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Implications of Priority Sector Lending on Capital Adequacy Ratio: An Evaluative Study on Non-Performing Assets

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Abstract

The survival and growth of banking industry is depends upon the credit creation ability and debt recovering capacity. In Indian context the banking institutions are struggling from growing outstanding debts termed as Non-Performing Assets (NPA). To avoid this and generate attractive revenue earlier banks were offering loans to creditworthy individual and large established business by ignoring those sectors whose development is much needed to develop the country and social welfare. The norms of priority sector lending introduced by the government mandate the banks to provide loans to priority sector. The particular research aims to evaluate the impact of total NPA in general and NPA of priority sectors in particular on the capital adequacy by examining the share of priority sectors NPA in total NPA. The study concluded that Indian banks are fundamentally strong with significantly higher capital adequacy ratio while comparing to Basel III standards. So that the banks can extend liberalized advances to priority sectors.

Keywords: **Basel Norms, Capital Adequacy Ratio, Non-performing Assets, Priority Sectors, Financial Sources**

JEL Classification Code: Q14, H81, G28

1. Introduction

The post-independence era of India has been characterized by the efforts on agriculture development from the grass root level. The Planning Commission of India introduced institutional arrangement towards upliftment through its policies. The first five year plan 1951 based on the Harrod-Domar model entirely focused on the primary sector, has achieved the growth rate of 3.6 per cent against the target 2.1 per cent (Revathi, 2022).

Though the macro level policy became successful; the micro level was depicting the failure of implementation. The financial institutions were looking forward providing advances to businessmen and high net worth individuals by ignoring the essential sectors, most crucially the agriculture; in fact their growth ensures the development of the country in true sense. The prevailing situation demanding major policy level changes in the field of flow of finance through the concept of Priority Sector Lending.

In 1972, the meaning of Priority sector Lending was formalised by the Reserve Bank of India (RBI) on the recommendation of the Informal Study Group on Statistics related to Advances to Priority Sector Lending. In 1974, the RBI advised the public banks to provide 33.3 per cent of their aggregate credit to the priority sectors by 1979 and private sector banks to provide 1/3rd of advances by the year 1980 (Udithraj, n.d.). Since then, the target under priority sector lending has been modified according to the requirement.

1.1 Non-Performing Assets and its Consequence

A non-performing asset may be considered as a loan or an advance where, interest and / or instalment of

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principal remain overdue for a period of more than 90 days in respect of a Term Loan (or) The account remains 'Out of order' for a period of more than 90 days, in respect of an Overdraft/Cash Credit (OD/CC) (or) The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted (or) In the case of direct agricultural advances as listed in Annex 1, the overdue norm specified at para 2.1.5 would be applicable. In respect of agricultural loans, other than those specified in Annex 1, identification of NPAs would be done on the same basis as non-agricultural advances (or) Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts. (RBI, 2011).

Since the beginning, Indian banks are struggling with twin balance sheet problem. The compulsion of priority sector lending added an extra volume to it. The agriculture being major head under priority sectors suffering from various drawbacks due to natural and infrastructural shortcomings. The rule of collateral free advances to agriculture has an adverse impact on recovering of loan given. The raising targets and growing NPA are hindering the profitability of the commercial banks.

1.2 Capital Adequacy: Significance and Implications

Capital adequacy ratio indicates the financial stability and solvency of the financial institutions. In the globalised era crisis in a particular economy would have drastic implications on the economies of rest of the world. The Great Recession brought by The Lehman Brothers collapse impacted the global economy several years. In response to the shortcomings of 2008 crisis, The Basel Committee on Banking Supervision (BCBS) came up with BASEL III Norms in 2010 to strengthen the international banking system and coordinate the banking regulations across the globe. BASEL norms requires the bank to maintain certain level of liquid assets and reserve capital to meet uncertainties effectively. The BCBS divides the capital of into Tier-1 and Tier-2 capital. Tier-1 consists the core capital, equity and disclosed reserves that appear in the financial statement. Teir-2 capitals are supplementary in nature which includes undisclosed reserves and unsecured subordinated debt instruments.

1.3 Statement of the Problem

The survival and growth of any financial institution is basically depends on the extent of its credit creation and ability to recover the same. The non-recoverable credit that is Non-Performing Assets in banking analogy questions the fundamentals of the institution. The collapsing of financial institutions has the grate implications on the country's economy in general and threatening global economy in particular. To overcome from the disastrous event globally.

2. Review of Literature

Review of literature augment the fundamental knowledge of a researcher in the particular research area. The researchers reviewed various articles from peer reviewed journals, some of them are as follows:

Mohanchandran (2000) conducted an empirical research entitled impact of priority sector lending by commercial banks on the rural development of Kerala. The objective of the study was to know the utilisation pattern of loan and reasons for non-payment of loan among farmers. Based on primary and secondary data, the researcher concluded that the present system of credit monitoring and servicing of banks are ineffective in preventing misutilisation of funds. The priority sector lending by commercial bank is helped the farmers in their socio-economic development, and bank should focus on the viability, suitability and potentiality of agriculture advance.

Meenakshi and Mahesh (2010) conducted a study on commercial banks regarding to banking sector reforms and non-performing assets. Based on the NPA trend of commercial banks from 2003 to 2009, the researchers conclude that NPA is the root cause for global financial crises. The problem of NPA received considerable attention after the liberalisation and accounting practices have been modified in this regard. The volume of bad loans have been declining, but the NPA in priority sectors still remains high. The study suggested to adopt self-help group model to provide loan to some of the sectors and it ensures the repayment of the bank.

Shenbagavalli (2013) studied on the strategy to manage the NPAs of public sector banks suggested that bank should conduct a personal visit and face to face interaction with the borrowers and inspection of borrowers business. This will help the bankers to know the financial status of the borrower and minimise the chances of wilful default. Effective information system mechanism helps the bank in continuous inspection of the accounts of the borrower in order to minimise of NPA.

Thorve (2017) conducted a research entitled "Analytical study of priority sector lending with special reference to lead bank scheme in Maharashtra". The objective of the study was to study the trends of priority sector lending of lead banks in Maharashtra state and study the contribution of lead banks in terms of priority sector lending under Maharashtra state. The study is based both on primary and secondary data; the sample size was 10 District of Maharashtra. The researcher concluded that all banks are looking for the business; open the branch according to size of population and it would lead the underdevelopment of certain region. The credit concentration by banks in certain profitable sector resulted in credit deficiency in other sector. The State Bank of India and Bank of Maharashtra are contributing well towards lending. Climate change, NPA and wilful default became a major hurdle for target achievement.

Agarwal *et al.* (2021) made a research entitled "The Impact of Non Performance Assets on Bank Performance under BASEL Regime- Empirical Evidence from India". The research was based on the data from 2008 to 2018 of 64 commercial banks. The researchers found that NPA decorate the banks profit margin and increase the provisions for bad debts. Further wealth erosion leads to lose the confidence of the investors. The Capital Adequacy Ratio under BASEL III norms helps in tightening the capital requirement and ensures stability.

3. Research Design

3.1 Objectives of the Study

1. To examine the advances of select banks against the target under priority sector lending.
2. To analyse the trend of non-performing assets in priority sectors among the select banks.
3. To evaluate the impact of non-performing assets on the Capital Adequacy Ratio of select banks.

3.2 Hypothesis

H_0: Total non-performing assets have no significant impact on the Capital Adequacy ratio of the select commercial banks.

3.3 Sources of Data

The study was based on secondary sources of data. The data have been referred from the annual reports of select commercial banks from 2017-18 to 2021-22. The researchers also referred scholarly articles and magazines.

4. Data Analysis and Interpretation

4.1 Advances by Select Commercial Banks towards Priority Sector Lending

The lending target under priority sector lending has been continuously revised by the RBI by its official directions. The commercial banks, either public sector or private sector, are bound by the direction of RBI. Table 1

Table 1. Percentage of Priority Sector Lending out of Total Advances

Year	2022	2021	2020	2019	2018	2017	Average	SD	Rank
State Bank of India	28.34	26.96	26.50	27.63	27.40	26.50	27.22	0.71	6
Canara Bank	49.96	48.48	46.03	44.56	44.79	43.41	46.20	2.52	1
Bank of Baroda	35.33	36.24	34.25	35.11	34.85	37.50	35.55	1.16	2
HDFC Bank	29.34	23.38	26.33	27.37	27.09	30.39	27.32	2.45	5
ICICI Bank	30.47	29.19	32.28	32.40	20.75	27.37	28.74	4.35	4
Axis Bank	37.55	31.25	26.93	25.60	25.55	28.89	29.30	4.59	3

Source: (Trendlyne, 2022)

represents the target achieved by the commercial banks under priority sector lending.

Table 1 represents share of priority sector among the total advance by the six select banks from the year 2016-17 to 2021-22. It can be observed that Canara Bank performing extremely well by providing average 46.20 per cent of total advances to the priority sector, the bank has been leading financial institution in each year to sanction loans to essential sectors of the economy followed by Bank of Baroda (35.55 per cent) and Axis Bank (29.30 per cent). The leading private sector giants ICICI Bank and HDFC Bank are performing moderately by providing 28.74 per cent and 27.32 per cent, respectively. On the other hand, public sector pioneer The State Bank of India, with an average 27.22 and standard deviation 0.71, constantly extending minimum advances to the priority sectors.

4.2 Trends of Non-performing Assets and Capital Adequacy Ratio among the Select Commercial Banks

While implementing BASEL norms notified by BCBS, the RBI adopts more conservative approach by modifying capital adequacy ratio to ensure resilience and sustainability of Indian banking industry among the international players. As per BASEL III norms released in 2009 the bank should maintain 8 per cent Capital to Risk Weighted Assets. The RBI modified and introduced in 2019, mandated 9 per cent for private sector banks and 12 per cent for public sector banks. As the capital adequacy position ensures the liquidity, solvency and shock absorbing capacity, as opposing it, NPA threaten the solvency position of the banks. The researcher in the Table 2 attempted to analyse the trend and evaluate the impact of NPA on the capital adequacy ratio of the select banks.

Table 3 represents the trends of non-performing assets in agriculture, priority sectors and total NPA with Capital Adequacy ratio for the six consecutive years. For further analysis the researchers tested the hypothesis by applying Regression model.

The results of linear regression of total Non-performing assets on Capital Adequacy Ratio of the State Bank of India

Table 2. Trends of NPA and CAR among select commercial banks (Figures in Percentage)

	Year	2017	2018	2019	2020	2021	2022	Average
SBI	Agriculture	5.65	11.12	11.68	15.95	15.22	13.38	13.38
	Trend	100.00	196.94	206.83	282.35	269.52	236.92	196.94
	Priority sector	1.50	2.28	2.13	2.22	2.10	2.04	2.04
	Trend	100.00	152.80	142.73	148.42	140.18	136.18	148.42
	Total NPA	6.90	10.91	7.53	6.15	4.98	3.97	3.97
	Trend	100.00	157.99	109.11	89.13	72.09	57.57	89.13
	CAR	**13.11**	**12.68**	**12.72**	**13.06**	**13.74**	**13.83**	**13.83**
	Trend	**100.00**	**96.72**	**97.03**	**99.62**	**104.81**	**105.49**	**101.60**
Canara Bank	Agriculture	3.72	4.58	5.39	6.19	6.10	5.66	5.66
	Trend	100.00	123.15	144.73	166.17	163.90	152.06	144.73
	Priority sector	5.53	6.79	5.97	6.46	8.96	7.54	7.54
	Trend	100.00	122.61	107.87	116.66	161.91	136.25	122.61
	Total NPA	9.63	11.84	8.83	8.21	8.93	7.51	7.51
	Trend	100.00	123.02	91.73	85.28	92.76	78.01	123.02
	CAR	**12.86**	**13.22**	**11.90**	**13.65**	**13.18**	**14.90**	**14.90**
	Trend	**100.00**	**102.80**	**92.53**	**106.14**	**102.49**	**115.86**	**102.80**

Bank of Baroda	Agriculture	11.88	11.13	9.88	13.76	7.79	7.75	7.75
	Trend	100.00	93.75	83.20	115.89	65.61	65.23	93.75
	Priority sector	11.89	9.98	8.44	9.27	8.60	8.51	8.51
	Trend	100.00	83.99	71.00	78.00	72.34	71.55	83.99
	Total NPA	11.73	13.72	9.61	9.40	8.87	6.61	6.61
	Trend	100.00	116.93	81.94	80.12	75.61	56.32	116.93
	CAR	**14.55**	**12.13**	**13.42**	**13.30**	**14.99**	**15.84**	**15.84**
	Trend	**100.00**	**83.37**	**92.23**	**91.41**	**103.02**	**108.87**	**83.37**
HDFC Bank	Agriculture	2.03	3.42	4.29	4.28	3.67	4.07	4.07
	Trend	100.00	168.86	211.72	211.51	181.17	200.79	168.86
	Priority sector	1.50	2.28	2.13	2.22	2.10	2.04	2.04
	Trend	100.00	152.80	142.73	148.42	140.18	136.18	152.80
	Total NPA	1.04	1.28	1.35	1.25	1.31	1.17	1.17
	Trend	100.00	122.79	129.05	120.09	125.78	112.10	122.79
	CAR	**14.55**	**14.82**	**17.10**	**18.50**	**18.79**	**18.90**	**18.90**
	Trend	**100.00**	**101.86**	**117.53**	**127.15**	**129.14**	**129.90**	**101.86**
ICICI Bank	Agriculture	3.11	3.14	3.73	4.22	4.28	5.29	5.29
	Trend	100.00	100.75	119.72	135.76	137.57	170.15	100.75
	Priority sector	2.16	2.21	1.94	2.28	3.42	2.67	2.67
	Trend	100.00	102.26	89.76	105.46	158.42	123.65	102.26
	Total NPA	8.74	9.90	7.38	6.04	5.33	3.76	3.76
	Trend	100.00	113.26	84.45	69.09	61.05	43.02	113.26
	CAR	**17.39**	**18.42**	**16.89**	**16.11**	**19.12**	**19.16**	**19.16**
	Trend	**100.00**	**105.92**	**97.12**	**92.64**	**109.95**	**110.18**	**105.92**
Axis Bank	Agriculture	3.25	3.93	5.51	4.86	4.17	3.70	3.70
	Trend	100.00	120.95	169.54	149.54	128.31	113.82	120.95
	Priority sector	2.26	3.07	2.92	2.89	2.98	2.12	2.12
	Trend	100.00	135.84	129.20	127.88	131.86	94.02	135.84
	Total NPAs	5.21	6.79	5.31	4.52	3.54	2.57	2.57
	Trend	100.00	130.33	101.92	86.76	67.95	49.39	130.33
	CAR	**14.55**	**14.82**	**17.10**	**17.53**	**19.12**	**18.54**	**18.54**
	Trend	100.00	101.86	117.53	120.48	131.41	127.42	101.86

Source: Desk research

Table 3. Regression analysis of non-performing assets on capital adequacy ratio

Bank	R	R Square	Adjusted R Square	Standard Error	Significant Value
State Bank of India	.868[a]	.754	.692	.26368	0.025b
Canara Bank	.394[a]	.155	-.056	1.01264	0.440b
Bank of Baroda	.773[a]	.597	.497	.95074	0.71b
HDFC Bank	.380[a]	.145	-.069	2.05534	0.457b
ICICI Bank	.297[a]	.088	-.140	1.33461	0.567b
Axis Bank	.830[a]	.689	.611	1.17944	0.41b
Predictors: (Constant): Total NPA		Dependent: CAR			

Source: Desk research

with 95 per cent of confidence corresponding significant value of 0.05 has observed the correlation coefficient of 0.868, squared R value of 0.754 and a variance of 0.692. From the above analysis of data, it can be concluded that total Non-performing assets have a significant impact on the capital adequacy ratio of the bank. Because, R value is 0.868 and significant value (p-value = 0.025) is less than 0.05. Hence, null hypothesis is rejected. Therefore, the non-performing assets have a significant impact on the Capital adequacy Ratio of the State Bank of India. The average total gross NPA of SBI is 3.97 per cent, and the gross NPA of agriculture is 13.38 per cent both are above the gross NPA of priority sector that is 2.06, which means the capital adequacy position of the bank is not impacted significantly by the priority sector as whole.

In the case of Canara Bank, HDFC Bank and ICICI Bank, the R square value is 0.155, 0.145 and 0.088, respectively, and the significant value is more than 0.05, which indicates that impact of NPA is negligible, and there are other variables which have significant impact on the capital adequacy ratio of the respective banks. Therefore, null hypothesis is cannot be rejected.

The linear regression indicates the R square value of 0.773 and 0.830 for Bank of Baroda and Axis Bank, respectively. It implies that there is an impact of non-performing assets on the CAR but not significant because the significant value is above the level of significant (0.05), therefore, the null hypothesis cannot be rejected.

5. Discussions and Conclusion

Since the economic liberalisation, there has been a heated debate going on the non-performing assets of the commercial banks, particularly public sector banks. Commercial banks, either public or the private sector, show their reluctance to provide loans to priority sectors particularly agriculture because of in dilemma on full recovery and such non-recovered debt threatens the solvency position of the banks in the financial term the capital adequacy level. The particular research lightens that the capital adequacy position of the banks are not significantly impacted by the priority sector lending because the gross NPA of these sectors as a whole is always less than that of total gross NPA for the select banks. Although gross NPA of agriculture, in particular is significantly high, when it included as priority sector in general, it has no significant impact on the capital adequacy ratio of the banks.

The study found that the select commercial banks are far away and far better in fulfilling capital adequacy norms put forward by the BASEL-III Convention. It implies that country's banking industry is fundamentally strong enough to absorb financial crisis effectively. This consistency in maintaining high capital adequacy ratio brings new hopes in liberalised lending towards priority sectors. So, the banks should assume their role in nation building by extending more advances to priority sector. Being a welfare state by directive principles, the socio-economic development of country particularly rural area have been the motto of administration. The concept of priority sector lending aims at the more inclusive and sustainable development. Finally the study concludes that priority sector lending should be encouraged and extended by assuming its implications on the socio-economic development of the country.

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