Principle of Diversification of Risks

This is also a cardinal principle of sound lending. A prudent banker always tries to select the borrower very carefully and takes tangibles assets as securities to safeguard his interest. Tangible assets are no doubt valuable and the banker feels safe while granting advances on the security of such assets, yet some risk is always involve therein. An industry or trade may face depressionary conditions and the price of the good and commodities may sharply fall. Natural calamities like floods, earthquakes, political disturbances in certain parts of the country may ruin even prosperous business. To safeguard his interest against such as foreseeing contingencies, the banker follows the principle of diversification of risks based on the famous maxim " do not keep all the eggs in one basket." It means that the banker should not grant advances to a few big frims only or to concentrate them in a few industries or in a few cities or regions of the country only. The advances, on the otherhand, should be spread over a reasonably wide area, distributed amongst a good number of customers belonging to different trade and industries. The banker thus diversifies the risk involved in lending. If a big customer meets misfortune, or certain trades or industries are affected adversely, the overall position of the bank will not be jeopardy.

6. Bank Credit, National Policy and Objectives

Banking institutions are amongst commanding heights of an economy. They must serve the national policy and objectives. Twenty major banks in India were nationalized to serve better the needs of development of the economy in conformity with the national policy and objectives. Necessary changes in the banking policies and practices were urgently necessitated in the wake of nationalization to serve wider social purpose of establishing democratic socialism in the country.

Significant changes have taken place in the concept of security observed by the bankers in their attitude towards the hitherto weaker and neglected sections of society during the last two decades. Banks have been directed to finance on a large scale agriculturalist, small industrialist, professional persons and transporters etc. Banks have also been asked to help in the implementation of the 20 point programme and have been directed to ensure the banks' advances within the priority sectors are given increasingly to the weaker and under privileged section at concessional rate of interest. Security of funds is not sought exclusively in the tangible assets of the borrower but also lend in his technical competence, management ability, honesty and integrity. Professional persons are given loans in large number for setting up of small businesses or for starting practice. The Deposit Insurance and Credit Guarantee Corporation guarantees such loans; it is to noted that bank credit has to act as an important instrument for achieving wider social purpose, national policies and objective. However, the basic principles of sound lending are fundamental and are observed even by the nationalized banks. The ways in which the basic principles are followed, of course, may be modified to suit the needs of the hour.

RBI's Guidelines on Bank Credit

It provides a framework of the rules/regulations/instructions issued to SCBs on statutory and other restrictions on loans and advances.

Banks should implement these instructions and adopt adequate safeguards in order to ensure that the banking activities undertaken by them are run on sound, prudent and profitable lines.

Guidelines

Statutory Restrictions

Advances against bank's own shares

In terms of Section 20(1) of the Banking Regulation Act, 194, a bank cannot grant any loans and advances on the security of its own shares.

Advances to bank's Directors

- ❖ Section 20(1) of the Banking Regulation Act, 1949 also lays down the restrictions on loans and advances to the directors and the firms in which they hold substantial interest.
- ❖ Banks are prohibited from entering into any commitment for granting any loans or advances to or on behalf of any of its directors, or any firm in which any of its directors is interested as partner, manager, employee or guarantor, or any company of which, or the subsidiary or the holding company of which any of the directors of the bank is a director, managing agent, manager, employee or guarantor or in which he holds substantial interest, or any individual in respect of whom any of its directors is a partner or guarantor.
- ❖ There are certain exemptions in this regard. In terms of the explanation to the Section 'loans or advances' shall not include any transaction which the Reserve Bank may specify by general or special order as not being a loan or advance for the purpose of this section.

- ❖ If any question arises whether any transaction is a loan or advance for the purpose of this Section, it shall be referred to RBI, whose decision thereon shall be final.
- ❖ For the above purpose, the term ‘loans and advances’ shall not include the following:
  - ✓ loans or advances against Government securities, life insurance policies or fixed deposit;
  - ✓ loans or advances to the Agricultural Finance Corporation Ltd;
  - ✓ such loans or advances as can be made by a banking company to any of its directors (who immediately prior to becoming a director, was an employee of the banking company) in his capacity as an employee of that banking company and on the same terms and conditions as would have been applicable to him as an employee of that banking company, if he had not become a director of the banking company. The banking company includes every bank to which the provisions of Section 20 of the Banking Regulation Act, 1949 apply;
  - ✓ such loans or advances as are granted by the banking company to its Chairman and Chief Executive Officer, who was not an employee of the banking company immediately prior to his appointment as Chairman/Managing Director/CEO, for the purpose of purchasing a car, personal computer, furniture or constructing/acquiring a house for his personal use and festival Advance, with the prior approval of the RBI and on such terms and conditions as may be stipulated by it;
  - ✓ such loans or advances as are granted by a banking company to its whole-time director for the purpose of purchasing furniture, car, Personal Computer or constructing/acquiring a house for his personal use and festival Advance, with the prior approval of the RBI and on such terms & conditions as may be stipulated by it;
  - ✓ call loans made by banking companies to one another;
  - ✓ facilities like bills purchased/discounted, purchase of cheques, other non-fund based facilities like acceptance/co-acceptance of

bills, opening of L/Cs and issue of guarantees, purchase of debentures from third parties, etc;

- ✓ line of credit/overdraft facility extended by settlement bankers to National Securities Clearing Corporation Ltd. (NSCCL)/ Clearing Corporation of India Ltd. (CCIL) to facilitate smooth settlement; and
- ✓ a credit limit granted under credit card facility provided by a bank to its directors to the extent the credit limit so granted is determined by the bank by applying the same criteria as applied by it in the normal conduct of the credit card business.

- ❖ Purchase of or discount of bills from directors and their concerns, which is in the nature of clean accommodation, is reckoned as 'loans and advances' for the purpose of Section 20 of the Banking Regulation Act, 1949.
- ❖ As regards giving guarantees and opening of L/Cs on behalf of the bank's directors, it is pertinent to note that in the event of the principal debtor committing default in discharging his liability and the bank being called upon to honour its obligations under the guarantee or L/C, the relationship between the bank and the director could become one of the creditor and ebtor. Further, it is possible for the directors to evade the provisions of Section 20 by borrowing from a third party against the guarantee given by the bank. Such transactions may defeat the very purpose of restrictions imposed under Section 20, if the bank does not take appropriate steps to ensure that the liabilities there under do not devolve on them.
- ❖ In view of the above, while extending non-fund based facilities such as guarantees, L/Cs, acceptance on behalf of directors and the companies/firms in which the directors are interested; it should be ensured that

    (a) adequate and effective arrangements have been made to the satisfaction of the bank that the commitments would be met by the openers of L/Cs, or acceptors, or gurantors out of their own resources,

(b) the bank will not be called upon to grant loan or advance to meet the liability consequent upon the invocation of gurantee, and

(c) no liability would devolve on the bank on account of L/Cs/acceptances.

In case, such contingencies arise as at (b) & (c) above, the bank will be deemed to be a party to the violation of the provisions of Section 20 of the Banking Regulation Act, 1949.

Restriction on Power to Remit Debts

Section 20A of the Banking Regulation Act, 1949 stipulates that notwithstanding anything to the contrary contined in Section 293 of the Companies Act, 1956, a banking company shall not, except with the prior approval of the Reserve Bank, remit in whole or in part any debt due to it by- any of its directors, or

(a) any firm or company in which any of its directors is interested as director, partner, managing agent or guarantor, or

(b) any individual, if any of its directors is his partner or guarantor.

Any remission made in contravention of the provisions stated above shall be void and have no effect.

Restriction on Holding Shares in Companies

- In terms of Section 19(2) of the Banking Regulation Act, 1949, banks should not hold shares in any company except as provided in sub-section (1) whether as pledge, mortgagee or absolute owner, of an amount exceeding 30 per cent of the paid-up share capital of that company or 30 per cent of its own paid-up share capital and reserves, whichever is less.
- Further, in terms of Section 19(3) of the Banking Regulation Act, 1949, the banks should not hold shares whether as pledge, mortgagee or absolute owner, in any company in the management of which any managing director or manager of the bank is in any manner concerned or interested.
- Accordingly, while granting loans and advances against shares, statutory provisions contained in Sections 19(2) and 19(3) should be strictly observed.

Restrictions on Credit to Companies for Buy-back of their Securities

In terms of Section 77A(1) of the Companies Act, 1956, companies are permitted to purchase their own shares or other specified securities out of their

- free reserves, or
- securities premium account, or
- the proceeds of any shares or other specified securities,

Subject to compliance of various conditions specified in the Companies (Amendment) Act, 1999. Therefore, banks should not provide loans to companies for buy-back of shares/securities.

Lending money to the public

Lending money is one of the two major activities of any Bank. Banks accept deposit from public for safe-keeping and pay interest to them. They then lend this money to earn interest on this money. In a way, the Banks act as intermediaries between the people who have the money to lend and those who have the need for money to carry out business transactions. The difference between the rate at which the interest is paid on deposits and is charged on loans, is called the "spread".

Banks lend money in various forms and they lend for practically every activity. Let us first look at the lending activity from the point of view of security. Loans are given against or in exchange of the ownership (physical or constructive) of various type of tangible items. Some of the securities against which the Banks lend are:

1. Commodities
2. Debts
3. Financial Instrument
4. Real Estate
5. Automobiles
6. Consumer durable goods
7. Documents of title

In my study advances are categorised according to the Balance Sheet of SCBs – The Third Schedule – Form ‘A’.

Among the Schedules of Balance Sheet, ***SCHEDULE – 9*** gives Advances. Let us see the contents of the ***SCHEDULE – 9***.

A. Nature for which the borrower requires the loan

(i) Bills Purchased and Discounted

(ii) Demand Loans and

(iii) Term Loans

B. The Security Offered by the Borrower

(i) Advances Secured by Tangible Assets

(ii) Advances Covered by Bank and Government Guarantees and

(iii) Unsecured Advances

C. I. Advances in India

(i) Priority Sectors

(ii) Public Sectors

(iii) Banks

(iv) Others

D. II. Advances Outside India

(i) Due from Banks

(ii) Due from Others

(a) Foreign Bill Finance

(b) Syndicated Loans and

(c) Others

Apart from this, the study also covered Sectoral Deployment of Gross Bank credit. In this case advances are classified into two types i.e.,

(A) Food Credit

(B) Non-food Credit

(i) Priority Sector and

(ii) Non-Priority Sector.

(A) Nature for which the borrower requires loan

The Banks also lend to people on the basis of their perceived personal worth. Such loans are called clean and the Banks are understandably cagey about extending such loans. The credit card arms of the various Banks, however, fill up this void.

Bills Purchased and Discounted

The bill of exchange is the most popular instrument of payment in financing the internal and foreign trade of India. Commercial banks provide credit facilities to their customers (sellers of goods) to finance receivables by means of bills in three ways.

1. They may negotiate (or purchase) bills payable on demand
2. They may discount usance bills drawn on D/A or D/P terms or
3. They may make advances against bills under collection.

Bills Purchased

Bills purchased are drawn payable on demand or at sight, i.e., upon presentation, and may be clean or documentary. In case of documentary bills, bill of exchange (drafts) are accompanied by documents covering goods, such as railway receipts (RRs) and motor transport receipts (MTRs). A document of title to goods gives the person in possession of it the right to transfer the goods represented thereby endorsement and/or delivery to any other person who can take delivery of goods in his own right. An advance against the pledge of goods themselves.

Bills Discounting

Bills discounting is a major activity with some of the smaller banks. Under this type of lending, banks takes the bill drawn by borrower on his (borrower's) customer and pay him immediately deducting some amount as discount/commission. The bank then presents the bill to the borrower's customer on the due date of the bill and collects the total amount. If the bill is delayed, the borrower or his customer pays the bank a pre-determined interest depending upon the terms of transaction.

Cash credit Account

This account is the primary method in which banks lend money against the security of commodities and debt. It runs lime a current account except that the money than can be withdrawn from this account is not restricted to the amount deposited in the account. Instead, the account holder is permitted to withdraw a certain sum called “limit” or “credit facility” in excess of the amount deposited in the account.

Cash Credits are, in theory, payable on demand. These are, therefore, counter part of demand deposits of the bank.

Overdraft

The word overdraft means the act of overdrawing from a bank account. In other words, the account holder withdraws more money from a bank account than has been deposited in it.

Overdraft, on the other hand, is allowed against a host of other securities including financial instruments like shares, units of securities including financial instruments like shares, units of mutual funds, surrender value of LIC policy and debentures etc. some overdrafts are even granted against the perceived “worth” or an individual. Such overdrafts are called clean overdrafts.

Term Loans

Term loans are the counter parts of Fixed Deposits in the banks. Banks lend money in this mode when the repayment is sought to be made in fixed, pre-determined installments. This type of loan is normally given to the borrowers for acquiring long term assets i.e. assets which will benefit the borrower over a long period (exceeding at least one year).

Purchases of plant and machinery, constructing building for factory, setting up new projects fall in this category.

Financing for purchase of automobiles, consumer durables, real estate and creation of infra structure also falls in this category.

B. The Security Offered by the Borrower

The advances are granted by banks in the form of security offered by the borrower. In this case advances are broadly classified in to

(i) Secured Advances and Unsecured Advances

A secured loan or advance means a loan or advance made on the security of assets, the market value of which is not at any time less than the amount of such loan or advance; and 'unsecured loan or advance' means a loan or advance not so secured.

In both types of secured and unsecured advances, it is desirable for the banker to satisfy himself, so far as it reasonably possible, from careful examination of all relevant facts, that the borrower is capable of effecting payment in accordance with his promise. Risk is inherent in lending, and the reduction of risk to an acceptable level is the function of security.

(ii) Advances Covered by Bank and Government Guarantees

C. I. Advances in India

(i) Priority Sector Lending

The Government of India through the instrument of RBI mandates certain type of lending on the banks operating in India irrespective of their origin. RBI sets targets in terms of percentage (of total money lent by the banks) to be lent to certain sectors, which in RBI's perception would not have had access to organized lending market or could not afford to pay the interest at the commercial rate. This type of lending is called Priority Sector Lending. Financing of Small Scale Industry, Small business, Agricultural Activities and Export activities fall under this category. This is also called directed credit in Indian Banking system.

(ii) Public Sector Advances

Public Sector Advances is another type of advances in India. It consists of advances of Central and State Governments undertaking such as Government Companies and Corporations which are according to the status to be treated Public Sector Undertakings (PSUs).

(iii) Advances to Banks

All advances to the banking sector include Co-operative banks. These type of advances is to facilitate the banks to lend to other banks.

(iv) Other Advances

All advances remaining from Priority Sector, Public Sector and Banks are included under the head other advances.

C. II. Advances Outside India

(i) Advances Due from Banks

Advances due from banks included external commercial borrowings – payment due in connection with foreign trade and other current business.

(ii) Advances Due from others

(a) Foreign Bill Finance

Banks can accept substitution of D/P bills and D/A bills provided the date of maturity of the D/A bills falls within the period prescribed for realisation.

(b) Syndicated Loans

Loan extended by a group of banks as to a corporate borrower. The loans-usually made at interest rate tied to a variable rate index such as the London Interbank Offered Rate (LIBOR) or rates on Bank Certificates of Deposit-are often sold to investors in the secondary market. In recent years institutional investors such as mutual funds became major buyers of syndicated loans.

Syndicated Loans to major corporate borrowers are rated by credit rating firms such as standard and poor's, using a rating system similar to that used for corporate bonds. With the creation of a secondary market linking loan-originating banks with investors, multi-bank commercial loans may someday trade as actively as corporate debt securities in *Over-The - Counter (OTC)* dealer market. Contrast with Highly Leverage Transaction a high-interest rate loan extended to riskier borrowers.

Sectoral Flow of Credit

Indian banks have the freedom to decide about flow of credit to the different segments. However, the regulators have prescribed exposure limits for the sectors, keeping in view the importance of meeting the credit needs of the various sectors, so that an individual or a group does not corner a major chunk of the funds. With the shift in approach from micro-management of credit through various regulations, credit allocation targets, and administered interest rates to a risk-based system of lending and market determined interest rates, banks have to develop and adopt appropriate credit risk assessment techniques.

There has been a sea change in the geographical and functional lending of the Scheduled Commercial Banks (SCBs) during the post nationalisation period. They have devoted an appreciable attention to provide credit to the neglected sectors which are widely known as priority sector.

It is important not only to analyse the growth of total bank credit over the years but also to review the sectoral deployment of such credit.

The Sectoral Flow Credit is classified under

(a) Food Credit and

(b) Non – Food Credit

- **(i) Priority Sector Advances and**
- **(ii) Non-priority Sector**

Food Credit

Public Sector Banks are plugging hard for food credit this year in a bid to push up credit-deposit ratio and boost the average yield on assets. Banking sources said it was not just the public sector banks that were seeking higher allocations of food credit, but private sector banks were also in the fray.

Food credit is normally done through quota allocations by SBI. Till last year, there was very little interest from the banks in financing food credit and the C/D ratio figures were above 59 per cent mostly on account of non-food credit off-take. But there has been a steady deterioration in the ratios. C/D ratios are currently the lowest in about 35 years. The banking industry average is currently in the region of about 51 per cent. With the peak season credit off-take also not very encouraging, the dependence of the most banks have been exclusively on Government securities and treasury operations for sustaining profitability. The I/D ratio for the banking sector is in the region of about 44 per cent as against SLR of 25 per cent. The bulk of these investments are exclusively in Government securities, public sector bonds and minuscule amounts in corporate debentures.

The outstanding food credit as March 27, 2009 was Rs. 46211 crore.

Non-food Credit

Non-food credits are including Priority Sector and Non-Priority Sector Lending.

Lending to Priority Sector

At a meeting of the National Credit Council held in July 1968, it was emphasized that commercial banks should increase their involvement in the financing of priority sectors, viz., agriculture and small scale industries. The description of the priority sectors was later formalized in 1972 on the basis of the report submitted by the Informal Study Group on Statistics relating to advances to the Priority Sectors constituted by the Reserve Bank in May 1971. On the basis of this report, the Reserve Bank prescribed a modified return for reporting priority sector advances and certain guidelines were issued in this connection indicating the scope of the items to be included under the various categories of priority sector. Although initially there was no specific target fixed in respect of priority sector lending, in November 1974 the banks were advised to raise the share of these sectors in their aggregate advances to the level of 33 1/3 per cent by March 1979.

At a meeting of the Union Finance Minister with the Chief Executive Officers of public sector banks held in March 1980, it was agreed that banks should aim at raising the proportion of their advances to priority sector to 40 per cent by March 1985. Subsequently, on the basis of the recommendations of the Working Group on the Modalities of Implementation of Priority Sector Lending and Twenty Point Economic Programme by Banks (Chairman: Dr. K. S. Krishnaswamy), all commercial banks were advised to achieve the target of priority sector lending at 40 per cent of aggregate bank advances by 1985. Sub-targets were also specified for lending to agriculture and the weaker sections within the priority sector. Since then, there have been several changes in the scope of priority sector lending and the targets and sub-targets applicable to various bank groups.

On the basis of the recommendations made in September 2005 by the Internal Working Group (Chairman: Shri. C. S. Murthy), set up in Reserve Bank to examine, review and recommend changes, if any, in the existing policy on priority sector lending including the segments constituting the priority sector , targets and sub-targets, etc. and the comments/suggestions received thereon from banks, financial institutions, public and Indian Banks' Association (IBA), it was decided to include only those sectors as part of the priority sector, that impact large sections of the population, the weaker sections and the sectors which are employment-intensive such as agriculture, and tiny and small enterprises.

Presently, the broad categories of priority sector for all SCBs are as under:

I. Categories of Priority Sector

(i) Agriculture (Direct and Indirect Finance)

Direct finance to agriculture shall include short, medium and long term loans given for agriculture and allied activities (dairy, fishery, piggery, poultry, bee-keeping, etc.) directly to individual farmers, Self-Help Groups (SHGs) of individual farmers without limit and to others (such as corporate, partnership firms and institutions) up to the limits indicated in Section I, for taking up agriculture/allied activities.

Indirect finance to agriculture shall include loans given for agriculture and allied activities as specified in Section I, appended.

(ii) Small Enterprises (Direct and Indirect Finance)

Direct finance to small enterprises shall include all loans given to micro and small (manufacturing) enterprises engaged in manufacture/production, processing or preservation of goods, and micro and small (service) enterprises engaged in providing or rendering of services, and whose investment in plant and machinery and equipment (original cost excluding land and building and such items as mentioned therein) respectively, does not exceed the amounts specified in. The micro and small (service) enterprises shall include small road & water transport operators, small business, professional & self-employed persons, and all other service enterprises.

Indirect finance to small enterprises shall include finance to any person providing inputs to or marketing the output of artisans, village and cottage industries, handlooms and to cooperatives of producers in this sector.

(iii) Retail Trade

Retail trade shall include retail traders/private retail traders dealing in essential commodities (fair price shops), and consumer co-operative stores.

(iv) Micro Credit

Provision of credit and other financial services and products of very small amount not exceeding Rs. 50000 per borrower, either directly or indirectly through a SHG/JLG mechanism of to NBFC/MFI for on-lending up to Rs. 50000 per borrower, will constitute micro credit.

(v) Education Loans

Education loans include loans and advances granted to only individuals for educational purposes up to Rs. 10 lakh for studies in India and Rs. 20 lakh for studies abroad, and do not include those granted to institutions.

(vi) Housing Loans

Loans up to Rs. 20 lakh to individuals for purchase/construction of dwelling unit per family, (excluding loans granted by banks to their own employees) and loans given for repairs to the damaged dwelling units of families up to Rs. 1 lakh in rural and semi-urban areas and up to Rs. 2 lakh in urban and metropolitan areas.

Targets / Sub-Targets

The target and sub-target set under priority sector lending for domestic and foreign banks operating in India are furnished below:

Table 3.3

Targets / Sub-Targets under Priority Sector Lending

	Domestic Commercial Banks	**Foreign Banks**
Total Priority Sector Advances	40 per cent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.	32 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, Whichever is higher.
Total Agricultural Advances	18 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.	No target.
	Of this, indirect lending in excess of 4.5% of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher, will not be reckoned for computing performance under 18 per cent target. However, all agricultural advances under the categories ‘direct’ and ‘indirect’ will be reckoned in computing performance under the overall priority sector target of 40 per cent ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.	
Small Enterprise Advances	Advances to small enterprise sector will be reckoned in computing performance under the overall priority sector target of 40 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.	10 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.
Micro Enterprises within Small Enterprises Sector	(i) 40 per cent of total advances to small enterprises sector should go to micro (manufacturing) enterprises having investment in plant and machinery up to Rs. 5 lakh and micro (service) enterprises having investment in equipment up to Rs, 2 lakh; (ii) 20 per cent of total advances to small enterprises sector should go to micro (manufacturing) enterprises with investment in plant and machinery above Rs. 5 lakh and up to Rs. 25 lakh, and micro (service enterprises with investment in equipment above Rs. 2 lakh and up to Rs. 10 lakh. (Thus, 60 per cent of small enterprises advances should go to the micro enterprises).	Same as for domestic banks.

Export Credit	Export credit is not a part of priority sector for domestic commercial banks.	12 % of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.
Advances to Weaker Sections	10 per cent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher.	No target
Differential Rate of Interest Scheme	1 per cent of total advances outstanding as at the end of the previous year. It should be ensured that not less than 40 per cent of the total advances granted under DRI scheme go to SC/ST. At least two third of DRI advances should be granted through rural and semi-urban branches	No target

(The net bank credit (NBC) should tally with the figures reported in the fortnightly return submiited under section 42(2) of the RBI, 1934.)

RBI Guidelines on Priority Sector Lending

The detailed guidelines in this regard are given hereunder.

I. Agriculture

Direct Finance

1.1 Finance to individual farmers [including Self Help Groups (SHGs) or Joint Liability Groups (JLGs), i.e. groups of individual farmers, provided banks maintain disaggregated data on such finance] for Agriculture and Allied Activities (dairy, fishery, piggery, poultry, bee-keeping, etc.)

1.1.1 Short-term loans for raising crops, i.e. for crop loans. This will include traditional/non-traditional plantations and horticulture.

1.1.2 Advances up to Rs. 10 lakh against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months, irrespective of whether the farmers were given crop loans for raising the produce or not.

1.1.3 Working capital and term loans for financing production and investment requirements for agriculture and allied activities.

1.1.4 Loans to small and marginal farmers for purchase of land for agricultural purposes.

1.1.5 Loans to distressed farmers indebted to non-institutional lenders, against appropriate collateral or group security.

1.1.6 Loans granted for pre-harvest and post-harvest activities such as spraying, weeding, harvesting, grading, sorting, processing and transporting undertaken by individuals, SHGs and cooperatives in rural areas.

1.2 Finance to others [such as corporate, partnership firms and institutions] for Agriculture and Allied Activities (dairy, fishery, piggery, poultry, bee-keeping, etc.)

1.2.1 Loans granted for pre-harvest and post-harvest activities such as spraying, weeding, harvesting, grading, sorting and transporting.

1.2.2 Finance up to an aggregate amount of Rs. One crore per borrower for the purposes listed at 1.1.1, 1.1.2, 1.1.3 and 1.2.1 above.

1.2.3 One-third of loans in excess of Rs. One crore in aggregate per borrower for agriculture and allied activities.

Indirect Finance

1.3 Finance for Agriculture and Allied Activities

1.3.1 Two-third of loans to entities covered under 1.2 above in excess of Rs. One crore in aggregate per borrower for agriculture and allied activities.

1.3.2 Loans to food and agro-based processing units with investments in plant and machinery up to Rs. 10 crore, undertaken by those other than 1.1.6 above.

1.3.3 (i) Credit for purchase and distribution of fertilizers, pesticides, seeds, etc.

(ii) Loans up to Rs.40 lakh granted for purchase and distribution of inputs for the allied activities such as cattle feed, poultry feed, etc.

1.3.4 Finance for setting up of Agriclinics and Agribusiness Centres.

1.3.5 Finance for hire-purchase schemes for distribution of agricultural machinery and implements.

1.3.6 Loans to farmers through Primary Agricultural Credit Societies (PACS), Farmers' Service Societies (FSS) and Large-sized Adivasi Multi Purpose Societies (LAMPS).

1.3.7 Loans to cooperative societies of farmers for disposing of the produce of members.

1.3.8 Financing the farmers indirectly through the co-operative system (otherwise than by subscription to bonds and debenture issues).

1.3.9 Existing investments as on March 31, 2007, made by banks in special bonds issued by NABARD with the objective of financing exclusively agriculture/allied activities may be classified as indirect finance to agriculture till the date of maturity of such bonds or March 31, 2010, whichever is earlier. Fresh investments in such special bonds made subsequent to March 31, 2007 will, however, not be eligible for such classification.

1.3.10 Loans for construction and running of storage facilities (warehouse, market yards, godowns, and silos), including cold storage units designed to store agriculture produce/products, irrespective of their location.

If the storage unit is registered as SSI unit/micro or small enterprise, the loans granted to such units may be classified under advances to Small Enterprises Sector.

1.3.11 Advances to Custom Service Units managed by individuals, institutions or organizations who maintain a fleet of tractors, bulldozers, well-boring equipment, threshers, combines etc., and undertake work for farmers on contract basis.

1.3.12 Finance extended to dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, irrespective of their location, subject to the following conditions:

(a) The dealer should be dealing exclusively in such items or if dealing in other products, should be maintaining separate and distinct records in respect of such items.

(b) A ceiling of up to Rs. 30 lakh per dealer should be observed.

1.3.13 Loans to Arthias (commission agents in rural/semi-urban areas functioning in markets/mandies) for extending credit to farmers, for supply of inputs as also for buying the output from the individual farmers/SHGs/JLGs.

1.3.14 Credit outstanding under loans for general purposes under General Credit Cards (GCC).

1.3.15 The deposits placed in RIDF with NABARD by banks on account of non-achievement of priority sector lending targets/sub-targets and **outstanding** as on April 30, 2007 would be eligible for classification as indirect finance to agriculture sector till the date of maturity of such deposits or March 31, 2010, whichever is earlier.

1.3.16 Loans already disbursed and outstanding as on April 30, 2007 to State Electricity Boards (SEBs) and power distribution corporation/companies, emerging out of bifurcation/restructuring of SEBs, for reimbursing the expenditure already incurred by them for providing low tension connection from step-down point to individual farmers for energizing their wells and for Systems Improvement Scheme under Special Project Agriculture (SI-SPA), are eligible for classification as indirect finance till the dates of their maturity, repayment or March 31, 2010, whichever is earlier. Fresh advances will, however, not be eligible for classification as indirect finance to agriculture.

1.3.17 Loans to National Co-operative Development Corporation (NCDC) for on-lending to the co-operative sector for purposes coming under the priority sector will be treated as indirect finance to agriculture till March 31, 2010.

1.3.18 Loans to Non-Banking Financial Companies (NBFCs) for on lending to individual farmers or their SHGs/JLGs.

1.3.19 Loans granted to NGOs/MFIs for on-lending to individual farmers or their SHGs/JLGs.

1.3.20 Loans granted to RRBs for on-lending to agriculture and allied activities sector.

1.3.21 Overdrafts, up to Rs. 25000 (per account), granted against 'no-frills' accounts in rural and semi-urban areas.

II. Small Enterprises

Direct Finance

2.1 Direct Finance in the small enterprise sector will include credit to:

2.1.1 Manufacturing Enterprises

(a) Small (manufacturing) Enterprises

Enterprises engaged in the manufacture/production, processing or preservation of goods and whose investment in plant and machinery does not exceed Rs. 5 crore.

(b) Micro (manufacturing) Enterprises

Enterprises engaged in the manufacture/production, processing or preservation of goods and whose investment in plant and machinery does not exceeds Rs 25 lakh, irrespective of the location of the unit.

2.1.2 Service Enterprises

(a) Small (service) Enterprises

Enterprises engaged in providing/rendering of services and whose investment in equipment (original cost excluding land and building and furniture, fittings and other items not directly related to service rendered or as may be notified under the MSMED Act, 2006) does not exceed Rs. 2 crore.

(b) Micro (service) Enterprises

Enterprises engaged in providing/rendering of services and whose investment in equipment (original cost excluding land and building and furniture, fittings and such items as in small enterprises) does not exceed Rs. 10 lakh.

(c) The small and micro (service) enterprises shall include small road and water transport operators, small business, professional and self-employed persons, and all other service enterprises.

2.1.3 Khadi and Village Industries Sector (KVI)

All advances granted to units in the KVI sector, irrespective of their size of operations, location and amount of original investment in plant and machinery. Such advances will be eligible for consideration under the sub-target (60 per cent) of the small enterprises segment within the priority sector.

Indirect Finance

2.2 Indirect finance to the small (manufacturing as well as service) enterprises sector will include credit to:

2.2.1 Persons involved in assisting the decentralised sector in the supply of inputs to and marketing of outputs of artisans, village and cottage industries.

2.2.2 Advance to cooperatives of producers in the decentralised sector viz. artisans village and cottage industries.

2.2.3 Existing investments as on March 31, 2007, made by banks in special bonds issued by NABARD with the objective of financing exclusively non-farm sector may be classified as indirect finance to Small Enterprises Sector till the date of maturity of such bonds or March 31, 2010, whichever is earlier. Investments in such special bonds made subsequent to March 31, 2007 will, however, not be eligible for such classification.

2.2.4 The deposits placed with SIDBI by foreign banks, having offices in India, on account of non-achievement of priority sector lending targets/sub-targets and **outstanding** as on April 30, 2007 would be eligible for classification as indirect finance to Small Enterprises Sector till the date of maturity of such deposits or March 31, 2010, whichever is earlier.

2.2.5 Loans granted by banks NBFCs for on-lending to small and micro enterprises (manufacturing as well as service).

III. Retail Trade

3.1 Advances granted to retail traders dealing in essential commodities (fair price shops), consumer co-operative stores, and;

3.2 Advances granted to private retail traders with credit limits not exceeding Rs. 20 lakh.

IV. Micro Credit

4.1 Loans to very small amount not exceeding Rs. 50000 per borrower provided by banks either directly or indirectly through a SHG/JLG mechanism or to NBFC/MFI for on-lending up to Rs. 50000 per borrower.

4.2 **Loans to poor indebted to informal sector**

Loans to distressed persons (other than farmers) to prepay their debt to non-institutional lenders, against appropriate collateral or group security, would be eligible for classification under priority sector.

V. State Sponsored Organisations for Scheduled Castes/Scheduled Tribes

Advances sanction to State Sponsored Organisations for Scheduled Castes/Scheduled Tribes for the specific purpose of purchase and supply of inputs to and/or the marketing of the outputs of the beneficiaries of these organizations.

VI. Education

6.1 Educational loans granted to individuals for educational purposes up to Rs. 10 lakh for studies in India and Rs. 20 lakh for studies abroad. Loans granted to institutions will not eligible to be classified as priority sector advances.

6.2 Loans granted by banks to NBFCs for on-lending to individuals for educational purposes up to Rs. 10 lakh for studies in India and Rs. 20 lakh for studies abroad.

VII. Housing

7.1 Loans up to Rs. 20 lakh, irrespective of location, to individuals for purchase/construction of a dwelling unit per family, excluding loans granted by banks to their own employees.

7.2 Loans given for repairs to the damaged dwelling units of families up to Rs. 1 lakh in rural and semi-urban areas and up to Rs. 2 lakh in urban and metropolitan areas.

7.3 Assistance given to any governmental agency for construction of dwelling units or for slum clearance and rehabilitation of slum dwellers, subject to a ceiling of Rs. 5 lakh of loan amount per dwelling unit.

7.4 Assistance given to a non-governmental agency approved by the NHB for the purpose of refinance for construction/reconstruction of dwelling units or for slum clearance and rehabilitation of slum dwellers, subject to a ceiling of loan component of Rs. 5 lakh per dwelling unit.

7.5 Loans granted to Housing Finance Companies (HFCs), Approved by National Housing Bank for the purpose of refinance, for on-lending to individuals for purchase/construction of dwelling units, provided the housing loans granted by HFCs do not exceed Rs. 20 lakh per dwelling unit per family.

The eligibility under this measure shall be restricted to five per cent of the individual bank's total priority sector lending, on an ongoing basis.

The above special dispensation shall apply to loans granted by banks to HFCs up to March 31, 2010. Such loans granted till March 31, 2010 will continue to be classified under priority sector till they are repaid.

VIII. Weaker section

The weaker sections under priority sector shall include the following:

(a) Small and marginal farmers with land holding of 5 acres and less, and landless labourers, tenant farmers and share croppers;
(b) Artisans, village and cottage industries where individual credit limits do not exceed Rs. 50000;
(c) Beneficiaries of Swarnajayanti Gram Swarozgar Yogana (SGSY);
(d) Scheduled Castes and Scheduled Tribes;
(e) Beneficiaries of Differential Rate of Interest (DRI) Scheme;
(f) Beneficiaries under Swarna Jayanti Shahari Rozgar Yojana (SJSRY);
(g) Beneficiaries under the Scheme for Liberation and Rehabilitation of Scavengers (SLRS);
(h) Advances to Self Help Groups;

(i) Loans to distressed poor to prepay their debt to informal sector, against appropriate collateral or group security.

(j) Loans granted under (a) to (i) abover to persons from minority communities as may be notified by Government of India from time to time.

In States, where one of the minority communities notified is, in fact, in majority, item (j) will cover only the other notified minorities. These States/union Territories are Jammu & Kashmir, Punjab, Meghalaya, Mizoram, Nagaland and Lakshadweep.

IX. Export Credit

This category will form part of priority sector for foreign banks only.

Interest Rates on Advances

Reserve Bank of India began prescribing the minimum rate of interest on advances granted by SCBs with effect from October 1, 1960. Effective March 2, 1968, in place of minimum lending rate, the maximum lending rate to be charged by banks was introduced, which was rescinded with effect from January 21, 1970, when the prescription of minimum lending rate was reintroduced. The ceiling rate on advances to be charged by banks was again introduced effective March 15, 1976, and banks were also advised, for the first time, to charge interest on advances at periodic intervals, that is, at quarterly rests. In the following period, various sector-specific, programme-specific and purpose-specific interest rates were introduced.

RBI Guidelines on Interest Rates on Advances

General

❖ Banks should interest on loans / advances / cash credits / overdrafts or other financial accommodation granter / provided / renewed by them or discount usance bills in accordance with the directives on interest rates on advances issued by RBI from time to time.

❖ The interest at the specified rates should be charged at monthly rests and rounded off to the nearest rupee.

❖ Banks should club term loans and working capital advances together for the purpose of determining the size of the loan and the applicable rate of interest.

Benchmark Prime Lending Rate (BPLR) and Spreads

- ❖ With effect from October 18, 1994, RBI has deregulated the interest rates on advances above Rs. 2 lakh and the rates of interest on such advances are determined by the banks themselves subject to BPLR and Spread guidelines. For credit limits up to Rs. 2 lakh, banks should charge interest not exceeding their BPLR. Keeping in view the international practice and to provide operations flexibility to commercial banks in deciding their lending rates, banks can offer loans at below BPLR to exporters or other creditworthy borrowers, including public enterprises, on the basis of a transparent and objective policy approved by their respective Boards. Banks will continue to declare the maximum spread of interest rates over BPLR.
- ❖ Given the prevailing credit market in India and the need to continue with concessionality for small borrowers, the practice of treating BPLR as the ceiling for loans up to Rs. 2 lakh will continue.
- ❖ Banks are free to determine the rates of interest without reference to BPLR and regardless of the size in respect of loans for purchase of consumer durables, loans to individuals against shares and debentures / bonds, other non-priority sector personal loans, etc.
- ❖ BPLR will be made uniformly applicable at all branches of a bank.

Determinants of Benchmark Prime Lending Rate (BPLR)

- ❖ In order to enhance transparency in banks' pricing of their loans products as also to ensure that the BPLR truly reflects the actual costs, banks should be guided by the following considerations while determining their BPLR:
  - ✓ Banks should take into account their actual cost of funds, operating expenses and a minimum margin to cover regulatory requirement of provisioning / capital charge and profit margin, while arriving at the benchmark PLR. Banks should announce a BPLR with the approval of their Boards.
  - ✓ The BPLR will be the ceiling rate for credit limit up to Rs. 2 lakh.

- ✓ All other lending rates can be determined with reference to the BPLR arrived at as above by taking into account term premia and / or risk premia.

- ❖ In the interest of customer protection and to have greater degree of transparency in regard to actual interest rates charged to borrowers, banks should continue to provide information on maximum and minimum interest rates charged together with the BPLR.

Freedom to fix Lending Rates

- ❖ Banks are free to determine the rates of interest without reference to BPLR and regardless of the size in respect of the following loans:

i. Loans for purchase of consumer durables;

ii. Loans to individuals against shares and debentures / bonds;

iii. Other non-priority sector personal loans including credit card dues;

iv. Advances / overdrafts against domestic / NRE / FCNR (B) deposits with the bank, provided that the depostis stands / stand either in the name(s) of the borrower himself / borrowers themselves, or in the names of the borrower jointly with another person;

v. Finance granted to intermediary agencies including housing finance intermediary agencies for on-lending to ultimate beneficiaries and agencies providing input support;

vi. Discounting of Bills;

vii. Loans / Advances / Cash Credit / Overdraft against commodities subject to Selective Credit Control;

viii. To a co-operative bank or to any other banking institution;

ix. To its own employees;

x. Loans covered by refinance schemes of term lending institutions.

Floating Rate of Interest on Loans

- ❖ Banks have the freedom to offer all categories of loans on fixed or floating rates, subject to conformity to their Asset-Liability Management (ALM) guidelines. In order to ensure transparency, banks should use only external or market-based rupee benchmark interest rates for pricing of their floating rate loan product. The methodology of computing the floating rates should be objective, transpare3nt and mutually acceptable to counter parties. Banks should not offer floating rate loans linked to their own internal benchmarks or any other derived rate based on the underlying. This methodology should be adopted for all new loans. In the case of existing loans of longer / fixed tenure, banks should reset the floating rates according to the above method at the time of review or renewal of loan accounts, after obtaining the consent of the concerned borrowers.

Enabling clause in loan agreement

- ❖ Banks should invariably incorporate the following provisions in the loan agreements in the case of all advances, including term loans, thereby enabling banks to charge the applicable interest rate in conformity with the directives issued by RBI time to time.
- ❖ Since banks are bound by the Reserve Bank's directives on interest rates on loans and advances, which are issued under Sections 21 and 35A of the Banking Regulation Act, 1949, banks are obliged to give effect to any revision of interest rates whether upwards or downwards, on all the existing advances from the date that the directives / revised interest rate come into force, unless the directives specifically provide otherwise.

Withdrawals against uncleared effects

- ❖ Where withdrawals are allowed against cheques sent for clearing, i.e. uncleared effects which are in the nature of unsecured advances, banks should charge interest on such drawals as per the directive on interest rates on advances.
- ❖ As a measure of customer service, the above instruction will not apply to the facility afforded to depositors for immediate credits in respect of cheques sent for collection.

Loans under consortium arrangement

- Banks need not charge a uniform rate of interest even under a consortium arrangement. Each member bank should charge rate of interest on the portion of the credit limits extended by it to the borrower, subject to its BPLR.

Charging of interest at monthly rests

- Banks were required to switch-over to the system of charging interest at monthly rests with effect from April 1, 2002. While switching over to the new system, banks were required to ensure that the effective rate does not go up merely on account of the switch-over to the system of charging / compounding interest at monthly rests and increase the burden on the borrowers.
- Interest at monthly rests shall be applied in case of all new and existing term loans and other loans of longer / fixed tenor. In the case of existing loans of longer / fixed tenor, banks shall move over to application of interest at monthly rests at the time of review of terms and conditions or renewal of such loan accounts, or after obtaining consent from the borrower.
- Instructions on charging interest at monthly rests shall not be applicable to agricultural advances and banks shall continue to follow the existing practice of charging / compounding of interest on agricultural advances linked to crop seasons. Banks should charge interest on agricultural advances for long duration crops at annual rests. As regards other agricultural advances in respect of short duration crop and allied agricultural activities such as dairy, fishery, piggery, poultry, bee-keeping, etc., banks should take into consideration due dates fixed on the basis of fluidity with borrowers and harvesting / marketing season while charging interest and compounding the same if the loan / instalment becomes overdue. Further, banks should ensure that the total interest debited to an account should not exceed the principal amount in respect of short term advances granted to small and marginal farmers.

Zero percent Interest Finance Schemes for Consumer Durables

- ❖ Banks should refrain from offering low / zero percent interest rates on consumer durable advances to borrowers through adjustment of discount available from manufacturers / dealers of consumer goods, since such loan schemes lack transparency in operations and distort pricing mechanism of loan products. These products do not also give a clear picture to the customers regarding the applicable interest rates. Banks should, also, not promote such schemes by releasing advertisement in different newspapers and media indicating that they are promoting / financing consumers under such schemes. They should also refrain from linking their names in any form / manner with any incentive-based advertisement where clarity regarding interest rate is absent.

Excessive interest charged by banks

- ❖ Though interest rates have been deregulated, charging of interest beyond a certain level is seen to be usurious and can neither be sustainable nor be conforming to normal banking practice. Boards of banks have, therefore, been advised to lay out appropriate internal principles and procedures so that usurious interest, including processing and other charges, are not levied by them on loans and advances. In laying down such principles and procedures in respect of small value loans, particularly, personal loans and such other loans of similar nature, banks should take into account, inter-alia, the following broad guideline:
  - ✓ An appropriate prior-approval process should be prescribed for sanctioning such loans, which should take into account, among others, the cash flows of the prospective borrower.
  - ✓ Interest rates charged by banks, inter-alia, should incorporate risk premium as considered reasonable and justified having regard to the internal rating of the borrower. Further, in considering the question of risk, the presence or absence of security and the value thereof should be taken into account.
  - ✓ The total cost to the borrower, including interest and all other charges levied on a loan, should be justifiable having regard to the total cost incurred by the bank in extending the loan, which is sought to be defrayed and the extent of return that could be reasonably expected the transaction.

- ✓ An appropriate ceiling should be fixed on the interest, including processing and other charges that are levied on such loans, which should be suitably publicised.

Credit Risk Management

To achieve and maintain effective credit risk management, a financial institution should develop and implement a comprehensive credit risk management programme in accordance with its credit risk strategy. The credit risk strategy should reflect the institution’s tolerance for risk and the desired level of profitability for incurring various credit risks. The board of directors, management and staff of the financial institution should be aware of and understand their respective responsibilities within the credit risk management programme.

An effective credit risk management programme includes the implementation of clearly defined credit policy and processes to facilitate the identification and qualification of risk inherent an institution’s lending and investment activities. The credit policy should clearly set out the parameters under which credit risk is to be controlled.

Credit Policy

The credit policy establishes the authority, rules and framework for the effective operation and administration of the credit portfolio. The policy should be communicated throughout the organisation in a timely manner and effectively through the use of appropriate procedures. It is critical that the policy be reviewed periodically (at least annually) to ensure that it remains effective and flexible, and continues to meet the institution’s objectives. Changes in statutory and regulatory requirements should also be incorporated in the policy.

A comprehensive credit policy that is effectively implemented enables the financial institution to:

(i) Maintain sound credit-underwriting standards;
(ii) Assess, monitor and control credit risk;
(iii) Properly evaluate new business opportunities; and
(iv) Identify, administer and collect problem credits.

The credit policy should specify, inter alia:

i. A credit philosophy governing the extent to which the institution is willing to accept credit risk;
ii. Levels of authority to approve credits. Delegated credit authority should be subject to timely review to ensure that it remains appropriate to current market conditions and expertise of credit officers;
iii. Target markets;
iv. Types of facilities to be offered, along with ceilings, pricing, profitability, maximum maturities and debt-service ratios of borrowers for each type of lending;
v. Loan portfolio ratios (e.g. total loans to deposit ratio, total loans as a percentage of capital base);
vi. Loan portfolio limits for aggregate exposure by country, industry, category of borrower/counterparty, product, groups of related parties and single borrowers etc.
vii. Criteria and procedures for granting new credits, unsecured credits and for credit restructuring and refinancing;
viii. Loan review procedures, including a grading/rating system;
ix. The minimum information required from loan applicants (considering Anti-Money Laundering and Know Your Customer best practices, and legal requirements);
x. Types of acceptable collateral and the criteria for accepting guarantees;
xi. Guidelines for classification, provisioning and write offs;
xii. Guidelines for obtaining and reviewing appraisals of real estate and other collateral;
xiii. Guidelines for related party transactions including limits for exposure to a borrower or group of related borrowers.