SPEECH

RURAL BANKING AT THE CROSS ROADS*

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"He who learns nothing from the past will be punished by the future" - Zarathushtra

Introduction

I am indeed privileged to have the distinction of delivering the First Special Lecture under the Syndicate Bank Chair on Rural Banking at the Mangalore University. The Syndicate Bank was the pioneer when commercial banks first entered into the area of rural credit and it is only befitting that the Syndicate Bank has instituted this Chair at Mangalore University.

2. Forty years ago, the Committee of Direction of the All India Rural Credit Survey presented its monumental Report. The Report was soon acclaimed as the *locus classicus* on the subject and as India quickly emerged in the *avant garde* of innovation in the area of rural credit, our achievements were sought to be emulated by other countries. While during the past 40 years we have achieved a lot in the area of rural credit we would be less than truthful if we were not to admit that the rural credit system in India today is in disarray and that we have yet to implement a cohesive policy package to restore the efficacy of the rural credit delivery system. Lest this initial statement be misconstrued as being iconoclastic let me hasten to add that we in India have, in the area of rural banking, taken rapid strides in the development of a rural banking system. The nationalisation of the Imperial Bank in 1955, the nationalisation of the 14 major commercial banks in 1969 (followed by the nationalisation of a further 6 commercial banks in 1980), the setting up of Regional Rural Banks (RRBs), all enabled an infrastructure to be developed which could meet the desired objectives. It is significant that of the total number of branches of scheduled commercial banks, over 57 per cent are now in the rural areas albeit accounting for only 14-15 per cent of aggregate deposits and credit.

Directed Credit

3. Over the years, direction of credit has become a strong instrument of policy. It was recognised that certain sectors which account for a sizeable part of output were given the go by as the major credit institutions viz., the commercial banks, did not give adequate attention to those sectors. The priority sector accounts for a major part of national output and yet in 1969 only 14 per cent of bank credit of commercial banks was channelled to these sectors. It was recognised that unless credit flows were more even, these sectors would not be able to keep up the momentum of growth. It is in this context that the 40 per cent priority sector target including a sub-target of 18 per cent for agriculture was introduced. While the objectives for direction of priority sector credit are well understood we need to carefully analyse what were the major problem areas in the flow of credit. Somewhere along the line priority sector lending was erroneously considered synonymous with behest lending. Rural credit was erroneously associated, not without reason, with poor recovery and high costs of servicing which made rural credit unprofitable for banks. While commercial banks were, to some extent, able to cross-subsidise their rural credit operations with other operations, institutions like the co-operatives and the RRBs had no other recourse and ended up with large losses; these institutions made the paradoxical yet rational choice of minimising their involvement in their central areas of responsibilities viz., rural credit.

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4. Since two-thirds of the country's population lives in the rural areas and nearly three-fourths of those below the poverty line live in the rural areas, it hardly needs to be stressed that the present impasse on rural credit needs to be quickly resolved. While I would like to return to the issue of the credit delivery system and the poverty alleviation programmes, it is necessary to stress that there is an imperative need to clearly distinguish between rural credit *per se* and specific poverty alleviation programmes.

The Problem of Rural Credit

5. The problem of rural credit in India has been analysed by a very large number of outstanding economists. It is surprising and rather sad that despite the best analysis of the problems and the sound advice tendered over the years the problems instead of being resolved, appear to be compounded. Thus, problem identification and policy prescription is not the critical area; what is crucial is the difficulties in policy implementation. It would be futile on my part to set out to this audience the basic multi-agency approach or the non-viability of institutional structures. Before discussing the implementation of specific policies it would be desirable to first set out a few select issues on which the conceptual cobwebs need to be cleared.

6. It is admittedly true that the mass of persons below the poverty line are in the rural areas. But this does not mean that all activity in the rural areas needs to be treated on par. A major area of difficulty has been the lack of clear delineation between activities which are commercially viable and activities which need to be provided subventions because the agents are below the poverty line. Again, undue importance has been given to the rural banking system in that it has erroneously been given the role of a total agent of development rather than a more specific yet vital role of a purveyor of credit. Moreover, with increasing evidence of a need to revamp the rural banking structure, the lack of a quick resolution as to the direction of change is creating undue anxiety and a freezing of normal credit initiatives by various segments of the rural banking structure. Studies on various aspects of rural credit are more extensive than in any other area and what is called for is implementation of a series of well sequenced reforms. Many of these reforms do generate some anxiety in that they require a clear departure from the norms which have been enshrined into our psyche and hence, change is easier said than done. With these provisos I now propose to turn to a few select policy issues on which we need to undertake hard policy decisions.

Interest Rate Policy

7. If rural financing institutions are to be self-sustaining, they must ensure that there is a reasonable spread between the cost of raising funds and the return on deployment of funds. Although it has all along been recognised that interest rates in the informal sector are way above those in the organised sector, there has been a proclivity to dampen lending rates in the organised sector. Initially, when sector – specific interest rates were prescribed, the rates for agricultural credit were kept low; again, when prescription of sector – specific lending rates was given up and the size of the loan was made the only criteria, lending rates for agriculture were low as large farmers who took loans of less than Rs. 2 lakh were provided substantial concessions. The lending rates were kept low ostensibly to ensure viability of operations of borrowers and it was felt that interest rate cross-subsidisation would ensure viability of the institutions. While commercial banks were able to cross-subsidise themselves to some extent, the co-operative banks and the RRBs had no such option and hence found the interest rate structure totally unviable. It is unbelievable that the co-operatives and the RRBs, which had operations essentially in rural areas, were expected at one time to undertake the bulk of their lending at 10 per cent while the maximum deposit rate was fixed at 13 per cent. No Indian rope trick will enable a bank to be viable if the administered interest rate structure is fixed in such a manner. The

institutions connected with rural lending sought a rational policy option in such a situation by minimising their involvement in rural lending. The upshot of this was that the operations of the RRBs and co-operatives came to a grinding halt and institutions which remained dedicated to their principal mandate of lending to the rural sector incurred huge losses. It is fortunate that since then the rate of 10 per cent on lending has been raised to 12.0 per cent while the deposit rate of 13 per cent has been reduced to 10 per cent; nonetheless even the present margins are insufficient to enable the rural financing institutions to be viable.

8. It is paradoxical that there is an aversion for higher interest rates in the organised rural credit structure while the alternative of borrowing from the informal market at phenomenally high rates does not invoke similar concerns.

9. If we do not learn the lessons of the past, we will have to pay a heavy price in the future. The time has come to consider a fundamental restructuring of interest rates as they are applicable to rural financing. The experience in a number of countries has shown that a repeal of interest rate ceilings on lending has not adversely affected the viability of the activities financed. On the contrary, such policies have resulted in a greater flow of credit for rural financing as the improved viability of the rural finance institutions would itself bring about a larger flow of resources to the rural sector. In this context, it would be highly desirable to totally deregulate the lending and deposit rates for the co-operative banks as well as the RRBs. These institutions would then be able to attract more deposits and the lending rates could then be related to the cost of raising funds. Keeping down interest rates on rural financing merely discourages the flow of resources to the rural sector. As has been stressed, time and again, what is important is the timeliness and adequacy of credit and not the cost of credit. Unfortunately, the misadventure of artificially low administered interest rates has virtually destroyed the fabric of rural financing. The time for esoteric debate is over and an early deregulation of lending and deposit rates for rural financing is necessary. Accordingly, the co-operative banks and RRBs should be given the freedom to decide their own interest rates. While providing this freedom, the banks should be required to ensure that the spreads between the deposit and lending rates are adequate to provide for their operating costs. It is not suggested that these banks should be allowed to sustain unduly large and inefficient spreads. In fact, in a competitive system, any bank would not be able to sustain unduly large spreads as activity would move away from that bank. While the interest rates of the primary agricultural credit societies' (PACS) are not prescribed by the RBI/NABARD, the Registrars insist on the PACS following the present rate structure prescribed by the RBI/NABARD; thus, in any meaningful deregulation of interest rates it is essential that the Registrars should no longer prescribe interest rates for the PACS.

Viable Lending and Poverty Alleviation Programmes

10. There are rapid changes taking place in the rural economy and there will, inevitably, be a move away from the traditional food and non-food crops to newer activities and some of these newer activities would be substantially more credit-intensive than traditional activities. Again, there is bound to be an increasing element of non-agricultural activity in the rural areas and this gets articulated in the plea that agriculture should be treated as an industry. A trend towards large projects in the rural areas is emerging and the rural financing agencies should not hesitate to finance these operations on strictly commercial terms. Again, banks need to be encouraged to finance such activities in the rural sector as are capable of generating a surplus; this would generate a greater element of stability in the operations of the rural financing agencies.

11. Lest, this be viewed as a recommendation that weaker sections be abandoned, let me hasten

to state that I am by no means advocating that the weakest segments of society should be shut out from the formal sector. What needs to be stressed is that it is necessary to very carefully delineate viable from unviable lending operations. To the extent it is recognised that because of dire poverty conditions, lending to certain segments is totally non-viable, such segments should not be financed by the banking system as poor recovery and defaults would be inevitable; moreover, such a milieu is extremely contagious as even viable borrowers could become chronic defaulters.

12. If a borrower is, *ab initio*, not viable, it would be imprudent to use the rural credit delivery system to provide subventions. It would be better that the indigent poor are directly financed through the subsidy route rather than part commercial finance and part subsidy from the State. Lest this be construed as advocating an unrealistic policy let me illustrate the point. Illustratively, if Rs. 1,000 crore of outright subsidy is to be blended with Rs. 4,000 crore of commercial lending to a certain target group, it would be better to segregate the relatively better-off segments from the genuinely indigent poor. Thus, from the target group the Government subsidy should be available only to say one-fifth of those who are being currently subsidised. In that way, the subsidy would cover the entire credit requirement of the indigent poor and would weed out from the subsidy beneficiaries the elements who only masquerade as indigent poor. To recapitulate, the stronger and viable borrowers could be provided bank credit on commercial terms and the really indigent poor should be provided outright grants through the poverty alleviation programmes. One must recognise that merely because the indigent poor are poor does not mean that they prefer a dole. Hence, programmes like Food for Work and properly supervised input subsidies are perhaps better than broad based indirect subsidies through the banking system. It is here that the Non-Governmental Organisations (NGOs) and Self-Help Groups (SHGs) have a significant role to play. These organisations can help the transition of the indigent poor from the outright subsidy stage to the stage where they become viable commercial borrowers from the banking system. Thus, the NGOs and SHGs should not spread their manpower resources too thinly and should concentrate at any point of time only on those making the transition. NGOs and SHGs should, however, retain their areas of strength and should not be required to become on-lending agencies. Again, improving what Katar Singh calls the 'Common Pool Resources' can provide substantial support to the beneficiaries of Government programmes. Improving the general infrastructure in the rural areas would greatly assist in the upliftment of the poor.

13. To explain this theme I would seek your indulgence to narrate an interesting debate that the late Professor D. T. Lakdawala had with decision makers in the Government many years ago. Professor Lakdawala was dwelling on the fact that granting of consumption loans to the indigent poor would only generate defaults as they did not have sufficient income generation capacity. In response to an emotionally charged attack that such a policy was insensitive to the needs of the poor, Professor Lakdawala replied in a soft voice that he did not question the need to provide succour to the indigent poor. In his view the decision to give a bank loan was a wrong one as the situation warranted a grant. Thus, grants should be restricted to Government programmes while banks should undertake only viable lending.

Structure of Rural Financing

14. The present structure of rural financing agencies is rendered excessively complex and inefficient by counter-productive transfer of funds. In the co-operative segment, the tiering of funds through the Reserve Bank - NABARD - State Co-operative Banks - District Co-operative Banks and PACS, who are the final lenders, is fraught with difficulties as the tiering merely adds to costs and the higher level agencies protect themselves through the inter-tier lending

while the PACS become the ultimate agency with a direct interface with the borrower. In such a situation, it is only to be expected that PACS have become dependent on outside resources for nearly 70 per cent of their lending. The freeing of the PACS interest rates would enable PACS to reduce their reliance on outside resources and if the operations of the PACS are to be viable they would need to increase their scale of operations to an optimal size. Although it may appear difficult at the grass roots level, closure of unviable PACS is an ineluctable necessity. With the rapid changes in the structure of output of agriculture and allied activities and changes in the scale of output it would be necessary for the higher level agencies to increasingly undertake direct lending and refinance to the lower tiers should progressively be reduced.

15. Again, the RRBs restructuring has been debated at length without a resolution of the problems of this sector. All the alternatives, viz., merger with the sponsor bank (Khusro Committee), merger into rural subsidiaries of commercial banks (Narasimham Committee) and the merger of all RRBs into a nation-wide National Rural Bank, have serious drawbacks. The first two alternatives are not acceptable as it is felt that the distinctive feature of RRBs would disappear while the third alternative would merely accentuate all the weaknesses of the RRBs into one weak giant. It is fervently hoped that the latest initiative of revamping of the balance sheets of 49 of the 196 RRBs by providing financial assistance and managerial strengthening, would arrest the deterioration and provide the mainsprings of a revival of rural credit flows.

Loan Recovery

16. The question of a satisfactory credit delivery system is intertwined with the loan recovery process. The experience both in India and in other countries, where voluntary agencies have provided yeoman service, shows that where these agencies have been able to provide assistance to borrowers, disbursements are much faster and by timely disbursements it is possible to also ensure effective loan recoveries. Satisfactory loan recovery is a basic pre-requisite for the smooth flow of credit and a milieu needs to be developed where defaulters are ostracised by society. There are many unorthodox ways in which it is possible to ensure improved productivity of credit such as profit sharing by the employees of the rural financing institutions and social cohesiveness in rural lending with peer group pressure to bring about a total aversion to loan defaults. Voluntary agencies and other innovative techniques which work in one setting do not necessarily work in another and attempts at replication without meeting essential precondition can seriously hamper the success of programmes and schemes which have been otherwise successful under certain conditions. While collateralisation of loans is considered necessary for the safety of the rural credit institutions, strict collateral requirements would imply that the poorer segments are unable to access the organised financial system. The agricultural borrowers are, relative to other borrowers, asset rich and income poor and it is in this context that it is necessary to develop programmes to raise income levels before channelling borrowers to the banking system.

The Role of NABARD

17. The NABARD has been principally a refinancing agency. With the restructuring of the rural credit system and the emergence of large credit-intensive agricultural and allied activities and the inexorable resources crunch which NABARD is facing, it is imperative that NABARD expeditiously undertakes a major restructuring of its own operations. It is being increasingly recognised that created money has deleterious effects and hence NABARD should plan its activities on the basis that large resources would not continue to flow from the Reserve Bank to NABARD. The NABARD is now a teenager and it can no longer afford to wear its swaddling clothes. It must, therefore, revamp its activities to drastically reduce its reliance on

created money. The belief that created money can contribute to output is a charade; it can only contribute to inflation. Thus, NABARD should progressively raise the bulk of its resources from the market and the bulk of its lending should be at market related interest rates. Subsidised lending by NABARD would necessarily have to become a relatively smaller segment of its total lending. It would, no doubt, be unfair to expect NABARD to adjust to the overall financial sector reform without granting it greater flexibility to reduce the areas where it is required to provide subventions. Illustratively; it is not reasonable to expect NABARD to continue to provide refinance to a commercial banking system which, at the present time, is afflicted by excess liquidity. Withdrawal of refinance to the commercial banks would not significantly affect the lending programmes of commercial banks while it could substantially reduce the resources crunch of NABARD. The NABARD should also be able to progressively reduce its large refinance operations to the State Co-operative Banks who, in turn, have large surplus resources parked with scheduled commercial banks via money market operations. A rationalisation of counter-productive inter-institutional credit flows would greatly help NABARD to prepare itself for the emerging milieu.

Concluding Observations

18. Issues relating to rural credit are indeed complex and any short presentation of these issues is bound to appear unsatisfactory. While I have raised certain issues, these are merely illustrative rather than exhaustive and moreover there are a number of issues of importance which are not covered in this presentation.

19. When one is a little lost one hankers for one's roots. So let me go back to the beginning of our efforts to design a viable rural credit delivery system. An unequivocally emotional clarion call was articulated many years ago:

"No aim of the State in India can be so great as the abolition of poverty. ... Rural Credit. ... in extent is as wide as rural society which means practically as wide as the Indian nation. In content it embraces all economic activities ... credit is only a layer of such activities ... In India the process of increasing and more equitably distributing the economic good must ... be conceived in terms of rural India. What India most needs today is a comprehensive and determined programme of rural regeneration ... with especial compassion for the weak and the disadvantaged."

I am sure that many of you would know that I am quoting from the peroration in the 1954 Report of the Committee of Direction of the All India Rural Credit Survey. While one may be bemused at the surcharged language of the Committee of Direction, the Committee had its heart in the right place and many of the problems of rural credit analysed by the Committee still remain central issues today.

20. Before I conclude, let me recapitulate 'Ten Commandments of Rural Credit'.

(i) For a viable structure of rural financing, interest rates should be deregulated and the various lending agencies should be allowed to freely determine their own deposit/lending rates.

(ii) There must be a clear demarcation between viable lending and poverty alleviation programmes and the system of subventions should be limited to a very small segment.

(iii) NGOs and SHGs should concentrate their efforts to help the indigent poor through the transition from grants to accessing credit on commercial terms and as such the efforts of these agencies should at any point of time be limited to a small segment; moreover, these agencies should not become on- lending agencies.

(iv) The tiering of the flow of funds from the higher to the lower level agencies and the return flow of placement of funds from the lower to the higher tiers is counter-productive and should be sizeably reduced.

(v) PACS should reduce their dependence on outside funds and PACS must be required to attain an optimal level of financing under a time-bound programme.

(vi) Restructuring of the RRBs needs to be expedited and selective closure of some of the totally unviable RRBs is unavoidable.

(vii) A milieu needs to be developed where loan defaulters are ostracised by society.

(viii) NABARD will have to restructure its operations to drastically reduce its reliance on created money and hence it should raise bulk of its resources from the market. Subsidised credit should become a smaller segment of NABARD's operations; withdrawal of NABARD's refinance to commercial banks would be apposite in the current context of excess liquidity in the commercial banking system.

(ix) Reducing counter-productive inter-institutional flows would be beneficial to the system as a whole.

(x) We should learn from the mistakes of the past so as to avoid being punished in the future.