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Possibility to priority: how priority sector lending can drive climate finance in India

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Summary

In emerging markets and developing economies, as well as advanced economies, governments have long used directed credit programmes as a central part of their industrial policy to channel finance to sectors of national importance. With governments and central banks increasingly prioritising climate mitigation and adaptation in their economic strategies, this report reviews evidence of the effectiveness of such programmes. We focus on India's Priority Sector Lending framework and analyse the experiences of 10 other countries to identify how directed credit has and has not succeeded in mobilising climate finance. Drawing on this evidence, we set out policy recommendations designed to enhance India's use of priority sector lending to channel credit to low-carbon and climate-resilient sectors.

India's priority sector lending (PSL) framework was first introduced in 1972. It requires commercial banks to direct a set share of their lending to sectors that serve national and social priorities, such as agriculture, small businesses, housing, education and, more recently, renewable energy. Under the current mandate, banks must allocate 40% of either Adjusted Net Bank Credit or the Credit Equivalent of Off-Balance Sheet Exposures to priority sectors. Over more than 50 years, the Reserve Bank of India (RBI) has adjusted the framework as new priorities have emerged. One example of this is the strengthened guidelines on renewable energy lending that India adopted after announcing its net zero commitments in 2021.

The PSL also provides a case study on how central banks can use quantitative and qualitative instruments to encourage or mandate the flow of credit to sectors that serve national, social and, increasingly, climate goals. We examine whether and how India can adapt its existing PSL tools to support a low-carbon and climate-resilient transition, drawing on both the country's experience and international examples.

While credit policy has often been part of a broader industrial strategy in Asian economies, India's PSL framework lacks the detailed and specific **project selection** that ought to accompany directed credit programmes, especially where industrial credit is involved. As a result, lenders tend to rely on general policy guidelines to select projects.

India could consider introducing **credit ceilings** for non-priority sectors as an instrument for combating inflationary periods and for diverting credit to low-carbon and climate-resilient sectors. Enabling credit to flow to sectors such as renewable energy and resilient agriculture could help the country build long-term resilience against the impacts of climate change and the low-carbon transition, such as volatile fossil-fuel and food prices. This would mirror Banque de France's use of credit ceilings and rediscount policy in the postwar period, and could be justified by the traditional goals of monetary policy, including the RBI's mandate to safeguard price stability.

One weakness of India's current approach to PSL has been the absence of **linkages between economic performance and credit allocation**. While there has been a rise in aggregate credit flows to India's priority sectors in recent times, it is unclear how this has affected the economic performance of these sectors. To address this, the RBI could link performance to PSL targets. India should ensure that continued flows of directed credit are contingent upon the performance of beneficiary firms, with banks free to threaten to deny access to credit when loanees fail to meet performance targets.

The RBI should continue to develop directed credit programmes in line with the requirements of the economy, including the need for **climate action**. India could promote lending to climate projects through a dedicated, phased renewable energy sub-target of the existing mandate, a proposal that has been put forth by various large commercial banks in the country.

Importantly, banks should continue to have the flexibility to meet mandatory lending requirements via multiple channels. India has had positive experiences with PSL certificates that can be openly traded between banking institutions that fail to meet broad or sector-specific lending targets because they lacked relevant experience of lending to priority sectors. Indonesia's post-pandemic Macroprudential Inclusive Financing Ratio provides an example of how flexibility can be part of a system-wide policy tool – especially in relatively sophisticated financial markets, where banks can acquire green securities or bonds to fulfil mandatory ratios without threatening financial stability.

A low-carbon and climate-resilient transition

Therefore, India could adapt its existing policy tools to support a low-carbon and climate-resilient transition by:

- Sharpening the design of the PSL framework's renewable energy targets, partly by including a dedicated sub-target and utility-scale eligibility criteria.
- Linking the PSL more explicitly to the national climate strategy and taxonomy.
- Introducing complementary instruments such as refinancing facilities, rediscounting initiatives and specialised institutions.
- Using instruments such as priority sector lending certificates to improve the market-based flexibility of lending requirements.
- Establishing a dedicated monitoring capacity for green lending and linking economic performance to credit allocation.

1. Introduction

Governments and central banks have long used directed credit programmes to steer financial resources towards activities deemed essential for national development, particularly where private incentives alone would lead to underinvestment. Central to postwar reconstruction and industrialisation in Europe and East Asia in the past, such programmes remain an important component of financial policy in several developing economies today. India's Priority Sector Lending framework demonstrates how such programmes can be adapted over time to reflect evolving developmental priorities, recently including climate objectives. As climate change becomes an increasingly material source of financial and macroeconomic risk, and as countries embed low-carbon and climate-resilient growth within their industrial strategies, interest is growing in how directed credit programmes can be repurposed to support green structural transformation. This report explores the rationale, design and evolution of such programmes, with a particular focus on India's PSL, to lay the groundwork for assessing how to use these tools to scale up credit for climate-aligned sectors in emerging markets.

Governments and central banks use directed credit programmes (DCPs) to influence how financial institutions allocate credit, aiming to channel funds to priority sectors of the economy. Central banks' DCPs served as a cornerstone of postwar economic and financial recovery and development in Europe and East Asia. Although they were gradually phased out in advanced economies in the late 1970s and 1980s, several emerging market central banks continue to use a variety of similar instruments to incentivise, limit or direct credit. They do so through, for instance, subsidised refinancing schemes, differential liquidity ratios and reserve requirements, as well as more directed credit policies, such as credit floors and ceilings.

There are lively debates around the effectiveness of DCPs. These policy instruments have traditionally been considered an unconventional and often ineffective measure for achieving growth and sustainability objectives (World Bank, 1989). Arguments against DCPs characterise them as repressive policies that constrain the size of the financial system, with adverse consequences for investment and economic growth. For example, DCPs could shift credit away from projects with potentially higher returns (McKinnon, 1973; Shaw, 1973). Since the 1980s, the World Bank (1989) has instead prescribed equilibrium credit rationing, a type of financial reform that minimises reserve requirements and facilitates open market operations for the purposes of monetary policy. Equilibrium credit rationing reform does so by removing interest rate ceilings and shifting towards a market-based allocation of bank credit (Kohli, 1997).

Arguments for DCPs emphasise the need to tackle financial exclusion. Supporters of these measures argue that open credit markets will inevitably lead to information asymmetries that cause some groups of people to be considered risky borrowers and, accordingly, denied credit even where the potential returns are higher. Government or central bank interventions through DCPs have been justified, so the argument goes, where improved credit allocation to marginalised groups with high growth potential produces clear efficiency gains (Kohli, 1997). Today, most DCPs target micro, small and medium-sized enterprises (MSMEs), microfinance institutions (MFIs) or, increasingly, small-scale renewables.

The rationale for introducing DCPs is driven by both economic and moral considerations (Kohli, 1997). From an efficiency perspective, a market-based allocation of credit driven by private profit may lead to underinvestment in areas with high social returns but low private returns. Government or central bank intervention may, therefore, be needed to channel credit to sectors where there this could have considerable social benefits and improve an existing allocation of resources, such as labour-intensive MSMEs. From an equity perspective, the unequal distribution of initial endowments can be rectified by

providing credit to small or disadvantaged borrowers, who then gain access to a means of production and income that helps reduce inequality.

Although credit policy is today considered an unconventional measure, it has historically been employed by central banks in emerging markets and developing economies (EMDEs), as well as advanced economies. DCPs have been adopted not just in India but also in Japan, China, the Philippines, Brazil, Nigeria, Nepal, Pakistan, the US and South Korea as an instrument for channelling finance to economic sectors that are considered of national importance (Kohli, 1997; Dev et al., 2026).

There continues to be broader debate about DCPs that focuses on whether quantitative mandates are a sound instrument of financial policy. We do not intend to resolve that debate, nor to argue that directed credit is the first-best instrument for climate finance relative to a carbon price or direct fiscal subsidies. Our starting point is narrower: instruments such as India's PSL are binding on the banking system, are being extended to climate-aligned sectors, and are already an established part of the financial architecture. Therefore, the operative question concerns not whether to build such instruments from scratch but how to ensure that those already in place produce better climate outcomes. The types of policies we analyse are highlighted in Box 1.1.

This is a particularly pressing question in the Indian context. NITI Aayog, the Indian Government's policy think-thank, places India's decarbonisation financing need at the centre of national economic planning, with a recent report estimating that an additional US$8.1 trillion is required for the country's net zero transition (NITI Aayog, 2026). While most of this financing will continue to come from bank credit from domestic and international sources, additional foreign direct investment will also be needed. Given the magnitude of this financing gap and the fact that flows of international climate finance are projected to decline in the near term, the question of how to extract more climate-aligned lending from an instrument the Reserve Bank of India (RBI) already operates is important to unlocking additional capital for climate finance.

Conceived of in the 1960s and early 1970s, the RBI's PSL scheme has been in place since 1972. In 1974, the scheme introduced a formal target requiring 33.3% of banks' lending to go to priority sectors. The policy has been updated several times since then to reflect India's evolving developmental priorities. Currently, the RBI's PSL guidelines mandate that scheduled commercial banks in the country must allocate, 40% of either Adjusted Net Bank Credit (ANBC) or Credit Equivalent of Off-Balance Sheet Exposures (CEOBSE) to priority sectors according to whichever is the higher amount.[1] ANBC is a bank's total loans and advances, net of bills rediscounted with the RBI and other financial institutions, plus specified investments such as non-supplementary leverage ratio bonds held to maturity. Priority sectors include agriculture, MSMEs, export credit, education, housing, social infrastructure and other weaker sections of the economy, such as small-scale farming and village industries (RBI, 2025a).

Since 2015, India has used the PSL framework to support the allocation of bank credit to renewable energy by including it as an eligible sector. The RBI was an early pioneer in the use of DCPs to support the renewable energy transition. Banks can hit the 40% PSL target by issuing credit for the construction of small-scale renewable energy projects in areas such as solar, biomass, windmills and micro-hydro, as well as renewables-based public utilities such as street lighting and village electrification. However, there is no mandatory sub-target for renewable energy.

So far, the role of DCPs in supporting a low-carbon and climate-resilient transition is largely unexplored. The RBI, among a handful of other central banks, has started to incorporate climate considerations into its DCPs. As climate change increasingly creates risks for financial and price stability, and is becoming a central pillar of national economic and industrial development strategies, there has recently been growing interest in more allocative green credit policy regimes organised around green industrial policy objectives (e.g. Kedward et al., 2022; Larsen, 2025).

We aim to inform how the central bank in India and central banks in other countries identify best practice for using DCPs to support climate action. Given that these programmes have played a major role in the economic development of advanced economies and EMDEs for decades, we draw on

[1] Foreign banks operating in India with more than 20 bank branches are also subject to the same requirements. Rural regional banks and urban cooperative banks have different targets of 75% and 60%, respectively (RBI, 2025a).

insights and lessons from countries around the world to inform the policies needed to scale up credit to low-carbon and climate-resilient sectors of the economy. To this end, we conducted a review of the literature on the effectiveness of DCPs in these countries, analysed relevant publicly available data (where available) and interviewed representatives of central banks and governments in these countries. Comparing historical and contemporary experiences across advanced economies and EMDEs enables us to provide insights into the institutional conditions, policy tools and governance arrangements that can support the reorientation of DCPs towards low-carbon and climate-resilient development.

Box 1.1. Directed credit policy

The broadest definition of directed credit policy describes it as encompassing all dimensions of money and credit that deal with the allocation of funds and their distributional consequences (Monnet, 2018). This definition explicitly includes financial regulation, government lending and subsidies, and lending from public investment banks (Bezemer et al., 2023; Hauge and Hickel, 2025). Taken at face value, this definition implies that even independent, inflation-targeting central banks are implementing credit policy even as they follow the market neutrality principle, which formally prohibits them from steering the private allocation of corporate credit (Gabor and Huth, 2026).

The RBI's definition of PSL is narrower and more focused on banks' operations: priority sectors are parts of the economy that would not receive timely and adequate credit unless banks were specifically directed to lend to them and to meet a binding quantitative target across a defined list of such sectors (RBI, 2025a).

Here, we use 'directed credit programme' (DCP) to refer to interventions that are structurally similar to this definition of PSL rather than the broader one. The examples we give share three features with the PSL framework:

- An explicit, rules-based intervention rather than a general financial regulation applied without regard to sectoral allocation.
- A binding sectoral allocation objective met through a mandate, a refinancing or guarantee instrument, or a macroprudential ratio.
- Terms conditional on a bank's lending performance against that objective rather than a uniform, economy-wide operation such as broad-based quantitative easing.

This means that our analysis does not cover untargeted financial regulation and general unconventional monetary policy instruments, such as economy-wide corporate bond purchases without a stated sectoral objective.

The remainder of the report is structured as follows: Section 2 provides an overview of DCPs, with a focus on how India's PSL is structured, as well as a summary of the evidence of its effectiveness. Section 3 reviews the literature to provide qualitative insights into the strengths and weaknesses of DCPs in other countries, and to identify lessons on target design, complementary instruments, eligibility, institutional capacity, compliance flexibility and structural preconditions and risks. Section 4 draws on this evidence to outline potential reforms of the PSL guidelines to support the low-carbon transition. Section 5 concludes our argument.

2. Priority sector lending in India

The PSL guidelines were introduced in the 1970s as part of India's wider development strategy and has evolved into a framework that mandates banks to support sectors with high social or strategic value, ranging from agriculture and renewable energy to MSMEs. This section traces the historical evolution of the framework, outlines its institutional design and operational mechanisms, and reviews the evidence on its effectiveness in diverting credit to marginalised sectors without materially impacting financial performance or stability.

How the PSL framework operates

As discussed, the PSL framework is a policy mechanism requiring banks to allocate a specific percentage of their total lending to sectors deemed crucial for the country's socio-economic development and inclusive growth. Eligible priority sectors include agriculture, MSMEs, export credit, education, housing, social infrastructure and weaker sections (see Table 2.1). Under the overall target, there are specific sub-targets for certain categories. For example, there is an 8% target for small and marginal farmers and a 7.5% target for MSMEs. Compliance is recorded on a quarterly and annual basis, with the total percentage calculated based on the average of the quarterly figures in the financial year.

Table 2.1. Overview of the RBI's priority sector lending guidelines

Sector	PSL targets	Loan quantity	Additional details
Agriculture	18% 14% for non-corporate farmers, of which 10% is for small and marginal farmers	Collateral-free up to ₹200,000	Agriculture has always been a core sector for the PSL framework. This sector is subdivided into agriculture infrastructure, farm credit and allied activities. Sub-targets for small and marginal farmers were added in 2015.
MSMEs	Included in the 40% PSL target 7.5% sub-target for micro enterprises	Based on MSME definition	Started as coverage of small-scale industries and expanded over time. Sub-categories include specific limits for investment in plants and machinery based on their size.
Export credit	Included in the 40% PSL target	RBI guidelines	Included in 1985; foreign banks now have specific targets. Domestic banks and foreign banks with 20+ branches need to lend up to 2% of ANBC (up to ₹250 million per borrower).
Education	Included in the 40% PSL target	Up to ₹2.5 million per individual	The loan limit has increased and is now ₹1 million in India and ₹2 million outside the country. As of 2025, the limit also includes loans for vocational and professional courses.

Housing	Included in the 40% PSL target	₹5 million in cities with population of more than 5 million ₹4.5 million in cities with population of less than 5 million, but more than 1 million ₹3.5 million in areas with population of less than 1 million	Loan limits increased several times; rural affordable housing broadened as part of the PSL framework in 2022.
Social infrastructure	Included in the 40% PSL target	Up to ₹80 million per borrower for schools, drinking water facilities and sanitation facilities Up to ₹120 million for building healthcare facilities in Tier II to Tier IV centres	Introduced in 2016 to build social facilities such as those in sanitation, healthcare and education. Limit raised from ₹50 million to ₹80 million in 2020; now includes rural schools, health centres, and water and sanitation projects.
Renewable energy	Included in the 40% PSL target	₹350 million for renewable energy-based power generators and renewable energy based public utilities ₹1 million for individual households	Added in 2015 to build renewable energy projects. Limit raised in 2020 and 2025 as renewables became a national priority.
Other (such as weaker sections and startups)	Included in the 40% PSL target 12% target for weaker sections	Up to ₹200,000 for self-help groups Up to ₹100,000 for distressed groups	Weaker sections include small and poor farmers, artisans, village and cottage industries, borrowers under government-sponsored schemes, scheduled castes and tribes, distressed farmers and peoples, women, people with disabilities and minority communities.

Source: Adapted from Reserve Bank of India (2025a).

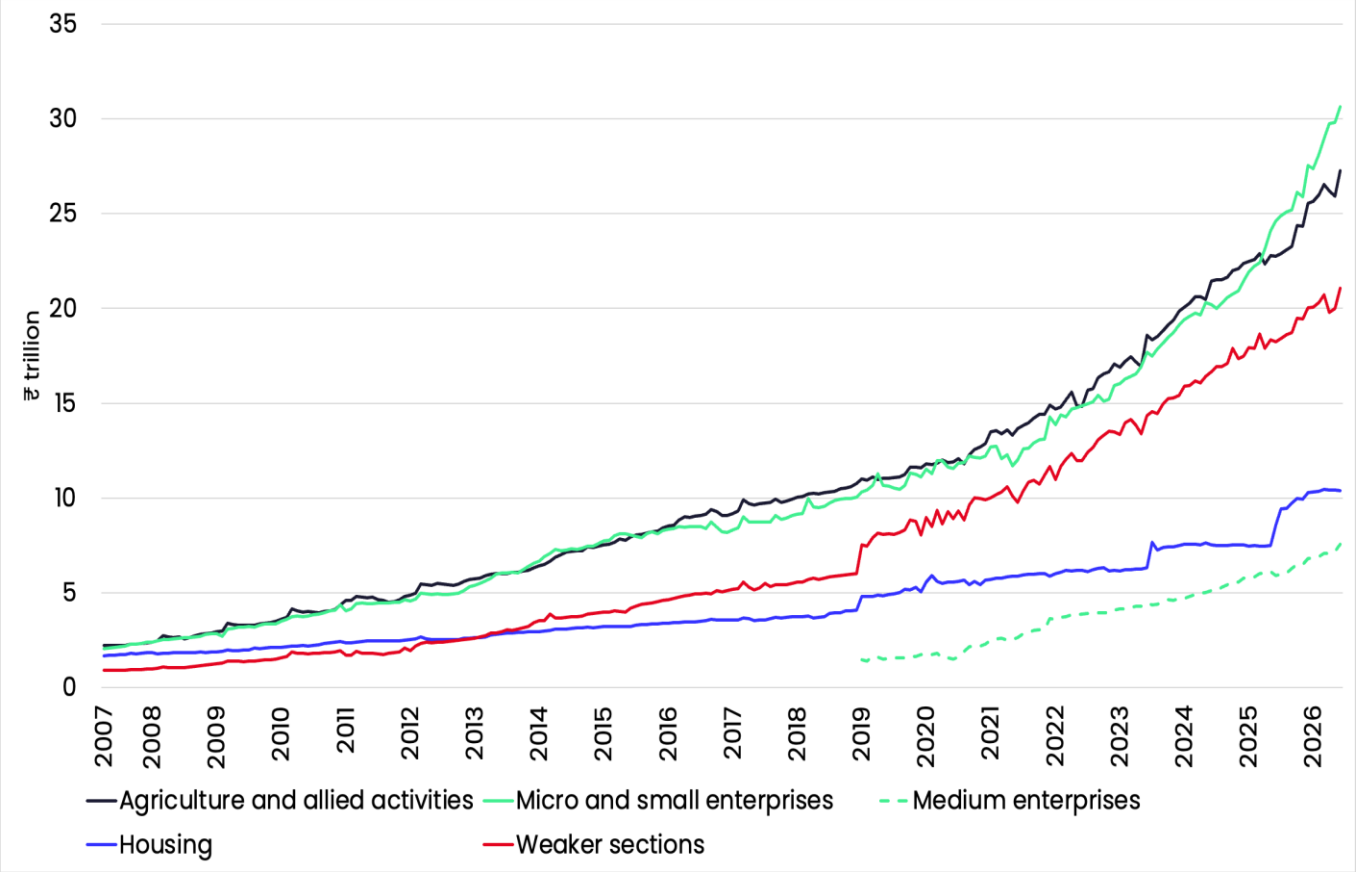
Banks that fail to meet their PSL targets face penalties or are required to provide compensation through alternative mechanisms. Those with a shortfall can deposit the difference into various development funds managed by public finance institutions such as the National Bank for Agriculture and Rural Development (NABARD), the Small Industries Development Bank of India (SIDBI) and the National Housing Bank (NHB). More commonly, to meet the shortfall, banks buy and sell PSL obligations via Priority Sector Lending Certificates (PSLCs) at a market-determined fee via the RBI's E-Kuber platform. These are the indirect instruments that banks most often use to meet their targets. PSLCs transfer not the underlying loan assets or the associated credit risk but the fulfilment of the obligation. This provides banks with the flexibility to manage their PSL targets while maintaining their competitive advantage in their focus sectors – and to do so without altering the availability of existing credit in most districts (Dev et al. 2026).

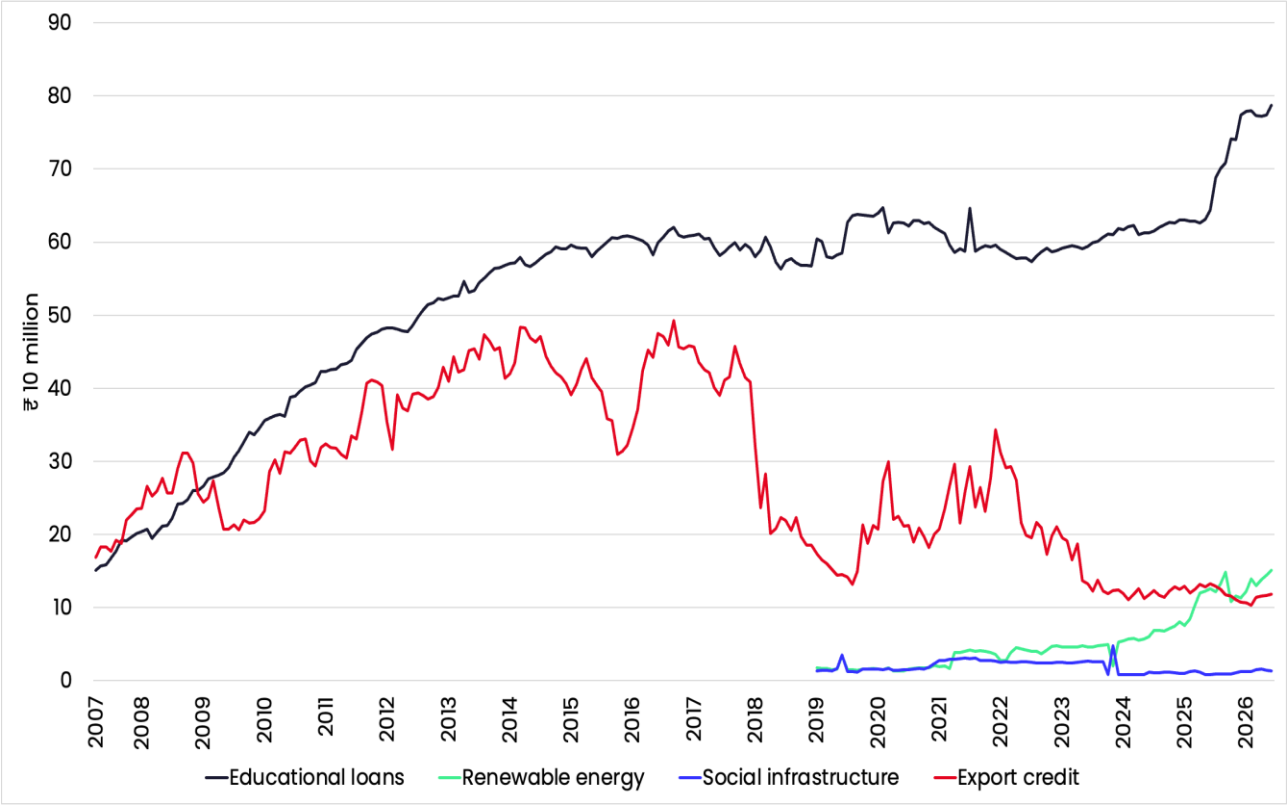
The PSL framework also has a subnational dimension. Since 1969, each district in the country has been assigned a designated 'lead bank', which is responsible for preparing District Credit Plans that translate national PSL targets into local lending priorities under the Lead Bank Scheme (RBI, 2025b). This is done in coordination with State Level Bankers' Committees chaired by representatives of the state government. This creates a two-level structure of incentives in which the RBI sets the targets, while their translation into actual credit allocation is shaped by state- and district-level politics and policy, including state governments' development priorities and the relative bargaining power of different sectors and regions within the process. There is a disparity between districts in terms of the concentration of bank lending, with 10% of the districts accounting for more than 45% priority sector advances (Dev et al., 2026). The RBI recently reviewed and revised the guidelines to "improve credit flow to priority sectors and promote financial inclusion in each district" (*Economic Times*, 2026).

Evidence of the PSL framework's effectiveness

Overall, lending to all previously marginalised priority sectors has gradually increased. After the PSL framework was introduced in 1972, the share of priority sector advances in net bank credit increased from 14.6% in 1969 to 44.6% in 1989. The framework appeared to have a substantial cumulative effect after its initial introduction, accounting for around 40% of investment in small firms during 1965–78 (Kohli, 1996; Eastwood and Kohli, 1997). The effects were especially apparent in agriculture and small industries. Initially, banks preferred to lend to more lucrative priority sectors, particularly housing, education and export credit. This came at the expense of credit allocation to less lucrative, lower-yielding and riskier sectors, such as agriculture and small-scale industries (Roy, 2006; Das et al., 2006; Uppal, 2009; Raman, 2013). The increase in lending also coincided with broader credit growth and a deepening of financial markets in the country. While the PSL framework contributed to the increase, it is difficult to separate its contribution from the wider trend or net out the opportunity cost of credit that might have otherwise flowed to higher-return projects (McKinnon, 1973; Shaw, 1973).

Figure 2.1. Gross outstanding credit to priority sectors (scheduled commercial banks)

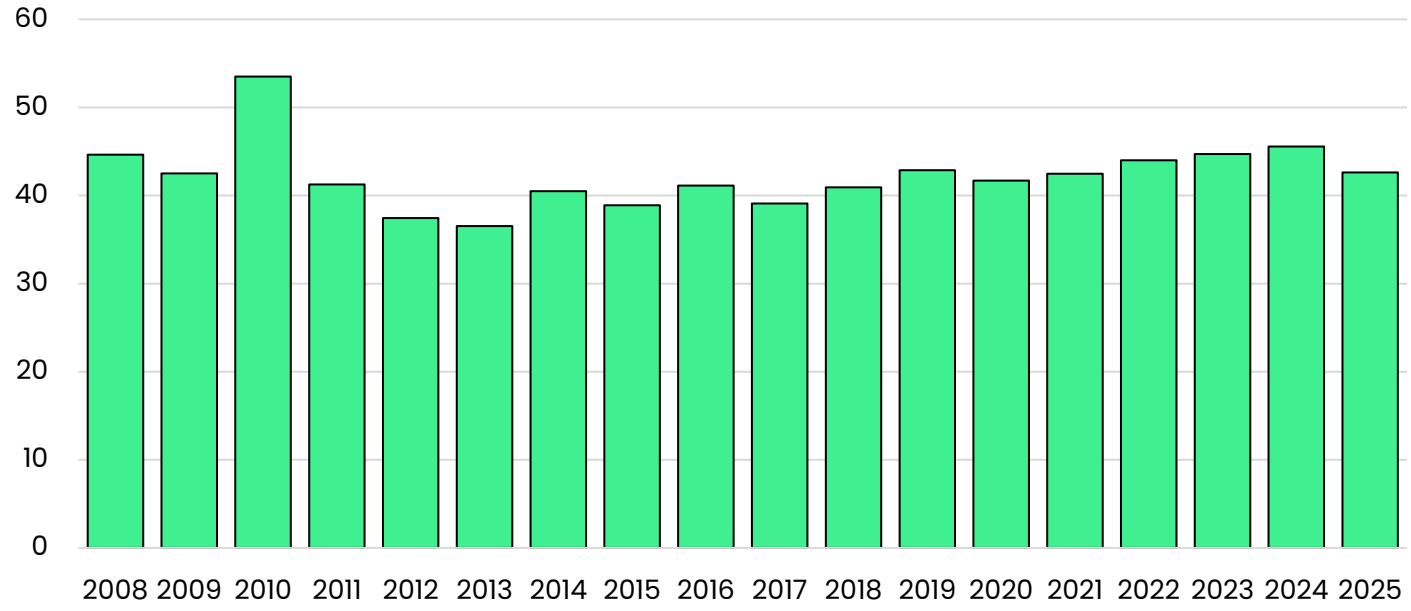




Source: Database on the Indian Economy (Reserve Bank of India, n.d.).

More recently, lending to agriculture, MSMEs and weaker sectors has risen (see Figure 2.1). Total disbursement of credit increased from ₹11.6 trillion in 2019 to ₹23.28 trillion in 2025 in the agricultural sector, and from ₹12.6 trillion in 2021 to ₹25.2 trillion in 2025 for micro- and small enterprises. Lending to weaker sections, housing, medium-sized enterprises and renewable energy have also experienced growth. Meanwhile, credit supply to social infrastructure and export credit has declined (see Figure 2.1). Overall, growth in credit to the main priority sectors has enabled the banking sector to consistently exceed its mandated share of lending to priority sectors since 2018 (see Figure 2.2), including sub-targets for individual sectors (State Bank of India [SBI], 2025).

Figure 2.2. Share of lending to priority sectors (percentage of ANBC)



Source: Authors' calculations based on data from the Database on the Indian Economy (Reserve Bank of India, n.d.).

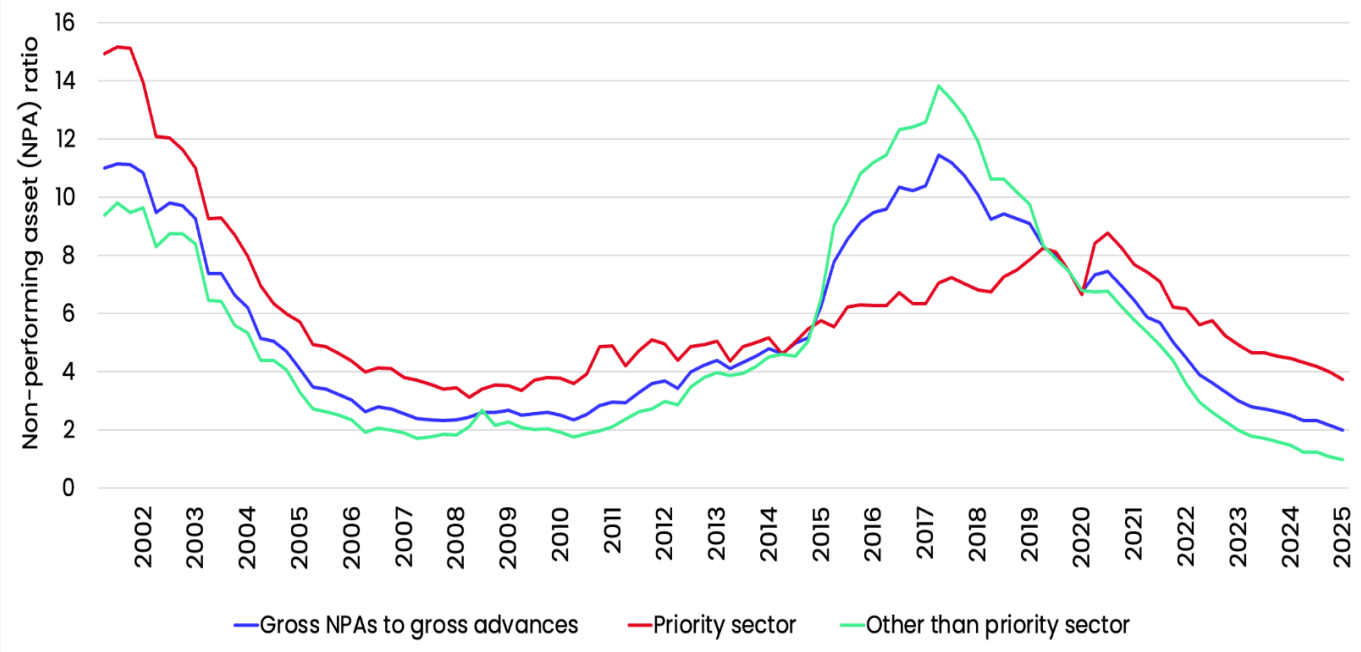
PSL only had a minor role in the displacement of lending to non-priority sectors. Although some non-priority sectors (e.g. trade, large-scale industry) suffered declines in credit allocation, total bank credit rose significantly after 1988 due to post-nationalisation reforms (Kohli, 1997). Therefore, while the PSL framework has considerably influenced credit flows in the banking system, the relationship between this and sectors' performance is unclear due to the rise in real investment in the period (ibid.).

Bank size has affected lending behaviour within the PSL framework. Smaller banks relying on 'soft information' (based on local and contextual knowledge), often exhibit comparative advantages in serving smaller borrowers. Conversely, larger banks have struggled to meet sectoral PSL targets due to their higher risk aversion and larger operational scale (Kohli, 1997). Although all banking groups have met their priority sector and sub-sector lending targets of late, they continue to experience problems in meeting their PSL targets (SBI, 2025).

The PSL framework has also had broader positive effects on welfare outcomes. The programme has increased the share of bank credit relative to external finance for the electrical-machinery and medical industries. This has led to small firms in India accounting for four-fifths of total employment in manufacturing and 40% of India's manufacturing exports. Rural credit led to modest increases in aggregate crop output, and sharp increases in the use of fertilisers and in investments in physical capital such as tractors, pumps and livestock (Binswanger and Khander, 1992). The programme had further positive effects on the rural financial system, rural non-farm employment and agricultural output.

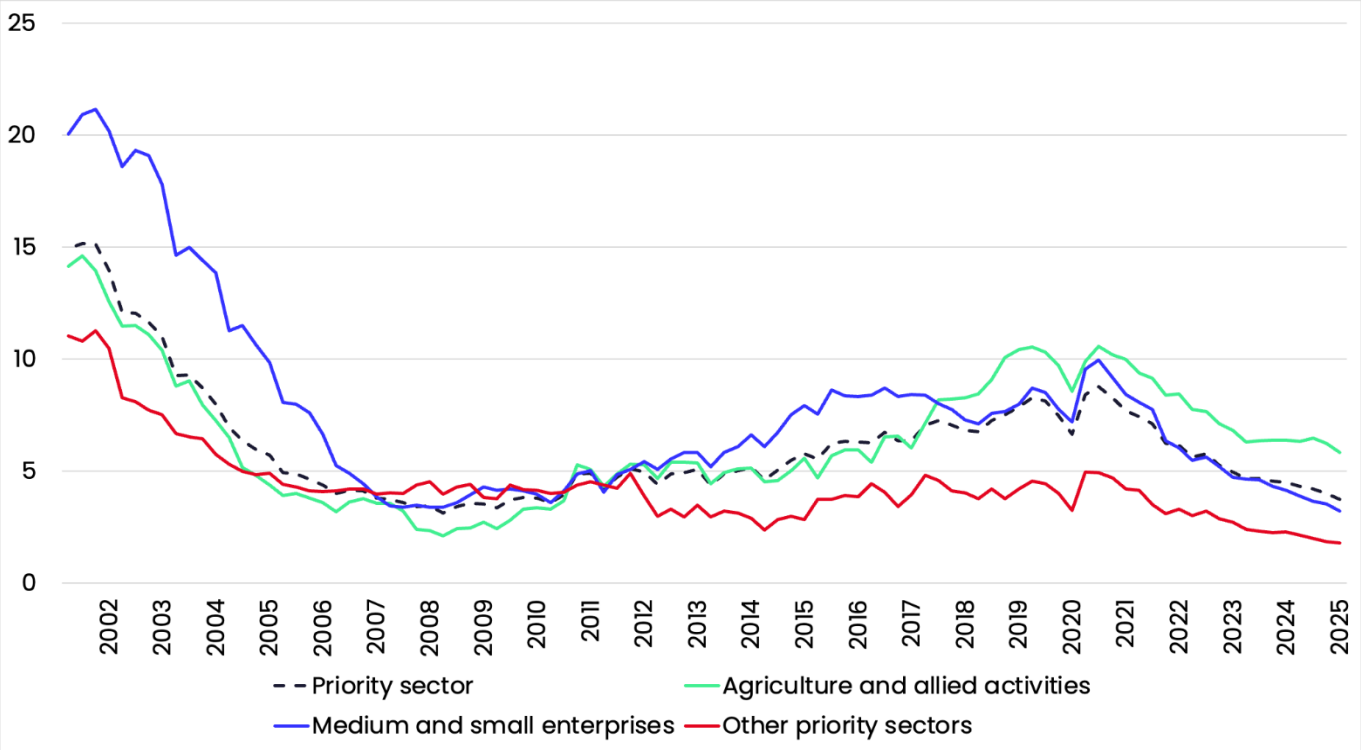
There has been a lively debate on the impact of DCPs – including the PSL framework – on non-performing assets (NPAs). Critics of DCPs argue that such mandates can reduce the quality of banks' loan portfolios (Swamy, 2012). There is some evidence of this in India, where the RBI notes that there is generally a higher share of NPAs in priority sectors (RBI, 2024; see Figure 2.3). However, in recent years, the share of NPAs in these sectors has been declining more sharply than those in non-priority sectors, especially since the Global Financial Crisis of 2008 (Chavan and Gambacorta, 2016). Furthermore, historically, the rise in NPAs in priority sectors has primarily been driven by loan defaults in agriculture, which is generally characterised by low-quality loans. Therefore, this appears to be a chronic, systematic problem rather than one caused by frameworks such as the PSL (Kohli, 1997; see Figure 2.4).

Figure 2.3. NPAs across priority and non-priority sectors



Source: Database on the Indian Economy (Reserve Bank of India, n.d.).

Figure 2.4. NPAs across priority sectors



Source: Database on the Indian Economy (Reserve Bank of India, n.d.).

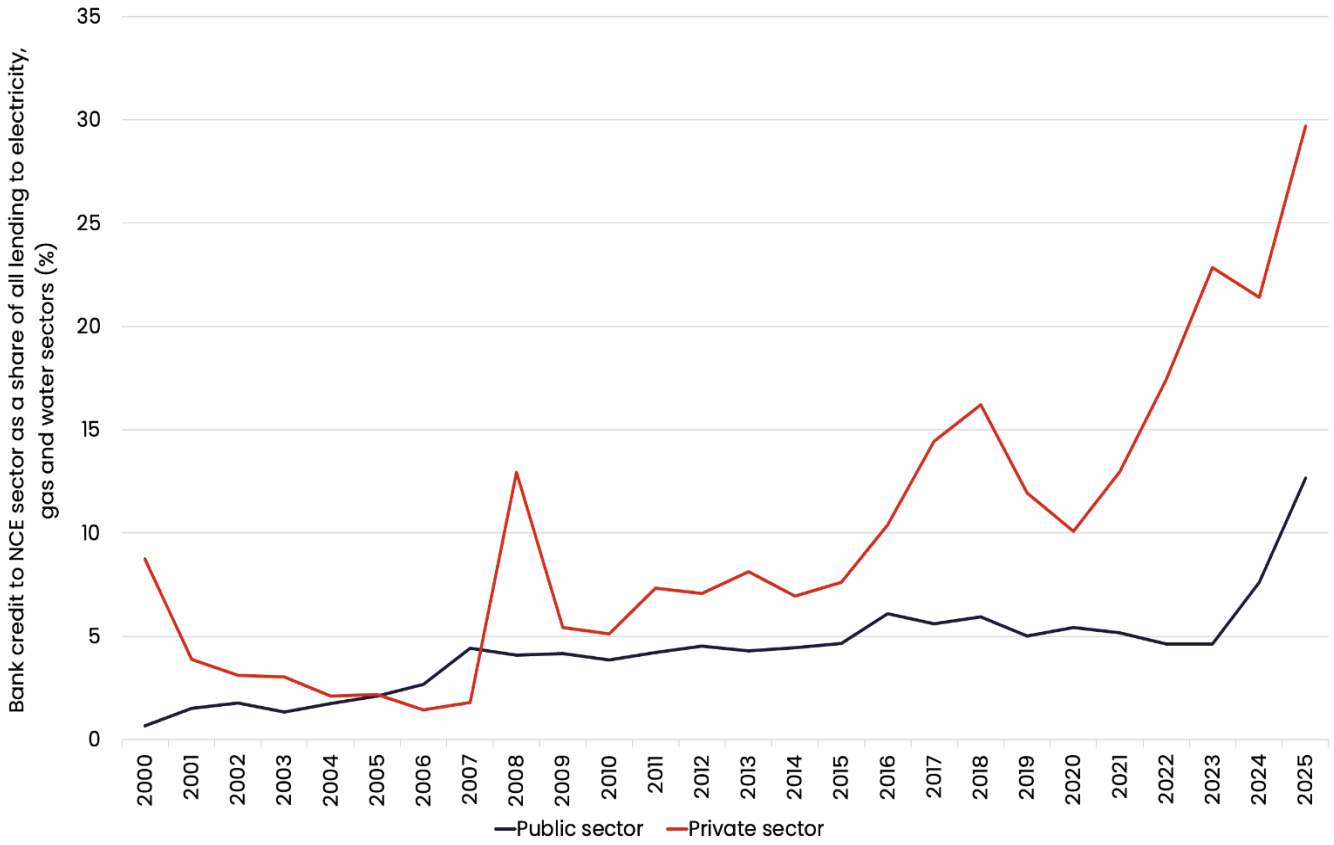
Inclusion of renewable energy in the PSL framework

The RBI included renewable energy in the PSL framework in 2015. This move aligned with India's commitments under the National Action Plan on Climate Change, published in 2008 (Ministry of Environment, Forest and Climate Change, 2008). The policy aimed to strengthen green infrastructure, create employment, and promote the energy transition by classifying loans for solar, wind, biomass and small hydropower projects as eligible for the PSL. Banks can provide up to ₹350 million (~$3.6 million) per borrower for renewable energy projects such as solar generators, micro-hydro plants, and biomass-based utilities, including rural electrification and street lighting systems (RBI, 2024a; RBI, 2025a).

The inclusion of renewable energy in the PSL was followed by an immediate but temporary rise in lending to non-conventional energy projects (RBI, 2024b; see Figure 2.5). However, it is not possible to establish whether this rise can be attributed to the inclusion of renewable energy as an eligible PSL activity, or whether lending increased due to a general trend towards renewable energy deployment in India's energy mix. The relatively modest and temporary increase in lending to renewable energy projects may have occurred due to a rise banks' lending to the energy sector more broadly (Sarangi, 2018). While the share of lending to non-conventional energy sources grew sharply once again in 2020 following the RBI's publication of updated guidelines the previous year, this could have partly resulted from the introduction of incentives for foreign direct investment. India's announcement of its 2070 net zero target at COP26 in Glasgow continued the trend.

Detailed guidance and use cases can support the uptake of the PSL. The updated guidelines for renewable energy that India published in 2019 established loan limits of ₹300 million for commercial lending to renewable energy projects (increased to ₹350 million in 2025) and, above all, provided specific examples of eligible projects. This may have helped address the vagueness of the first directive. Analysis by the State Bank of India (SBI) confirms that explicit recognition and prioritisation of renewable energy within the PSL framework alleviated credit constraints in the sector, leading to rapid growth in the share of non-conventional energy (NCE) credit compared to overall energy credit (SBI, 2025).

Figure 2.5. Bank credit to NCE sector as a share of all lending to electricity, gas and water sectors (%)



Source: Authors' calculations based on data obtained from CEIC India Premium Database (CEIC, n.d.) and RBI report on Trend and Progress of Banking in India 2023–24 (Reserve Bank of India 2024b). Note: Non-conventional energy refers to sources of energy that are renewable or clean, and serve as alternatives to fossil fuels.

The evidence suggests that the PSL has been most effective at redirecting credit to renewable energy projects when India defines specific eligibility criteria (rather than relying on broader, undifferentiated categories) and reinforces this with complementary policy signals. It has been less effective when banks faced residual risk, regulatory uncertainty or a longer maturity of loans that the mandate alone did not address. These issues are not unique to the Indian case. As we set out in Section 3, other countries' experiences with DCPs involve mechanisms that could help mobilise climate finance by informing a redesign of the PSL's approach to complementary refinancing, the specificity of eligibility criteria, institutional monitoring capacity and the flexibility of market-based compliance.

3. International lessons on the effectiveness of directed credit programmes

This section sets out the methodology we use to identify lessons on how DCPs can be adapted to mobilise additional private climate finance and public expenditure for climate action. We examine other countries' approach to DCPs, comparing historical and contemporary experiences across advanced economies and EMDEs. Drawing on these experiences, we provide cross-cutting insights into the institutional conditions, policy tools and governance arrangements that can support the reorientation of DCPs towards low-carbon and climate-resilient development.

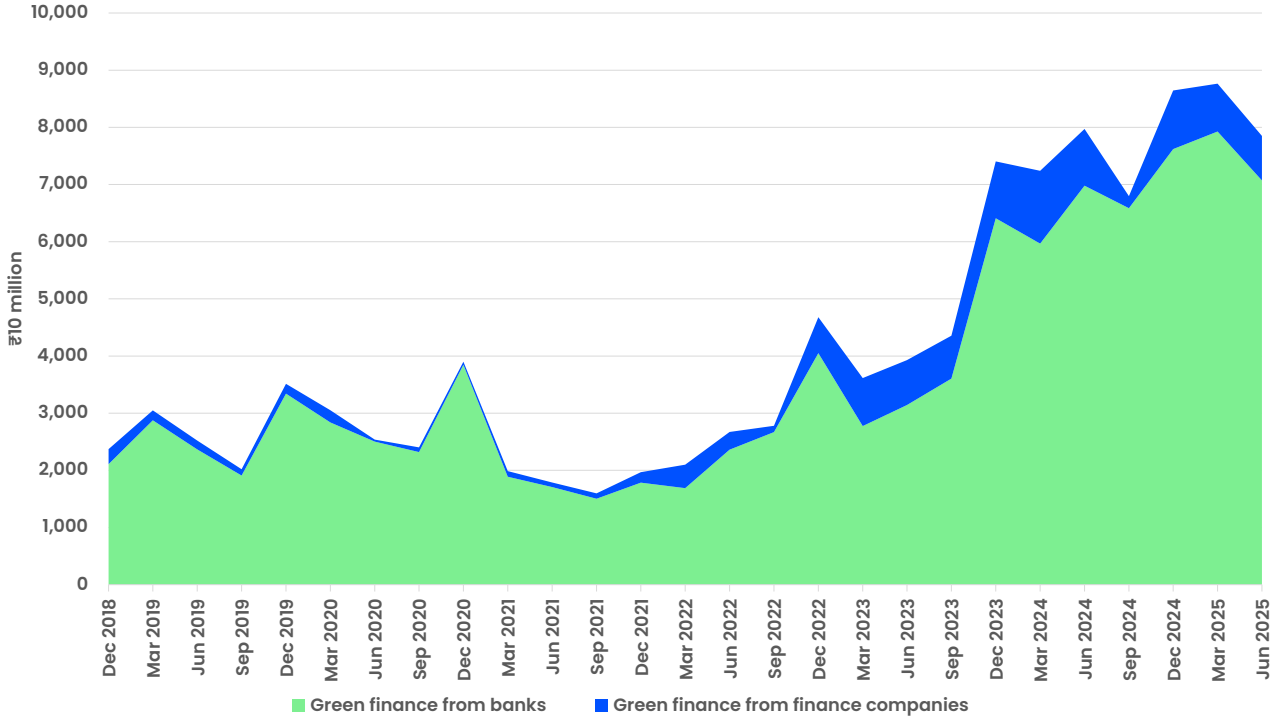
Setting mandatory targets

Mandatory lending targets sustain compliance and, in some cases, improve loan quality when they are phased in gradually and allow some flexibility in how they are met. Rigid targets that lack phasing or enforceable consequences for non-compliance tend to be missed, lose credibility and erode over time. For instance, in the late 2000s, Bangladesh Bank began actively supporting green finance through a concessional refinancing programme and credit allocations for financial firms. In 2009, the bank implemented a ৳2 billion revolving refinancing scheme to promote environmentally friendly products such as solar energy, biogas facilities and effluent treatment plants. Due to the success of the scheme, the bank has since been increased the fund to ৳10 billion and it now covers 70 different types of projects. In 2016, Bangladesh Bank implemented an additional refinancing facility called the Green Transformation Fund, which is capped at ৳50 billion and focuses on manufacturing and export-oriented entities (Bangladesh Bank, 2025). There are additional refinancing schemes at the central bank for technology development (৳10 billion) and Shariah-based refinancing schemes for green products (৳1.25 billion).

Due to the slow uptake of subsidised lending and competition from a separate government-owned scheme, Bangladesh Bank introduced mandatory lending targets for sustainable and green finance in 2016. Since then, banks in Bangladesh have been mandated to dedicate a minimum of 15% of their total lending to sustainable projects, and 5% to over 100 different types of green finance products and projects.

The mandatory lending target has been largely successful in increasing green finance and investment in Bangladesh (see Figure 3.1). Central bank data shows that in 2022, Bangladeshi banks invested a total of US$12 billion in sustainable finance and US$1.1 billion in green finance, an increase of 58% and 69% compared to 2021, respectively (Hossain, 2023). Such investment has steadily risen in recent years (see Figure 3.3), largely focused on green socially responsible financing (38%), energy and resource efficiency (30%) and green or environmentally friendly establishments such as certified green buildings or affordable housing (10%). While this growth has not had a significant effect on the profitability of banks (Ahmed and Das, 2024), some financial institutions have struggled to implement the policy. Specifically, publicly owned commercial banks and state-owned commercial banks have been slow to disburse green financing. Of the ৳7,006,340 million in total outstanding green finance (loans disbursed as of June 2025), less than 10% came from these two types of financial institutions. By contrast, private commercial banks accounted for ৳461,560 million in outstanding green finance. Publicly owned banks' relatively minor role in green finance stems from their lack of awareness and capacity, small-scale green entrepreneurs' inability to prove their creditworthiness and secure funding from commercial banks, and the comparatively high transaction costs associated with smaller transactions (Hossain, 2018).

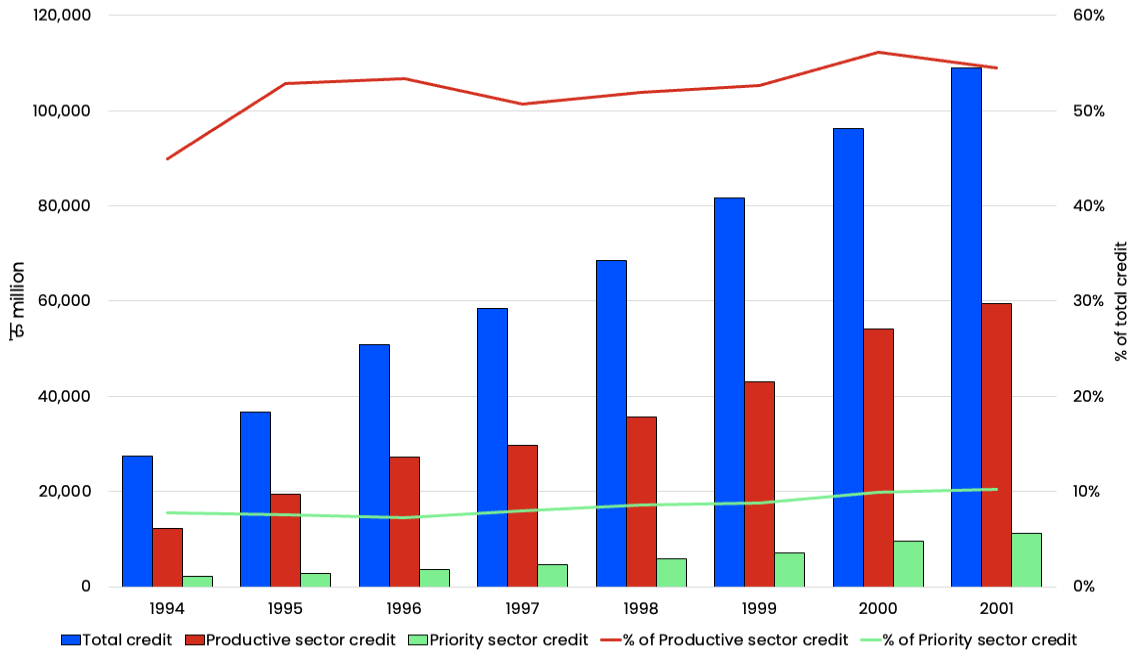
Figure 3.1. Quarterly trends in green finance in Bangladesh



Source: Bangladesh Bank Quarterly Review Reports on Sustainable Finance of Banks and Finance Companies (Bangladesh Bank, 2018–25).

Nepal phased in its green finance targets over more than a decade. The target for agriculture was 10% in 2011–12 and increased to 15% in 2016–17. Under the current target, 15% of lending from most banks, and 20% of that from licensed development banks, must be directed to agriculture and SMEs by mid-2028. In 2023, Nepal introduced a lending target for renewable energy of 10%. Banks that hit the target for agriculture may offset a shortfall in their lending to other priority sectors with lending to their own area of expertise (Budhathoki et al., 2025). As Figure 3.2 shows, this approach to improved, unified targeting has been associated with a positive effect on non-performing loans (ibid).

Figure 3.2. Commercial bank lending to productive sectors in Nepal



Source: Nepal Rastra Bank (2010).

Nepal adopted this phased approach to green finance after previous strategies produced mixed results. As far back as 1990, Nepal mandated that 40% of lending should go to productive sectors, but commercial banks never met that threshold, with even the country's two public–private banks preferring to pay penalties rather than lend to the agricultural sector or provide micro-finance.

In 2023, Nepal Rastra Bank (the country's central bank) introduced a target under which at least 10% of lending would go to renewable energy projects, with a focus on hydropower. The target is coupled with policy incentives such as tax relief, a refinancing facility, interest capitalisation and duty exemptions for renewable energy projects (NBI, 2025). In total, this means that Nepal Rastra Bank will mandate that 40% of lending goes to three priority sectors: agriculture (15%), SMEs (15%) and renewable energy. These requirements are being phased in, and some banks are already meeting the agriculture and renewable energy targets. However, lending to SMEs remains weak (*New Business Age*, 2023).

Under Indonesia's post-pandemic Macroprudential Inclusive Financing Ratio (RPIM), banks have consistently channelled at least 30% of their lending to micro, small and medium-sized enterprises (MSMEs). This is in marked contrast with the rigid 20% MSME lending mandate that preceded it, which banks were often unable to fulfil as it required them to meet the targets only through directed lending. However, while the earlier mandate was flawed, its suspension in 2001 had a significant negative effect on small firms' turnover and impeded their growth more broadly (Auwalin, 2020). Therefore, the evidence suggests that discontinuing a mandate can have real costs and that underperforming targets should be reformed rather than abandoned.

Rigid mandates that are neither phased in nor enforced have consistently underperformed. For instance, the Philippines' Magna Carta policy for MSMEs, which has been in place with various revisions since 1991, has not raised the share of banks' lending to MSMEs as intended. This share was just 16.4% in 2010 (Khor et al., 2015), and non-compliance rose sharply after the micro/small enterprise target was raised from 6% to 8% in 2008. The policy suffered from unclear procedures and introduced no clear consequences for non-compliance, with 20% of banks still missing an interim 10% target by 2017. The country's separate Agri-Agra Law fared similarly: compliance ratios declined consistently between 1975 and 1996 (Medalla and Ravallo, 1997), and agriculture's share of total lending fell from roughly 46% in 2012 to only 10% by mid-2022, before a 2022 reform broadened the definition of eligible agricultural lending and reversed the decline.

Banks in Nigeria consistently missed their lending targets in all relevant sectors under their directed credit policy in the 1980s and 1990s (Babalola and Odoko, 1996). The targets were set for lending to agriculture, solid minerals, manufacturing and export-oriented industries. Commercial banks were reluctant to lend to less profitable sectors, and agricultural lending targets proved particularly ineffective in altering lenders' and borrowers' behaviour (ibid.; Balogun and Otu, 1991), leading to the phase-out of all targets in 1993. In contrast to the policy the Philippines adopted in 1991, Nigeria's more recent approach to lending targets has been to avoid reviving broad sectoral quotas. Introduced in 2021, the Central Bank of Nigeria's (CBN) 100 for 100 Policy for Production and Productivity is a narrower, more targeted instrument that identifies a limited number of high-impact projects for concessional, medium- to long-term financing, resulting in cumulative disbursements of around ₦114 billion across more than 70 projects by the end of 2022 (CBN, 2022). This policy has had some positive effects on agricultural and real sector output, but its impact has been unevenly distributed.

Preferential refinancing and credit guarantees

Directed credit policies have frequently been paired with concessional refinancing or credit guarantees. The evidence suggests that this pairing supports the imposition of a mandatory target.

In the postwar period, Banque de France supported priority lending by rediscounting medium-term credit to public and semi-public institutions such as the Caisse des Dépôts et Consignations and Crédit Foncier, before extending the policy to commercial banks (Monnet, 2018). The Bank of Japan and the central banks of Belgium and Italy later replicated the model, while Germany's Bundesbank extended long-term loans to the Kreditanstalt für Wiederaufbau (KfW) to support the reconstruction of priority and export-oriented sectors. This combination of rediscounting and, in France's case, quantitative credit ceilings on non-priority sectors is credited with expanding credit to targeted sectors within a year of its introduction, while containing inflationary pressure (Kriz, 1951). Postwar credit policy in

France was successful precisely because it did not solely rely on a rigid system of quotas but rather employed a variety of tools, including direct loans, rediscounting, guidelines and other incentives (Monnet, 2018).

Nepal's experience shows that guarantees, not just refinancing, can play a similar role. Since 1974, Nepal Rastra Bank's Deposit Insurance and Credit Guarantee Corporation has provided a 75% credit guarantee to the public–private Nepal Bank and Rastriya Banijya Bank to incentivise priority lending to rural sectors. Combined with the mandatory lending requirements discussed above, this policy is an early example of a guarantee instrument that pairs with a quota rather than relying on the quota alone.

In Korea, the central bank's Intermediated Lending Support Facility offers low-interest loans to banks based on their SME lending performance, albeit without a direct sectoral (or green) mandate. This builds on a longer history in which preferential credit access through nationalised banks, often at subsidised rates, supported Korea's heavy and chemical industries, with the manufacturing sector consistently receiving the largest share of bank loans as a proportion of GDP relative to other industries (Bank of Korea, n.d.).

The People's Bank of China (PBoC) uses the same pairing on a larger scale, combining informal window guidance with a wider toolkit of preferential refinancing instruments: dedicated policy banks the China Development Bank, the Agricultural Development Bank of China, and the Export–Import Bank of China supply concessional funding directly to priority sectors, alongside more targeted relending, rediscounting facilities and differentiated reserve requirements. In 2021, the PBoC launched a targeted long-term relending operation called the Carbon Emission Reduction Facility, which allows banks to lend at a subsidised interest rate for up to 60% of the loan principal for a green project (Larsen and Jackson, 2025).

At times, this guidance has materially shifted both the volume and sectoral composition of bank lending, particularly before market deepening and financial liberalisation began to reduce the PBoC's leverage over credit allocation (Chen et al., 2020). Within this toolkit, the PBoC has paired window guidance with dedicated green rediscounting and relending tools to steer credit towards environmentally sustainable sectors and away from polluting industries. Periods of active green guidance have coincided with a measurable rise in renewable energy investment and a reduction in air pollution (Dikau and Volz, 2023). While these trends reversed after the PBoC phased out green targets in 2014, this is a correlation rather than a causally established effect (ibid.). Importantly, the pass-through of China's 2020–21 lending facilities to commercial-bank lending depended heavily on eligibility rules and banks' balance-sheet incentives, not just the existence of the facility alone (Deng et al., 2023).

Bangladesh's experience provides a useful warning about the limits of refinancing alone. By 2025, Bangladesh Bank's concessional refinancing schemes, a revolving fund established in 2009 and the 2016 Green Transformation Fund (capped at ৳50 billion) had only disbursed around ৳320 million. They have been eclipsed by the separate, government-run Infrastructure Development Company Limited (IDCOL), whose Solar Home Systems programme, which is partly financed in part by a US$416 million World Bank facility, supported the sale of 4.1 million solar home systems and expanded electricity access to around 20 million people. The relative success of IDCOL was largely due to the fact that it is simpler to access and less bureaucratic than the central bank's schemes.

In 2016, the State Bank of Pakistan introduced a dedicated Revised Financing Scheme for Renewable Energy, which is separate from its priority sector mandate. By 2021, cumulative outstanding financing under the scheme had grown by 242%, covering nearly 600 projects. This sits alongside Pakistan's broader National Financial Inclusion Strategy, which is supported by tax relief on interest income from lending to SMEs, low-cost housing finance and farm credit.

As discussed, Nigeria's 100 for 100 Policy follows the same logic, breaking from the outright failure of broad sectoral mandates. Rather than reintroducing an economy-wide target, the CBN now channels concessional, medium- to long-term financing to a limited, periodically identified set of high-impact projects. This narrower instrument is better suited to a limited monitoring capacity than the broad mandate was.

Specifying eligibility criteria

The precision of an eligibility definition shapes credit uptake as much as the size of the underlying target: vague or overly broad definitions slow lending while clear, explicit definitions accelerate it. India's record with the PSL is evidence of this, as the definitions it uses are more precise than vague categories. As set out in Section 2, renewable energy has been a standalone PSL category since 2015, but renewable lending was nonetheless crowded out by banks' existing exposure to conventional power, and the original ₹150 million loan ceiling largely confined eligibility to small-scale, distributed projects (Sarangi, 2018). The 2019 revision's explicit list of eligible project types and higher loan ceiling addressed part of this – and was followed by a marked acceleration in non-conventional energy lending (SBI, 2025). However, the specificity of eligibility criteria and exposure treatment are two distinct elements of policy design, both of which matter.

The importance of precision is also evident elsewhere. The Philippines' Agri-Agra Law saw lending decline for years under a narrower definition of eligible agricultural activity, and only recovered once the definition was broadened to include fisheries and rural development in the 2022 reform. In China, the effectiveness of the PBoC's window guidance has been reinforced by the China Banking Regulatory Commission's use of clear, monitorable metrics of loan-to-deposit ratios, capital adequacy and loan-loss rates. Such metrics give banks an unambiguous basis for compliance, consistent with the idea that eligibility rules shape how far a facility's intended effect results in bank lending (Deng et al., 2023).

The clearest, most directly transferable lesson from these cross-country comparisons is one that India has already partly learned from its own experience: the specificity of what counts as an eligible project matters as much as the size of the underlying target, but it is not sufficient on its own where exposure treatment or loan-size ceilings remain binding. This helps make the case for treating eligibility definitions as a living part of the PSL framework that should be updated with illustrative examples following the emergence of new sub-sectors of renewables (such as storage, green hydrogen and distributed solar) rather than revisiting them only once uptake has already stalled.

Institutional capacity and monitoring

A strong institutional capacity for monitoring and appraisal appears to be a precondition of a DCP that functions well over long periods. The World Bank (1993) identified three characteristics of successful policy-based lending in Japan: reliance on the private sector to select and manage individual projects, close correspondence between national economic plans and directed credit, and respect for the managerial independence of the government financial institutions that manage the flow of funds, with firms selected on economic rather than political criteria. This was paired with effective monitoring that kept loan losses low, along with a disciplined exit: credit was withdrawn once firms gained access to private capital markets and was redirected to new borrowers. Every additional dollar of government-directed credit to Japanese machine-tool firms was associated with more than two dollars of additional fixed-asset investment (Calomiris et al., 1994).

South Korea's programmes relied on similarly strong institutional capacity for project appraisal and monitoring, along with the use of export targets as a metric of success (Westphal, 1990). Selective credit measures had particularly beneficial effects on SMEs in Korea during 1970–81 where this appraisal capacity was in place (Leite and Vaez-Zadeh, 1986). The World Bank (1993) attributes much of the success of directed credit in Japan, Korea, Taiwan and Singapore to strong civil services and professional financial institutions more broadly. At the same time, Bangladesh's early post-independence experience illustrates how state influence be detrimental: political influence over publicly owned banks led to credit being disbursed without proper commercial consideration, contributing to a systemic rise in non-performing loans (Mollik and Bepari, 2009). This was a governance failure rather than a design failure, but it was one with the same practical consequence of undermining the programme's credibility.

China's experience with PBoC window guidance shows a different route to the same underlying requirement: institutional reach and reinforcement rather than a high-quality civil-service alone. The effectiveness of window guidance in China relates to two features of its institutional design (Fukumoto et al., 2010). First, historically, non-bank channels of financial intermediation have remained

underdeveloped in China, meaning that a large share of credit continues to flow through banks directly subjected to PBoC directives. This gives the central bank's guidance a long reach that would be harder to achieve in a more market-based system. Second, China has reinforced its window guidance rather than leaving it to stand alone: the China Banking Regulatory Commission (CBRC) monitors indicators such as loan-to-deposit ratios, capital adequacy ratios and loan-loss rates that align closely with the PBoC's own objectives, so that prudential supervision amplifies the authority of the guidance rather than operating as a separate, potentially conflicting layer of oversight. This model of institutional capacity is distinct from Japan's or Korea's project-level appraisal strength, working through the alignment of two institutions' monitoring functions rather than through the sophistication of either one alone.

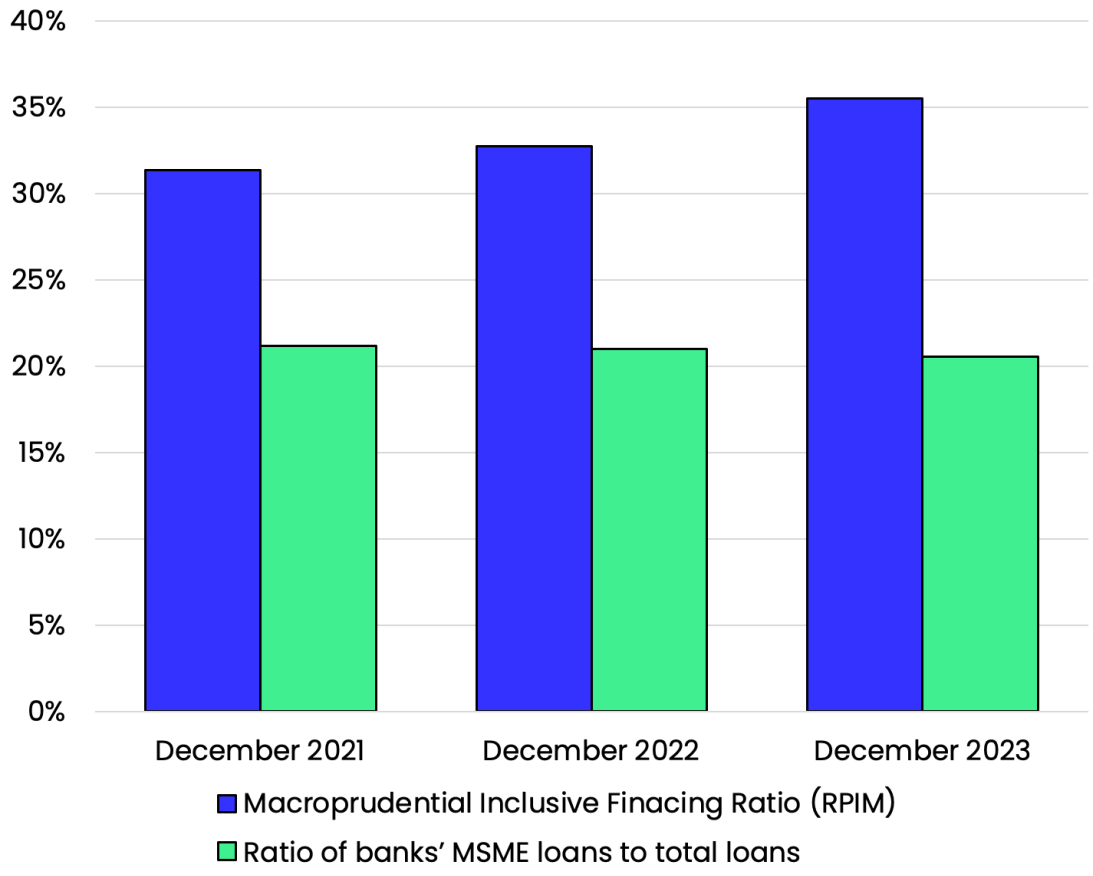
The cross-country evidence suggests that monitoring and appraisal capacity, not just the target itself, can separate a successful DCP from an unsuccessful one. This shows the importance of building dedicated renewable energy monitoring and appraisal capacity within the existing PSL institutions as green lending volumes rise.

Market-based compliance flexibility

It is vital to build market-based flexibility into a mandate. This allows banks to meet an obligation through indirect channels as well as direct lending, which improves compliance without undermining efforts to achieve the overarching target.

India's PSLC mechanism provides an example of market-based flexibility built into a directed credit mandate. The mechanism allows banks to trade the fulfilment of their PSL obligation via the RBI's e-Kuber platform without transferring the underlying loan asset or its credit risk.

Figure 3.3. Macroprudential Inclusive Financing Ratio to actual lending



Source: IMF (2025).

Indonesia's RPIM extends this logic and is a more flexible, system-wide tool. The RPIM requires banks to provide financing to MSMEs and other underserved groups in a manner that avoids financial instability. Its structure allows banks to meet the requirements through multiple channels, including not only direct lending but also lending via other entities and the purchase of eligible securities. The International Monetary Fund (IMF, 2025) describes the RPIM as a system-wide policy tool because it operates more like a structural ratio than a bank-specific mandate, acknowledging that not all banks have the expertise to lend directly to all targeted sectors. Banks can meet the RPIM's requirements by purchasing securities issued by firms in priority sectors, while banks that lend directly can issue green or inclusive bonds for other banks to acquire. As discussed, since the adoption of the RPIM, banks in Indonesia have consistently met or exceeded the 30% inclusive financing target (see Figure 3.3). Therefore, the broad flexibility of the instrument and its system-level design appear to have strengthened compliance across the financial sector.

India's PSLC mechanism could be extended in the same direction as Indonesia's model, allowing banks to comply with PSL renewable energy requirements partly through the purchase of green bonds or securities issued by renewable energy developers. This could be particularly relevant for larger Indian banks and foreign banks, which tend to be the most risk-averse in priority sector lending generally, and which may lack the origination capacity to lend directly to renewable energy projects at scale (Kohli, 1997).

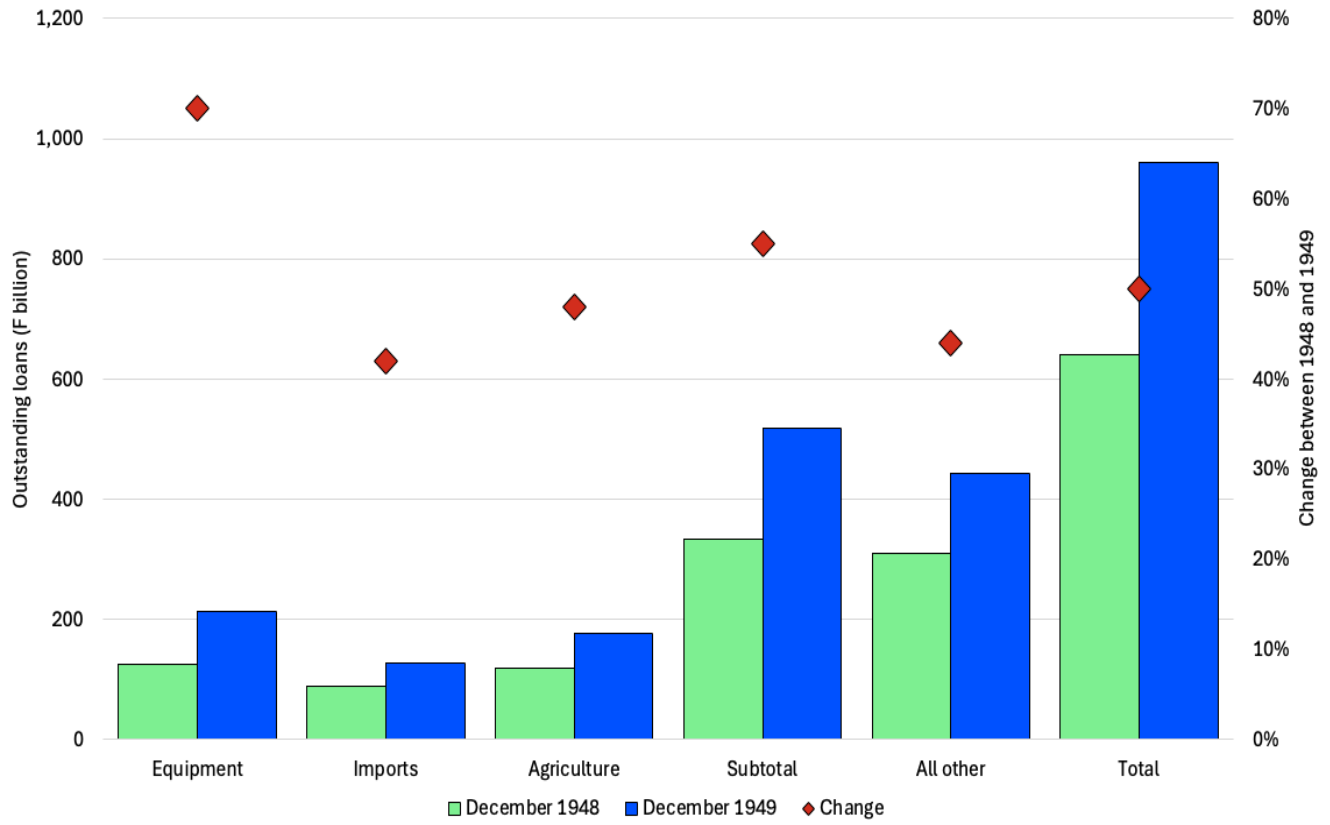
Structural preconditions and risks

Directed credit does not work equally well in every financial system. Postwar credit controls in France, Italy and Belgium were effective because those systems were largely bank-based and segmented, with fewer substitutes for state-directed bank lending (Monnet, 2018). Banque de France first placed *encadrement du crédit* (quantitative credit ceilings) on commercial banks in 1947 to tackle money and commodity hoarding but, a year later, created a channel in which these restrictions were relaxed to allow for credit expansion to priority sectors of the economy, namely the re-equipment of industry, the financing of wheat crops and the promotion of exports. The policy was largely successful in increasing credit allocation to these sectors in the year after it was introduced, resulting in progress in industrial agricultural production and exports (Kriz, 1951; see Figure 3.4). DCPs were an important part of the nationalisation of monetary policy that took place after the Second World War to reestablish France's growth potential, resulting in the 'Trente Glorieuses', a 30-year period of high growth and stable financial conditions (Monnet, 2018). While some loans were extended directly from the Finance Ministry or state development banks, the Government also provided guidelines to specialised credit institutions with sector-specific expertise on lending to priority sectors. Further credit was channelled via commercial banks by creating incentives through a rediscounting window for loans to specific sectors rather than through a rigid system of quotas. The system only began to fall apart in the 1970s and 1980s when inflation rose and banks learned to circumvent credit ceilings using substitutes through, for instance, subsidiary structures and off-balance-sheet lending.

Contemporary economists noticed that credit controls in postwar Europe worked well only in a system that was mostly bank-based and that included few substitutes for state-led financial intermediation (Monnet, 2018). An oligopolistic banking system is better adapted to the implementation of quantitative credit controls than a unit banking system such as that in the US, where compliance with general rules was more difficult to verify (Fousek, 1957), or the UK, where non-bank private financial institutions and the stock market could easily replace bank loans. The role of large state-led non-bank financial institutions and the limited role of the stock market are also viewed as key features of the implementation of credit policy. As economist Eric Monnet argues, it is:

> straightforward that in an economy where a unique price clears financial markets and where there is always a substitute for a type of financial asset, it is almost impossible to intervene in the allocation of credit. Without segmentation of financial markets, it is impossible to control credit in one sector only, to isolate domestic assets from foreign assets or to disconnect quantities from prices (Monnet, 2018: 247–82).

Figure 3.4. Composition of bank credit in France, 1948–49



Source: Kriz (1951).

Japan's experience shows a parallel dynamic in a different instrument: financial liberalisation in the 1980s, including the expansion of non-bank financial channels and capital mobility, undermined the Bank of Japan's ability to control credit through window guidance, as banks gained access to funding and lending opportunities outside the central bank's influence (Fukumoto et al., 2010). This is the same segmentation logic that Monnet identifies, observed independently in another financial system (ibid.).

Other countries' experiences also carry other lessons about the risks of directed credit that lacks adequate monitoring. Japan's COVID-era emergency lending and guarantee facilities prevented widespread credit freezes but have been associated with 'zombie lending' risks, where financial institutions continue to issue or extend loans to insolvent businesses, and may not address the deeper structural issues facing some SMEs (Hoshi et al., 2022). In Latin America, politically directed credit has often failed to drive growth and has instead led to an inefficient use of public resources that disproportionately benefited larger or wealthier borrowers rather than the small or low-income groups it targeted. This effect can be seen the use of subsidised farm credit in countries such as Nicaragua (McKinnon, 1991), Costa Rica (Vogel, 1984) and Colombia (Tybout, 1983).

India's financial system remains largely bank-based, with public banks extending a high share of all credit. The Indian financial system is also less securitised than the US or UK systems, where credit direction has historically struggled. This structural condition favours continued use of the PSL as a policy lever for climate finance. Nonetheless, the experiences of Japan and France are a reminder that this precondition is not permanent: as India's financial markets deepen and its non-bank credit channels grow, the same type of erosion could eventually occur.

4. Policy implications

This section sets out recommendations for how the PSL framework could evolve to better support the low-carbon transition. We argue for a dedicated, phased renewable energy sub-target within the existing mandate, while cautioning that its marginal impact should be assessed alongside public banks' separate state-ownership commitments to the energy transition. We recommend adopting sharper project eligibility criteria that are informed by India's emerging climate finance taxonomy, along with stronger mechanisms for coordinating the PSL with national climate and industrial strategy. India should also consider using complementary tools beyond the mandate to reach smaller borrowers and adapt to a more sophisticated financial system, including credit ceilings, green rediscounting, and support for specialised institutions such as NABARD. Finally, we recommend extending compliance flexibility to green bonds and securities, while strengthening the links between institutional monitoring and performance to safeguard asset quality as green lending rises.

Target design

The RBI should continue to develop DCPs in line with the requirements of the economy, including the need for climate action. For over 50 years, the RBI has monitored and adjusted the PSL framework to accommodate the emergence of new national priorities, such as strengthened guidelines on the renewable energy target following India's announcement of its net zero commitments in 2021. As the low-carbon and climate-resilient transition becomes an increasingly important part of the policy agenda in developing economies, there will be a growing need for further adjustments to and expansion of DCPs to support climate action. In this, the Government could promote lending to climate projects through a dedicated, phased renewable energy sub-target of the existing mandate, which states that commercial banks must allocate 40% of either ANBC or CEOBSE to priority sectors.

Recently, public sector banks in India have proposed setting this target at 2% (*Business Standard*, 2026), along with an increase in the loan limit from ₹350 million to ₹1 billion to enable lending to utility-scale renewable energy projects, such as street lighting systems and the electrification of remote villages (SBI, 2026). Nepal's and Bangladesh's phased-in green and renewable sub-targets sustained compliance and, in the case of Nepal, were also associated with an improvement in loan quality. By contrast, renewables' position within the broad PSL energy category contributed to the post-2015 dilution problem, where credit flowed to both non-renewable and renewable sectors, with the former often receiving a larger share (Sarangi, 2018). Classifying utility-scale renewable energy as a priority sector would also help larger domestic banks and foreign banks meet mandatory lending targets that would otherwise prove challenging.

This recommendation should be weighed against the fact that India's largest lenders to renewable energy are predominantly public sector banks. Some of these banks operate under separate government ownership commitments to support the energy transition that, in practice, may be more binding than the PSL requirement. Where this is the case, the PSL's marginal contribution to utility-scale renewable lending may be smaller than the headline recommendation implies. Therefore, establishing how much of any observed increase reflected the PSL specifically, as opposed to these other state-ownership commitments, would require further research beyond the scope of our analysis.

Defining eligibility and linking the PSL to India's climate strategy

While credit policy has often been part of a broader industrial strategy in Asian economies, India's PSL lacks the detailed and specific project selection that ought to accompany credit programmes,

especially where industrial credit is involved. Lenders tend to rely on general policy guidelines to select projects. The RBI has already provided an interim list of eligible green activities and projects in its 2023 green deposit framework and its 2025 directions on climate finance and the management of climate change risk (RBI, 2025c). The climate finance taxonomy currently under development will help establish these definitions and enable a clearer assessment of how much the PSL is supporting climate mitigation or adaptation activities in other sectors.

Institutional mechanisms that support coordination between the government, banks and industry could also be helpful, as Japan's experience demonstrates. Close correspondence between national economic plans and directed credit was a precondition of Japan's disciplined-exit model and low loan losses. Comparable coordination mechanisms in India could help ensure that renewable energy lending under the PSL remains aligned with national climate and industrial strategy as they both evolve.

Expanding complementary instruments

India could consider credit ceilings for non-priority sectors as an instrument for combating inflationary periods and for diverting credit to low-carbon and climate-resilient sectors. Enabling credit to flow to sectors such as renewable energy and resilient agriculture could help build long-term resilience against the impacts of climate change and the low-carbon transition, such as volatile fossil-fuel or food prices. This would mirror Banque de France's use of credit ceilings and rediscount policy in the postwar period, and could be justified by the traditional goals of monetary policy, including the RBI's mandate to safeguard price stability.

As financial markets in developing economies become increasingly sophisticated, it may be necessary for their central banks to abandon DCPs in favour of more targeted measures. The experiences of countries in Europe, North America and East Asia suggest that credit policies may only be effective in oligopolistic banking systems, where general rules are more easily verified (Monnet, 2018). In developing economies, the growing role of non-bank financial institutions and the stock market may gradually erode credit policies' effectiveness in supporting priority sectors, including renewable energy. This may require more targeted measures to support further credit growth in low-carbon or climate-resilient sectors, such as green rediscounting or relending tools. As in postwar France, rediscounting could be phased in via state-owned banks or All India Financial Institutions and combined with detailed guidance (Monnet, 2018).

Specialised public or private credit institutions may be the most effective vehicles for improving access to credit for small-scale renewable energy projects and MSMEs that need to invest in climate-resilience measures. Green entrepreneurs, smallholder farmers, MSMEs and other marginalised groups in hard-to-reach sectors of developing economies have often struggled to access credit, despite the presence of mandatory credit floors. They may be best served by unbureaucratic fiscal subsidies or support from specialised financial institutions such as rural development banks, including India's NABARD. These measures could, in turn, be accompanied by green rediscounting or relending tools. Some countries have also benefited from coupling mandatory lending targets with fiscal incentives, such as tax reliefs on interest income from lending to marginalised sectors.

More generally, incentives to encourage uptake could complement the expansion of the PSL to renewable energy and other low-carbon or climate-resilient activities aligned with India's evolving climate finance taxonomy. For example, as in the case of Bangladesh, subsidised refinancing facilities provided by specialised financial institutions (such as NABARD, SIDBI and the National Bank for Financing Infrastructure and Development) could encourage banks to meet PSL targets, especially for activities and technologies that are still in the process of proving their commercial viability. This may be particularly relevant to nascent low-carbon technologies (including transition finance), adaptation and resilience measures (including infrastructure) and green lending to SMEs.

Compliance flexibility

Banks should continue to have the flexibility to meet mandatory lending requirements via multiple channels. India has had positive experiences with PSL certificates that can be openly traded between

banking institutions that fail to meet broad or sector-specific lending targets because they lacked relevant experience of lending to priority sectors. Indonesia's RPIM provides an example of how flexibility can be part of a system-wide policy tool – especially in relatively sophisticated financial markets, where banks can acquire green securities or bonds to fulfil mandatory ratios without threatening financial stability.

Building on this, India could extend PSLC-style flexibility to allow banks to comply with renewable energy requirements partly through the purchase of green bonds or securities issued by renewable energy developers, alongside direct lending and certificate trading between banks. However, domestic corporate and green bond markets would need to be deep and liquid enough to support this, and banks would require a broad enough investor base to purchase renewable energy securities at the scale demanded by the compliance mechanism. Indonesia's RPIM operated in a financial system that is closer than India's to meeting these conditions. In the Indian case, the evidence is mixed: while the country has seen an increase in corporate and sovereign green bond issuances in recent times, other issuances (especially sovereign issuances) have lacked sufficient subscriptions and have had to be delayed or cancelled.

Institutional capacity and accountability

The RBI could link performance to PSL targets. One weakness of India's current approach has been the absence of linkages between economic performance and credit allocation. While aggregate credit flows to priority sectors have risen, it is unclear how this has affected the economic performance of these sectors. India should ensure that continued flows of directed credit are contingent upon the economic performance of beneficiary firms, with banks free to threaten to deny access to credit when loanees fail to meet performance targets (Kohli, 1997).

This points to a broader need to build dedicated monitoring and appraisal capacity for green lending within the RBI, NABARD, SIDBI and related institutions, ahead of further increases in such lending. Institutional monitoring capacity is a precondition for, rather than a byproduct of, successful DCPs – as seen in Japan and Korea, and in a different form in China's alignment between PBoC guidance and CBRC prudential supervision.

Strengthening accountability in banks' approach to PSL climate objectives also raises the question of which institutions should be responsible for oversight. Parliament could play a role in periodic scrutiny of aggregate PSL performance and its climate-relevant sub-targets through the appropriate standing committees, as it has in the past for the PSL framework more broadly. However, the RBI may be better suited to handling technical matters such as setting detailed targets and eligibility criteria, with its decisions informed by banks and All India Financial Institutions. State governments, meanwhile, already have an institutional channel for doing so through the State Level Bankers' Committees, which coordinate the PSL's district-level implementation via the Lead Bank Scheme. Extending their remit to include monitoring of state-level renewable energy lending performance (alongside the technical oversight exercised by the RBI, NABARD and SIDBI) would connect climate-specific accountability to a layer of the PSL's governance structure that already has a regional foothold, obviating the need for an entirely new institution.

Finally, India should monitor asset quality in the renewable energy sector as it receives a growing amount of PSL lending. Nigeria's and Latin America's failed or captured lending mandates, and the risk of zombie lending associated with Japan's COVID-era emergency facilities, are a reminder that an expansion of lending without adequate monitoring can quietly damage loan quality or channel credit towards better-connected borrowers rather than the intended target group. Pairing any expansion of the renewable energy sub-target with such monitoring would guard against this risk.

5. Conclusion

India does not need to fundamentally reimagine priority sector lending to serve its climate objectives. Instead, it should refine this process in the areas that have already been tested elsewhere in the world. As our analysis sets out, while India's financial system may currently be suited to a mandate-based approach, the country needs to create the instruments and institutional capacity that will ensure such lending supports climate finance in the long term.

Directed credit programmes have proved to be a durable, if contested, tool of economic policy for over half a century. India's Priority Sector Lending framework is among the clearest examples of how such a tool can be continuously adapted rather than retired. We have shown that while the PSL's extension to renewable energy was an early innovation among central banks, it has only been partially successful so far. This is due to a mismatch between the scale of eligible projects and India's investment in renewable energy, compounded by the fact that banks' exposure to fossil-fuel power limits their room to lend into the new mandate.

This is not a uniquely Indian problem, nor is its solution likely to be found in India's experience alone. The cross-country evidence we draw on in our analysis shows that common underlying questions about the design of lending mandates persist across very different financial systems and stages of development. Many of the same issues arise everywhere from postwar France's pairing of credit ceilings with rediscounting to Japan's and Korea's disciplined, monitored approach to project-level lending, to China's alignment of central bank guidance with prudential supervision, to Bangladesh's and Indonesia's more recent experiments with phased, flexible green mandates. Where directed credit has worked in the long term, it has rarely done so through the mandate alone: success has been determined by the combination of a credible, well-defined target with complementary refinancing or guarantees, institutional capacity to monitor and enforce this target, and flexibility in compliance. Where directed credit has failed, the common thread has been the absence of one or more of these complementary factors rather than the presence of a mandate, as was the case with Nigeria's and the Philippines' unenforced quotas, Latin America's failed or captured subsidies, and Bangladesh's early experiences.

For India, this suggests that PSL does not need to be fundamentally reimagined to serve its climate objectives but should be refined in the areas that other countries have already tested. India would not need to depart from the PSL's existing architecture to introduce a dedicated and phased renewable energy sub-target, utility-scale eligibility, closer alignment between the PSL's monitoring and the national climate taxonomy, complementary refinancing or credit guarantees, extended market-based flexibility, or stronger performance linkages. These measures would be extensions of instruments that the RBI has already used successfully elsewhere in the framework, such as PSLCs and sectoral sub-targets.

India's financial system may be structurally suited to a mandate-based approach today, but the experiences of Japan, France and, increasingly, China show that this is not permanent: as non-bank financial channels and capital markets deepen, the leverage that a quantity mandate provides will gradually erode, and more targeted instruments such as green rediscounting, refinancing facilities and credit guarantees will need to take on a larger share of the work. Therefore, the task for the RBI and central banks in other emerging markets is not simply to strengthen PSL as it exists today, but to begin building the complementary instruments and institutional capacity that will allow directed credit to remain an effective lever of climate finance as their financial systems evolve.

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