

CREDIT ALLOCATION BY INDIAN COMMERCIAL BANKS

Ramanadh Kasturi*

Abstract *Bank credit plays an important role in economic development. Growth in bank credit can influence the demand for goods and services and is a powerful tool to boost the economy, especially when there is a slowdown. On the other hand, it is important to note that what part of bank credit is extended to each sector over a period of time, so that it will help in understanding how various sectors are expanding and further it helps in analyzing the quality and dimension of growth. It is also a need to analyze whether the bank credit is being extended to the sectors that are part of strategic policy initiatives. This article aims at discussing the Guidelines of the Central Bank of India (RBI) and the credit allocation by scheduled commercial banks of India to various sectors of the economy.*

Keywords: *Credit Allocation, Indian Commercial Bank, Bank Credit, Credit Growth, and Sectoral Deployment*

INTRODUCTION

A discussion on credit allocation of Indian commercial banks is imperative to learn the trends in various loan segments. Credit is broadly divided into two groups namely, public and private credit. Public credit is the credit for public use, i.e., all grants of credit to units of government. Credit extended to individuals, private institutions is considered as private credit. Credit for private use can be divided into bank credit, investment credit, agricultural credit and commercial credit.¹ Bank credit is created by banks from the deposits through their loan transactions, which is one of the essential functions of commercial banks, and it forms a source for all other forms of credit. Investment credit refers to the funds extended for capital investment in economic activities. For an individual investors and institutions, investment in businesses may take the form of equity (share) capital, preference shares, debentures, commercial papers etc., for banks and other financial institutions; it may take the form of term lending, overdraft, working capital finance and venture capital. Agriculture credit is the credit extended for all agricultural purposes such as crop loans, loan for seeds, agricultural equipment, irrigation such as canalization, and purchase of pumpsets etc., commercial credit may take different forms such as credit extended by manufacturers to wholesalers, wholesalers to retailers, and retailers to

consumer. Commercial banks are involved in all the types of credit mentioned in modern banking. They lend government, private institutions, agriculture and consumers.

NEED FOR THE STUDY

Credit allocation involves macro-level decision-making on loan portfolio of a bank. At macro-level, banks decide on the strategic sectors and segments to deploy available funds to ensure a maximum possible return over the investment. The principles of portfolio selection are applicable to some extent in credit allocation of commercial banks. Credit deployment is the phrase commonly used in Indian banking literature, which means distribution of banks' funds for different purposes. Credit deployment is one of the bankers' axioms to advance small and moderate sums to many customers, rather than large sums to few customers. The principal objective of credit deployment is to ensure that commercial banks confine their lending and investment operations to their own resources and within this overall constraint, allocation of fund in accordance with broad structural and regional priorities indicated by the banking regulator².

Market value of a bank depends on the risk-return profile of the loans held by a bank. According to Moody's analysis loan profitability can be assigned to two major aspects, one the selection for loan allocation and two, the subsequent performance of the loan. A bank can potentially gain on appropriate selection of a segment. This gain is the difference

¹ Credit management handbook. National Association of Credit Management; Prepared by Credit Research Foundation, Second Edition 1965, Richard D. Irwin, Homewood, IL.

² Ibid., pp. 7-21.

* Swarna Bharathi Institute of Management Science, Khammam, Telangana, India. Email: ramanathkasturi@yahoo.com

between the funds extended to a loan account and the value of the loan. Value of a loan depends on the characteristics of the loan a market considers as important. The second aspect of the profitability is based on portfolio management. The profitability of a single loan can be extended to the overall profitability of the bank as a whole.³

In the era of transition from under development to developing, many economies like India have deregulated several sectors and essentially the banking that offered freedom to commercial banks to operate in their strategic segments. This has given ample of opportunities to grow for well managed banks and has at least, forced banks for self sustenance.⁴ However, in the best interest of respective economies, central banks often intervene the functioning of commercial banks with certain norms to promote the growth in various sectors. In India, selection of loan segments by commercial banks is partly regulated by RBI, which stipulates the norms for advances to certain priority sectors in consultation with the policy initiatives of the Government of India.

REVIEW OF LITERATURE

Gray Charles Melvin (1978) added in his study that the control of bank lending and/or reserves must lie in control of factors external to banking from which bank loans and reserves are derived. He found that bank portfolio equation embodying assumptions of asset management are not so well-specified in an era of liability management. Vasireddy Chandraiah (1990) in his study on bank credit revealed that control is necessary on bank credit. He pointed that 'credit has come to play pre-dominant part in the settlement of monetary business transactions of all kinds and these represent a powerful force for good or evil'. D. Perumalla Rao (1993) in his Ph.D. thesis "Management of Finances in Commercial Banks: A Study" found that the banks' operations in India are constrained on one hand by direct allocation of credit for the specific sectors which enjoy concessional rate of interest and on the other hand by administering structure of interest rate. KV Kamath (2012) in his paper "Changing Paradigm in Indian Banking" noted that there is a rising demand for retail loans and remarked that there has been a constant increase in per-capita income in India from \$260 in the year 1980 to \$ 550 in 2003 and it is likely to raise to \$4,000 by 2020.

³ Ibid., pp. 7–21. (2002). *The economics of the bank and of the loan book*. San Francisco: CA: Moody's K.M.V., p. 4.

⁴ Jacqueline Symss. (2003). *Marketing of banking services: A case study of Andhra Bank*. Thesis, submitted to Osmania University, Hyderabad, p. 122.

CREDIT ALLOCATION AND RBI GUIDELINES

Section 21 and subsection 2 of RBI Act empowers RBI to issue directions in general to all banks and specific directions to particular banks with respect to the purposes of lending, margin requirements, proportion of advances lent to a party to the paid-up capital, reserves and deposits of the bank, the maximum amount of guarantee to a party, the rates of interest on loans and guarantees. The general guidelines of RBI on deployment include public food procurement, export and designated priority sectors such as agriculture, small scale industries, working capital needs of public sector undertakings and self employment schemes.⁵ The Reserve Bank of India prescribes from time to time, the limits on banks' exposure to individuals and groups of borrowers to avoid concentration risk and to fix the limits on exposure to various industries or sectors for ensuring better risk management. Exposures norms set by RBI consists of various aspects such as exposure limits to individual and group borrowers, foreign currency exposure, margin requirements for various forms of loans, specific financing needs of various segments.

- Individual exposure is limited to 15 percent of capital funds. However, this limit can be exceeded by 5 percent for lending infrastructure projects. With a prior approval of the boards of respective banks, this limit may further be extended to 25 percent for infrastructure projects and 20 percent to other projects.
- The credit exposures to groups of borrowers are limited to 40 percent of capital funds of the bank and may be extended by another 10 percent for infrastructure projects. In exceptional circumstances with the prior approval of the board, the limit may be raised by another 5 percent in both the cases.
- Financial institutions should not extend revolving credit facility to short term Floating Rate Notes/Bonds or Debentures issued by corporate entities.
- Financial Institutions are advised not to provide finance to NBFCs for Bills discounted/rediscounted by NBFCs except those arising from the sale of commercial vehicles including light commercial vehicle subject to normal lending safeguards; Investments made by NBFCs in shares, debentures, etc., of a current nature (i.e., stock in trade), investment in and advances to

⁵ Vaisreddy Chandrayya. (1990). *Bank credit in India*. Published Thesis, New Delhi: Discovery Publishing House, pp. 21–22.

subsidiaries, group companies or other entities and investments in, and inter-corporate loans/deposits to/in other companies.⁶

- Further to the above mentioned norms, commercial banks have been subject to directed lending to priority sectors. Several steps in respect of priority sector lending were initiated and implemented by RBI are discussed below.
 - National Credit Council meeting held in July 1968 emphasized the need for lending to agriculture and small scale industries.
 - RBI constituted an informal committee to study the statistics relating to priority sector advances to identify priority sectors and the same was formalized in 1972.
 - In 1974, banks were asked to increase their share of advances to 33 1/3 percent by March 1979.
 - In March 1980, CEOs of public sector banks with the Union Finance Minister agreed that priority sector

advances be made to 40 percent by March 1985 and sub-targets were also specified to sub-sectors.

- Revision of guidelines was last revised in 2007 as per C.S. Murthy committee's recommendations.
- RBI has set up a committee under the Chairmanship of M.V. Nair, to suggest revised guidelines with regard to classification of priority sector lending. As per the recommendations of the committee, priority sector includes the following categories
 - Agriculture
 - Micro and Small Enterprises
 - Education
 - Housing
 - Export Credit
 - Others.⁷
- The targets/sub-targets for priority sector are as follows.

⁶ RBI Documents. (2013). *Master circular: Exposure norms for financial institutions*, July 1.

⁷ RBI Documents. (2012). *Master circulars: Priority sector lending-targets and classification*, July 20.

Table 1: Norms for Priority Sector Lending by RBI

Categories	Domestic Commercial Banks/Foreign Banks with 20 and above branches	Foreign Banks with less than 20 branches
Total Priority Sector	40 percent of Adjusted Net Bank Credit (ANBC) or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher	32 percent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher
Total agriculture	18 percent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher, will not be reckoned for computing achievement fewer than 18 percent target. However, all agricultural loans under categories 'direct' and 'indirect' will be reckoned in computing achievement under the overall priority sector target of 40 percent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, Whichever is higher.	No Specific Target. Forms part of total priority sector target.
Micro & Small Enterprises (MSME)	Advances to micro and small enterprises sector will be reckoned in computing achievement under the overall priority sector target of 40 percent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher. 40 percent of total advances to micro and small enterprises sector should go to Micro (Manufacturing) enterprises having investment in plant and machinery up to Rs 5 lakh and micro (service) enterprise having investment in equipment up to Rs 2 lakh; 20 percent of total advances to micro and 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) enterprise with investment in equivalent above Rs 2 lakh and up to 10 lakh.	No specific target. Forms part of total priority sector target.

Categories	Domestic Commercial Banks/Foreign Banks with 20 and above branches	Foreign Banks with less than 20 branches
Export Credit	Export credit is not a separate category. Export credit to eligible activities under agriculture and MSE will be reckoned for priority sector lending under respective categories.	No specific target. Forms part of total priority sector lending.
Advances to Weaker Sections	10 percent of ANBC or credit equivalent amount of Off-Balance Sheet Exposure, whichever is higher	No specific target. Forms part of total priority sector lending.

Source: RBI Documents

CREDIT DEPLOYMENT BY SCHEDULED COMMERCIAL BANKS

Deployment of available bank funds in various loan assets in India are divided into segments on a broader perspective, such as agriculture loan, personal loans, loans and advances to small and medium enterprise, corporate loans etc. In India major classification of loans is made on the basis of the purpose namely, food and non-food credit. Food credit includes all loans and advances made for food items in whatever the form they are produced and irrespective of the type of customer. Non-food credit refers to all loans and advanced made for any other purpose than for food. In another classification, Banks in India are subject to regulation on sectoral deployment of funds namely priority sector lending. Of the total gross bank credit, non-food credit was found at an average of 97.7 percent and that of food credit was found to be 2.03 percent. Proportion of food credit during the period of study was highest at the end of March 2005 with 3.95 percent followed by 2.81 percent at the end of March 2006 and 2011 and lowest with 1.57 percent at the end of March 2010 followed by 1.72 percent at the end of March 2011. The proportion of non-food credit was highest at the end of March 2010 and lowest at the end of March 2005.

The non-food credit is divided into four major segments, viz., Agriculture and Allied Activities, Industry, Services and Personal Loans. Among the four segments, the average annual credit was highest to industry and found to be 40.71 percent of total gross bank credit followed by services sector with 23.71 percent. Personal segment received an average of 23.71 percent of gross banking credit and agriculture

segment received the least of 12.45 percent. At the end of March 2006, 2007 and 2012, personal loan segment constituted almost one-fourth of gross bank credit and its lowest share was identified at the end of March 2011 with 18.37 percent.

Robust credit growth is witnessed during the years of under the study because of economic growth and improved investor and consumer confidence. The growth across various segments of gross bank credit reveals that the average annual growth rate is highest in the services segment with 27.11 percent and lowest in personal loan segment with an average of 18.36 percent. Agriculture, industry and services reflect comparable average annual growth rates, which have grown on par with the gross banking credit. The overall credit growth was highest at the end of March 2006 with 38.90 percent and lowest at the end of March 2010. The average annual growth in food credit was found to be low during the period and a negative growth rates were witnessed at the end of March 2006 and 2008. Highest growth in food credit was identified at the end of March 2011 with 32.02 percent followed by a growth rate of 27.30 percent at the end of 2012.

Personal Loan segment has recorded a highest growth rate at the end of March 2006 with 44.35 percent and lowest of 4.12 percent at the end of March 2010. The compound annual growth rates of various segments disclose that industrial lending was highest with 20 percent and is more than overall credit growth of 17 percent. Lowest CAGRs are found with food credit and personal segment loans which stood at 10 percent and 12 percent respectively, while agriculture and service sectors have grown 17 percent and 18 percent respectively.

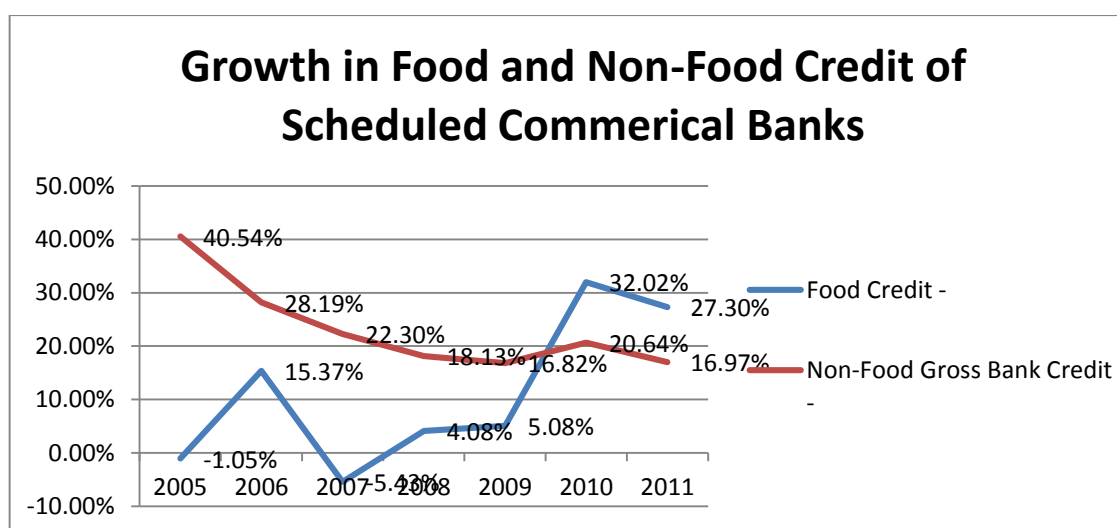
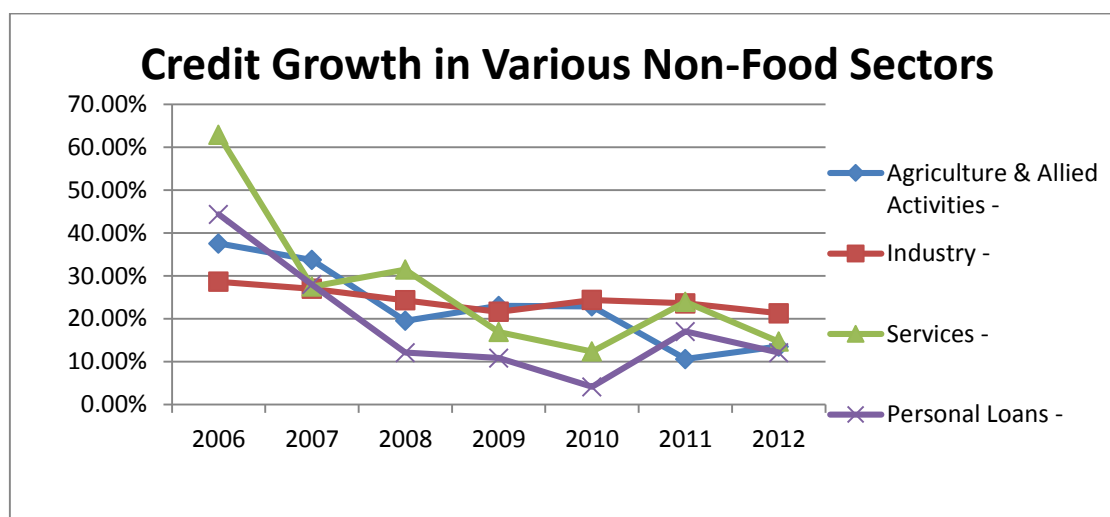


Table 2: Outstanding Credit of Commercial Banks to Major Segments (In Rs Billions)

	2005	2006	2007	2008	2009	2010	2011	2012	Average
I. Gross Bank Credit	10409.1	14458.4	18481.9	22472.9	26485.0	30885.7	37314.7	43713.5	100%
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	
A. Food Credit	411.2	406.9	469.5	444.0	462.1	485.6	641.1	816.1	2.03%
	(3.95)	(2.81)	(2.54)	(1.98)	(1.74)	(1.57)	(1.72)	(2.81)	
B. Non-Food Credit	9997.9	14051.5	18012.4	22028.9	26022.9	30400.1	36673.5	42897.4	97.97%
	(96.05)	(97.19)	(97.46)	(98.02)	(98.26)	(98.43)	(98.28)	(97.19)	
Agriculture & Allied Activities	1252.5	1722.9	2303.8	2753.4	3386.6	4161.3	4603.3	5225.3	12.45%
	(12.03)	(11.92)	(12.47)	(12.25)	(12.79)	(13.47)	(12.34)	(11.92)	
2. Industry	4268.9	5490.6	6973.4	8668.8	10543.9	13114.5	16208.5	19659.8	40.71%
	(41.01)	(37.98)	(37.73)	(38.57)	(39.81)	(42.46)	(43.44)	(37.98)	
	2005	2006	2007	2008	2009	2010	2011	2012	Average

3. Services	2025.7	3300.2	4207.7	5531.9	6467.7	7267.9	9008.0	10329.3	23.71%
	(19.46)	(22.83)	(22.77)	(24.62)	(24.42)	(23.53)	(24.14)	(22.83)	
4. Personal Loans	2450.8	3537.8	4527.6	5074.9	5624.8	5856.3	6853.7	7683.1	21.10%
	(23.54)	(24.47)	(24.50)	(22.58)	(21.24)	(18.96)	(18.37)	(24.47)	

Source: RBI Documents. *Figures in parentheses represent the proportion of loans as a percent of total gross bank credit.

Table 3: Growth across Major Loan Segments

		2005	2006	2007	2008	2009	2010	2011	2012	Average Annual Growth	CAGR
	Gross Bank Credit	-	38.90%	27.83%	21.59%	17.85%	16.62%	20.82%	17.15%	22.97%	17%
1	Food Credit	-	-1.05%	15.37%	-5.43%	4.08%	5.08%	32.02%	27.30%	11.05%	10%
2	Non-Food Gross Bank Credit	-	40.54%	28.19%	22.30%	18.13%	16.82%	20.64%	16.97%	23.37%	17%
2.1	Agriculture & Allied Activities	-	37.56%	33.71%	19.52%	22.99%	22.88%	10.62%	13.51%	22.97%	17%
2.2	Industry	-	28.62%	27.01%	24.31%	21.63%	24.38%	23.59%	21.29%	24.40%	20%
2.3	Services	-	62.92%	27.50%	31.47%	16.92%	12.37%	23.94%	14.67%	27.11%	18%
2.4	Personal Loans	-	44.35%	27.98%	12.09%	10.84%	4.12%	17.03%	12.10%	18.36%	12%

Source: Calculated from RBI reports.

Table 4: ANOVA for Loans Across Segments

ANOVA						
Source of Variation	SS	df	MS	F	P-value	F crit
Between the Segments	0.028177	3	0.009392	1.519178	0.243607	3.159908
Within the Segments	0.240697	6	0.040116	6.48871	0.00089	2.661305
Error	0.111284	18	0.006182			
Total	0.380158	27				

The study indicates that there is a significant difference in growth credit across various segments while the growth in bank credit within each segment shows no significant difference.

These figures indicate that the bank credit towards various segments is dynamic signifying the shifts in preferences of the economy. India being an agriculturally pre-dominant country has been diverting its economic activity towards industry and services. Service sector is expanding in the economy demanding more funds for its expansion. Personal Lending has been stagnant or found with low growth as a result of low consumer confidence due to less economic growth in recent years with that of the recent past.

REFERENCES

- Chandrayya, V. (1990). *Bank credit in India*. Published Thesis. New Delhi: Discovery Publishing House, pp. 21–22.
- Irwin, R. D. (1965). *Credit: Management handbook*. Prepared by Credit Research Foundation; National Association of Credit Management Second Edition, Homewood, IL.
- Kealhofer, S. (2002). *The economics of the bank and of the loan book* (p. 4). San Francisco, CA: Moody's K.M.V.
- Padma, A. S. (1995). *Performance of banks' lending to priority sectors: An appraisal of Andhra Bank in Warangal District*. M.Phil. Dissertation, Kakatiya University Warangal, p. 9, 84–89.
- Perumalla, R. D. (1993). *Management of finances in commercial banks: A study*. Ph.D Thesis, Kakatiya University, pp. 40, 54, 73 and 224.
- RBI Documents. (2012). *Master circulars: Priority sector lending-targets and classification*, July 20.

RBI Documents. (2013). *Master circular: Exposure norms for financial institutions*, July 1.

Symss, J. (2003). *Marketing of banking services: A case study of Andhra Bank*. Thesis, submitted to Osmania University, Hyderabad, p. 122.