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Priority Sector Lending in Asia

Historically, Asian governments have used state-directed priority sector lending as a policy tool to improve access to credit for underserved sectors. Today, India, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam implement some form of priority sector lending, whether through lending quotas or interest rate caps. Among priority sectors, small- and medium-sized enterprises (SMEs) and agriculture frequently receive preference across the geographies considered in this sample, creating an opportunity to assess common implications of current priority sector lending programs.[1] This *Asia Focus* discusses Asia's experience with priority sector lending, reviews the current state-level priority sector lending policies in several Asian economies, assesses the implications for the respective domestic banking systems, and examines potential alternative mechanisms to encourage lending to priority sectors.

Asia's Experience with Priority Sector Lending

State-directed priority sector lending is not a new phenomenon in Asia. The Japanese and Korean governments both relied heavily on priority lending to industrial firms during their rapid economic development in the latter half of the 20th century. China has also had extensive experience with state-directed priority lending, though the government no longer maintains major priority lending programs.[2]

Governments typically implement priority sector lending programs based on the theory that the financial sector might otherwise underserve socially beneficial projects because of underpriced risks, information asymmetries, or high transaction costs that the private sector is unwilling to bear.[3] Policy objectives that may motivate state-directed lending include:

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

Current Priority Sector Lending Policies in Asia

Currently, the most common form of priority sector lending in Asia is the use of lending quotas by banking regulatory authorities. India, Indonesia, Thailand, and the Philippines implement such quotas. In the case of India, 40% of all bank loans must go to priority sectors, which include agriculture, SMEs, and export-oriented industries. Indonesia and the Philippines both direct priority sector lending to SMEs, with quotas of 20% and 8%, respectively, while Thailand directs 20% of bank deposits to agriculture (14%) and SMEs (6%).[4]

In an alternative approach, Malaysia and Vietnam mandate interest rate discounts for lending to priority sectors.[5] In Vietnam, loans to agriculture, SMEs, export-oriented industry, and technology are capped at 200 basis points above the deposit rate ceiling. As of March 2014, this meant priority sector interest rates of 8%; by contrast, loans to other sectors are not capped.[6] In Malaysia, loans to SMEs are capped at 200 basis points above the base lending rate.[7]

Notably, all six countries considered in the sample direct credit to SMEs, while three also target agriculture (see *Table 1*).[8] In each economy, SMEs are significantly underrepresented in the allocation of credit given their relative contribution to GDP and employment (see *Table 2*). SMEs in Indonesia and Malaysia suffer particularly large credit gaps relative to other developing Asian economies. The credit gap for SMEs around Asia makes the sector a typical target for priority sector lending programs.

Table 1: Priority Sector Lending Regimes in Asia

Country	Preferential Lending	Priority Sectors
	Loan Quotas	
India[9]	40%	Agriculture (18%), SMEs, export, microfinance
Indonesia	20%	SMEs
Philippines	8%	SMEs (6% small; 2% medium)
Thailand	20% of deposits	Agriculture (14%) and small-scale industries (6%)
	Interest Rate Cap[10]	
Vietnam	200 basis points above deposit ceiling	Agriculture, SMEs, export, technology
Malaysia	200 basis points above base lending rate[11]	SMEs

Table 2: SMEs and the Economy[12]						
Country	**% GDP**	**% Employment**	**Credit (% GDP)**	**SME Definition[13]**		
				Micro	*Small*	*Medium*
India	17.0 [2012][14]	40.0	4.3	Up to INR 2.5M (USD[15] 40K) in assets	INR 2.5-5M (USD 40-80K)	INR 5-10M (USD 80-170K)
Indonesia	56.5 [2009]	97.0	0.7	Up to IDR 50M (USD 4K) in assets	IDR 50-500M (USD 4K-40K)	< IDR 500M- 10B (USD 40-850K)
Malaysia	31.9 [2010]	59.0	17.4	Up to MYR 300K (USD 90K) in sales	MYR 300K-3/15M (services/manufacturing; USD 90K-1M/4.7M)	MYR 3-20/15-50M (USD 1M-6.3M/4.7-15.7M)
Philippines	35.7 [2009]	63.2	--	Up to PHP 3M (USD 70K) in assets	PHP 3-15 M (USD 70K-340K)	PHP 15-100M (USD 340K-2.3M)
Thailand	36.7 [2010]	78.2 [2009]	30.7	n/a	Up to THB 50M (USD 1.6M) in assets	THB 50-200M (USD 1.6-6.2M)
Vietnam	26.0 [2007]	77.3 [2002]	--	n/a	Up to VND 20B (USD 1M) in assets	VND 20-100B (USD 1M-4.7M)

Implications for the Banking System

Priority sector lending is generally motivated by a policy goal of increased access to finance, but such lending could affect banking system stability if recipient sectors suffer asset quality problems. The consistent focus of priority sector lending programs on SMEs provides an opportunity to consider common implications of these programs in Asia. Despite well-founded policy intentions to expand SME access to finance given the economic importance of the sector, a number of data sources suggest increasing lending to SMEs may cause asset quality deterioration in a country's banking system.

Concerned about mounting asset quality issues in India's banking system, the Reserve Bank of India (RBI) recently assessed the asset quality of each lending sector.[16] Non-performing loan (NPL) figures from 2001 to 2013 demonstrate a consistently higher share of NPLs coming from priority sectors, including SMEs (see *Table 3*).[17] Though SME loans comprised just 8.9% of total credit, they represented 15.1% of NPLs, 6.2 percentage points higher than expected if SME loans were of similar asset quality to overall lending.[18]

In Indonesia, the banking system's SME loan portfolio continues to exhibit inferior asset quality compared to the aggregate portfolio. Over the past three years, the SME NPL ratio has ranged from 130 to 170 basis points above the overall NPL ratio.[19]

Econometric analysis of data from other countries shows a similar pattern observed in India and Indonesia of higher NPL ratios for loans to SMEs compared to overall corporate lending. A World Bank study indicated that the average NPL ratio in developing countries for SMEs is 6.5%, compared to 4.1% for large firm loans; however, the finding is only statistically significant at the 10% level.[20] Data from the OECD generally show SME loans having a higher level of stress than overall lending (see *Table 4*), though some countries have SME loans with lower NPL figures.[21]

Priority lending to the agricultural sector—promoted by India, Thailand, and Vietnam—may also negatively impact asset quality. The RBI's data indicate that Indian banks have suffered declining asset quality in agricultural lending as they aggressively expand credit to the sector in meeting the lending quota (see *Table 3*). As with SME lending, agricultural loans have a higher average share of NPLs (14.1%) than expected given total allocation of credit to agriculture (11.4%). In Thailand, where agricultural lending also receives priority, data for bank loans in the Agriculture, Fishing, and Forestry category also show a higher average share of NPLs than expected given total allocation to the sector, with an average spread between NPL and overall credit ratios of 112 basis points.[22]

Table 3: Share of Indian Priority and Non-Priority Sectors in Total Credit and NPLs, 2001-2013 (%)										
	All Priority Sectors		*Agriculture*		*SME*		*Other Priority Sectors*		**Non-priority Sectors**	
	Credit	*NPLs*	*Credit*	*NPLs*	*Credit*	*NPLs*	*Credit*	*NPLs*	*Credit*	*NPLs*
Avg. Share[23]	32.4	44.8	11.4	14.1	8.9	15.1	12.1	15.6	67.6	55.2
Over-weighted Share of NPLs	12.4		2.7		6.2		3.5		-12.4	

Table 4: NPLs as a Percentage of Total Loans from Select OECD Countries, 2007/2011						
Country	**SMEs [a]**		**All business [b]**		**SME NPL Spread [b-a]**	
	2007	**2011**	**2007**	**2011**	**2007**	**2011**
Chile	7.1[i]	6.0	2.5[i]	2.0	4.6[i]	4.0
Hungary	5.4[ii]	15.9	4.7[ii]	17.4	0.7[ii]	1.5
Italy	6.8	10.6	4.5	8.5	2.3	2.1
New Zealand	2.0[i]	2.8	1.6[i]	1.9	0.4[i]	0.9
Portugal	2.1	8.2	1.7	6.7	0.4	1.5
Russia	7.6[i]	8.2	5.8[i]	4.7	1.8[i]	3.5
Thailand	7.9	3.6	9.6	3.1	-1.7	0.5
Turkey	3.8	3.1	5.4	4.2	-1.6	-1.1

Note: i: Data as of 2009; ii: Data as of 2008.
Source: OECD, *Financing SMEs and Entrepreneurs 2013: An OECD Scoreboard*, August 2013.

Implications for Foreign Banks

Priority sector lending requirements may also discourage foreign banks from entering a market to the extent they must follow the same mandate. Foreign banks in India have expressed the concern that meeting priority sector lending requirements are a challenge for their business models, which tend to focus on the banks' competitive advantages in trade finance, foreign exchange trading, and derivatives. Shortly after India permitted foreign banks to create wholly owned subsidiaries for the first time, Citibank decided to forego the expansion opportunity, likely a result of stronger implied priority sector lending requirements.[24] Foreign banks in Indonesia shared similar concerns after Bank Indonesia announced its current SME lending quota in late 2012, with Standard Chartered indicating that foreign banks would not be ready to meet such a requirement.[25]

Alternative Methods for Directing Credit

Given the important policy goal of increasing access to finance for under-banked sectors of developing Asian economies, governments might seek alternative mechanisms beyond universal quotas or interest rate caps to encourage lending while minimizing economic distortions.

In the past, countries have relied on a variety of other schemes to direct lending to priority sectors, including credit guarantees and loan securitization. Each of these mechanisms has drawbacks, however. In the case of credit guarantees, moral hazard may lead to excessive lending and additional asset quality stress, while also undermining the effectiveness of interest rates in managing risk.[26] Loan securitization—employed in the European Union's SME lending market—may offer banks access to capital market funding to meet priority lending requirements. India allows priority sector lending securitization in limited form, but banks must continue to hold these assets on their balance sheets, thereby retaining the potential negative effect on asset quality and capital. Even if countries allowed the transfer of credit risk to bond or equities markets, many developing Asian countries lack capital market depth to support priority loan securitization. Furthermore, moral hazard and transparency issues may lead to inappropriate risk management by banks or investors, creating broader systemic instability.

Regulators in India, Asia's largest director of priority credit, contemplated one promising alternative in a 2012 review of the priority sector lending program. In the alternative approach considered by the RBI, Priority Sector Lending Certificates (PSLCs) would replace strict quotas in a system where qualified lenders, such as microfinance institutions, would lend to priority sectors, earn a PSLC, and then sell the certificate to another banking institution seeking to fulfill a priority sector lending quota.[27] Importantly, the loans would remain on the books of the originating institution. Banks seeking to meet their quotas via PSLCs would not assume any risk, but instead would subsidize lending by other institutions specialized in priority sectors. The RBI recommended testing PSLCs through an initial trial, but it has yet to implement such a program.

In theory, a market for PSLCs would finance system-wide priority sector lending directed by microfinance institutions and other organizations with a comparative advantage in lending to sectors like agriculture and SMEs.[28] Such organizations would have more specialized credit risk assessment methodologies for these sectors and would better manage credit risks, particularly compared to banks with no prior experience lending—not to mention a physical presence—in less-developed areas. PSLCs would offer other advantages as well:

- By keeping priority sector loans off banks' balance sheets, regulators would lessen the burden of banks preparing for enhanced Basel III capital requirements.
- Existence of a PSLC market would allow access to non-financial market participants such as governments, NGOs, and foreign donors interested in supporting priority sectors.[29]
- In a white paper on financial reform, the RBI posited that PSLCs would encourage the creation of financial institutions specializing in priority sector lending much like the U.S. Community Reinvestment Act did beginning in 1977.[30]

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

Conclusion

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

Endnotes

1. In some cases, research and literature include the more specific "micro" category in analyzing small- and medium-sized enterprises—labeling the group "MSMEs"— while the classification of such enterprises itself varies by geography. For the purposes of this paper, reference to SMEs includes the "micro" category.
2. Policy lending played a larger role in the early years of China's economic reform era, providing approximately one-third of total bank credit, particularly given the sector focus in the original mandate of many of China's state-owned banks.
3. Dimitri Vittas and Yoon Je Cho, "Credit Policies: Lessons from East Asia," World Bank Policy Research Working Paper, Vol. 1458, May 31, 1995.
4. For further details on various country programs, see: Reserve Bank of India (RBI), "Priority Sector Lending - Targets and Classification," February 1, 2014; Bangko Sentral ng Pilipinas (BSP), "Status Report on BSP Initiatives to Improve Credit Access of Small and Medium Enterprises," February 2, 2004; *Country Finance: Thailand*, Economist Intelligence Unit, April 2012; "Growing MSMEs," *Forbes Indonesia*, June 12, 2013.
5. This paper primarily considers loan quotas or interest rate caps currently used to promote priority sector lending; it does not examine such prioritized lending through state-owned banks, which may have policy mandates (for example, the Bank for Agriculture and Agricultural Co-operatives conducts a large share of Thailand's agricultural lending).
6. The State Bank of Vietnam (SBV) set the current deposit rate ceiling at 6% in March 2014 and subsequently lowered the interest rate cap for priority sector loans in parallel. See *Vietnam Investment Review*, "SBV lowers interest rates on agri-loans," March 24, 2014.
7. Bank Negara Malaysia (BNM), "1998 Lending Guidelines to the Priority Sectors," March 25, 1998.
8. China's State Council, its foremost policy making body, announced on May 30, 2014 that it would lower reserve requirement ratios for banks that direct a certain proportion of lending to the agricultural and SME sectors. The People's Bank of China, which would implement such a policy change, has not yet released details of the new program.
9. Recent RBI panels convened on the topic of the priority sector lending program have discussed raising the overall quota even higher to 50% of all national credit as well as a 15% requirement for SMEs similar to the agricultural sub-target.
10. Prior to April 1, 2014, the RBI had capped interest rates on loans granted by microfinance companies at 26%.
11. For loans MYR 500,000 (USD 160,000) and below.
12. Data on SME share in GDP, employment, and credit from Shigehiro Shinozaki, "A New Regime of SME Finance in Emerging Asia: Empowering Growth-Oriented SMEs to Build Resilient National Economies," Asian Development Bank Working Paper No. 104, December 2012.
13. Respective definitions of each country's SMEs via central bank authorities: RBI, Bank Indonesia (BI), BNM, BSP, Bank of Thailand (BOT), and SBV.
14. Data on Indian SME share of GDP and employment from Zinnov, an Indian management consultancy. See *Economic Times*, "SMEs employ close to 40% of India's workforce, but contribute only 17% to GDP," June 9, 2013.
15. Exchange rates as of September 8, 2014: INR 60.25 / 1 USD; IDR 11,737 / USD 1; MYR 3.18 / USD 1; PHP 43.68 / USD 1; THB 32.07 / USD 1; VND 21,510 / USD 1.
16. Shashidhar M. Lokare, "Re-emerging Stress in the Asset Quality of Indian Banks: Macro-Financial Linkages," RBI Working Paper Series No. 03/2014, February 2014.
17. Banks may support higher NPL ratios by charging higher interest for loans from sectors posing higher credit risk, though in Malaysia and Vietnam interest rate caps prevent such risk management. Credit guarantee programs for sectors like SMEs—present in India and Malaysia, for example—may also prevent asset quality deterioration, though, particularly in a country like India where the state plays a major role capitalizing banks, credit guarantees may just shift problem loans to a different part of the government's balance sheet, undermining the government's ability to support the banking system through capital injections. See "Alternative Methods for Directing Credit" for further discussion of the disadvantages of credit guarantee programs.
18. As Table 3 shows, more broadly speaking, priority sector lending shows an over-weighted share of non-performing loans of 12.4 percentage points. Though representing 32.4% of total credit, they represent 44.8% of NPLs.
19. Bank Indonesia; FRBSF calculations. The BNM, BOT, SBV, and BSP do not release specific NPL figures for SME lending.
20. Thorsten Beck, Asli Demirguc-Kunt, and Maria Soledad Martinez Peria, "Banking SMEs around the world: Lending practices, business models, drivers and obstacles," World Bank, April 30, 2008.
21. The World Bank's econometric analysis indicates the SME-large loan gap is, in fact, more pronounced in developed countries, at 6.9% versus 2.5%, though the study found no statistically significant difference between developed and developing country NPL ratios for SME and large firms.
22. Bank of Thailand; FRBSF calculations. Data not available for state-owned banks with large agricultural portfolios.
23. FY2013 data for the first half of the year.
24. *Business Standard*, "Citibank not to set up its subsidiary in India," April 11, 2014.
25. *Jakarta Post*, "SME loan requirement may hurt foreign banks," December 7, 2012.
26. Op. cit. "Credit Policies: Lessons from East Asia."
27. Reserve Bank of India, "Report of the Nair Committee on Priority Sector Lending," February 21, 2012.
28. Pacific Community Ventures, "Case Study 12: Priority Sector Lending," *Impact Investing: A Framework for Policy Design and Analysis*, January 2011.
29. Ibid.
30. Planning Commission, Government of India, "A Hundred Small Steps: Report of the Committee on Financial Sector Reforms," 2009, p. 66.

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