SFBs' PSL Obligations Lowered from 75% to 60%; to Boost Flexibility and Build Diversified Loan Book

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Synopsis

- The Reserve Bank of India (RBI) on June 20, 2025, revised the priority sector lending (PSL) norms for Small Finance Banks (SFBs), reducing the overall PSL target from 75% to 60% of Adjusted Net Bank Credit (ANBC) or Credit Equivalent of Off-Balance Sheet Exposures (CEOBE) (whichever is higher), effective FY26 marking a significant shift in their lending obligations. This change, effective from FY26, is aimed at enhancing the operational flexibility and sustainability, while maintaining their financial inclusion mandate. This timely shift is expected to improve risk management, enable portfolio diversification, and free up resources for redeployment into more secure, better risk-adjusted assets amid rising stress in the microfinance segment.

Background

- SFBs were established under distinct licensing guidelines (2014 & 2019) with a core mandate to advance financial inclusion by serving unbanked and underbanked segments. To ensure this, SFBs were mandated to have a higher PSL requirement (75% of ANBC) compared to Universal Banks (40% of ANBC). Out of this:
    - **Mandatory Component (40%):** 40% of ANBC must be allocated to specific PSL sub-sectors (such as agriculture, micro-enterprises, education, housing, etc.) as per RBI's detailed PSL guidelines.
    - **Flexible Component (35%):** The remaining 35% could be allocated flexibly across any PSL sub-sectors, allowing SFBs to leverage their strengths and focus areas.
- Under the revised framework:
    - The overall PSL requirement was reduced from 75% to 60% for ANBC or CEOBE, whichever is higher.
    - The allocation of the mandatory component of 40% to specific sub-sectors under PSL remains unchanged, but the calculation basis has been broadened to ANBC or CEOBE, whichever is higher.
    - The flexible component reduced from 35% to 20%, which SFBs can allocate to any PSL sub-sectors where they have a competitive or operational advantage, also calculated on ANBC or CEOBE, whichever is higher.
    - Introduction of CEOBE alongside ANBC marks a significant shift. This ensures the PSL target reflects the bank's overall credit risk footprint, including off-balance sheet exposures like guarantees and letters of credit. This leads to a potentially higher denominator for target calculation.

PSL difference for SFB and Universal Banks

Feature	Small Finance Banks (SFBs)	Universal Banks (UBs)
Overall PSL Target	60% of ANBC or CEOBE, whichever is higher	40% of ANBC
Composition Flexibility	Two Components: Mandatory 40% (as per RBI sub-targets) + 20% Flexible (bank's discretion)	Single Component: Entire 40% governed by RBI-defined sub-targets
"Competitive Advantage" Focus	20% of PSL can be directed toward sectors where the bank has operational or market strengths	No provision for such discretion
Calculation Basis	Based on ANBC or CEOBE, whichever is higher	Based on ANBC only

Feature	Small Finance Banks (SFBs)	Universal Banks (UBs)
Core Regulatory Philosophy	Differentiated Banking Model: Higher PSL with flexible allocation for inclusion-driven goals	Universal Obligation Model: Uniform compliance across all banks

Benefits of the revision

- Frees up capital for non-PSL segments, enhancing commercial viability based on higher risk-adjusted returns by targeting better credit profile customers with lower credit cost.
- The revised framework enables portfolio diversification, reducing overdependence on single PSL sub-sectors such as microfinance. SFBs can now expand into secured and lower-risk asset classes such as housing, MSMEs, and gold loans, improving risk-adjusted returns and lowering delinquency exposure.
- It promotes consistency across banking models while preserving the focus on financial inclusion.
- The 60% target is more attainable. It lowers the regulatory burden, especially during rapid growth or economic stress periods, easing compliance and operational pressure while reducing the risk of regulatory penalties.
- Using ANBC or CEOBE, whichever is higher, provides a more accurate measure of total credit exposure (including off-balance sheet items), aligning with modern risk management practices.

CareEdge Ratings View

This circular follows two recent regulatory developments: the March 2025 circular, in which the RBI expanded the exposures eligible for PSL, and the June 2025 circular, in which the RBI reduced the qualifying assets threshold for NBFC-MFIs from 75% to 60%.

Sanjay Agarwal, Senior Director, CareEdge Ratings, said, "The revised PSL guidelines mark a strategic inflexion point for Small Finance Banks. The RBI has created a more balanced and practical regulatory framework by reducing the overall PSL target while preserving operational flexibility. These changes allow SFBs to strengthen profitability, enhance risk management, and diversify their portfolios beyond microfinance, enabling them to evolve into more resilient, full-spectrum financial institutions, without compromising their foundational mandate of financial inclusion. According to CareEdge estimates, approximately Rs 41,000 crore, or 15% of advances, could be freed up based on data as of March 31, 2025. A lower PSL requirement would create opportunities for SFBs to sell Priority Sector Lending Certificates (PSLCs) or offload excess PSL exposure to other market participants. However, since the PSLC premium is currently low, this change's immediate impact on profitability may be limited in the short term. The ability to redeploy this capital into higher-yielding or lower-risk segments such as secured retail, MSME, or housing finance offers significant upside for SFBs. Crucially, this regulatory shift comes at a time when the Gross Non-Performing Assets (GNPA) for Small Finance Banks increased to 4.35% as of March 31, 2025, compared to 3.50% a year earlier, primarily driven by those SFBs with a higher concentration in microfinance lending. In this context, the revised norms offer relief, allowing SFBs to rebalance their portfolios, mitigate concentration risk, and chart a more sustainable growth path."

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