SECTION - I

STRUCTURAL AND ORGANISATIONAL CHANGES IN AGRICULTURE

1.1 Available indicators suggest that India is poised for high rate of growth. The sustainability of growth momentum, however, will critically depend on sustainability of growth in agricultural sector. In spite of decline in its share in the Gross Domestic Product (GDP) from 44.5 per cent in 1970-71 to 22.2 percent in 2003-04, there has been no significant change in the proportion of workforce depending on agriculture. It still provides livelihood support to about two-thirds of the country's population and is the single largest private sector occupation. It also accounts for about 14.7 per cent of the total export earnings and provides raw material to a large number of industries.

1.2 Within the agriculture sector the allied sectors like horticulture, animal husbandry, dairy and fisheries, have an important bearing on the overall economic growth, and also on health and nutrition of the masses. Agriculture is the largest user of land and water. To maintain the ecological balance, there is a need for sustainable and balanced development of agriculture and allied sectors.

Ongoing Changes in Agriculture Sector

1.3 The important changes taking place in Indian agriculture include, among others, the following:

i) The agriculture sector in India is undergoing major structural changes. The share of allied sectors in agriculture, mainly dairying, fisheries and poultry is becoming more important. In fact, the share of livestock products in gross value of agricultural product (i.e. crop production *plus* livestock raising) is progressively increasing. It had increased from being, less than 16 per cent in 1970-71 to 26 per cent in 1995-96. It is also true of the share of fisheries in agricultural GDP, which has increased from 1.7 per cent to 3.1 per cent during the above period. The main engine of growth for the allied sectors was the increase in income and consequent changes in the dietary pattern.

ii) Apart from shift in importance of allied sectors in the recent years, there is also a shift in the crop composition. Three major changes have taken place in this regard. In the first place, the share of non-food crops has increased in terms of area devoted to these crops. For example, in the triennium ending 1971-72, nearly 25.7 per cent of the cultivated area was devoted to non-foodgrains. Their share increased to 35.1 by the 1999-2000. Second noteworthy development is that food crops i.e., sugarcane, oil seeds, spices and condiments, fruits and vegetables, etc., are acquiring greater importance. The third important change is that the share of superior cereals like rice and wheat in the total foodgrains production has been increasing.

iii) During the course of development, land as an input in agricultural production declines in importance and the non-land inputs acquire greater importance. The share of the purchased inputs in the input structure has increased significantly over the period indicating modernization of Indian agriculture. This has also strengthened its backward linkages. Demand from agriculture for inputs from the industrial sector is becoming progressively more important.

iv) Significant changes have taken place in the agrarian structure of India as indicated by the changes in the pattern of landholdings. The landholding pattern reveals that it is dominated by the marginal and small holdings. The latest available figures suggest that nearly 36 per cent of agriculture land in the country is now owned by the small and marginal farmers, whose shares account for 19 per cent and 17 per cent, respectively. Further, the land cultivated in the small and marginal holdings is progressively increasing. While the land owned and cultivated by the medium holdings has remained stable, the land owned and cultivated by the larger owners is progressively declining. These changes in agrarian structure are the outcome of institutional, technological and demographic factors.

v) In the context of the commercialization of agriculture, marketing of agricultural produce has emerged as a challenging area. It requires, smooth channels for the transport of produce, physical infrastructure, such as warehousing and market complex, and credit support to producers. The credit needs for the development of market infrastructure for agriculture sector will be enhanced in the context of commercialization and globalisation.

The Future Direction and Challenges

1.4 The future directions of Indian agriculture will largely depend on the domestic agriculture policy as well as the changing directions of globalisation. According to the National Agriculture Policy document (NAP, 2002), the policy seeks to actualize the vast untapped growth potential of Indian agriculture, strengthen rural infrastructure to support faster agricultural development, promote value addition, accelerate the growth of agro business, create employment in rural areas, secure a fair standard of living for the farmers and agriculture workers, discourage migration to urban areas and face the challenges arising out of economic liberalization and globalisation. Over the next two decades, it envisages to attain:

- A growth rate exceeding 4 per cent per annum in the agriculture sector.
- Growth that is based on efficient use of resources and at the same time conserves soil, water and bio-diversity.
- Growth, which is equitably spread across regions and covers all farmers.
- Growth that is demand driven and caters to domestic markets as well as maximises benefits from exports of agricultural products in the face of the challenges arising from economic liberalisation and globalisation.
- Growth that is sustainable technologically, environmentally and commercially.

1.5 In terms of globalisation, three important provisions in WTO agreements i.e., reduction in trade barriers, increased market access, and reduction in Aggregate Measure of Support (AMS), are likely to have substantial implications for the agriculture sector. In the emerging global situation India could increase its market share in world exports by diversifying the agricultural production towards high value and hi-tech agriculture. Therefore, the acceleration in agriculture exports hinges critically on identifying those agricultural products in which India has a comparative advantage. Institutional credit will play an important role in this respect.

The Evolution of Rural Credit Delivery System

1.6 Credit has been considered not only as one of the critical inputs in agriculture, but also an effective means of economic transformation. A large number of agencies, including cooperatives, regional rural banks, commercial banks, non-banking financial institutions, self-help groups and a well spread informal credit outlets together represent Indian rural credit delivery system. These networks apart from working as financial intermediaries also play a key developmental role in the economy. The key milestone of rural credit system are Rural Credit Survey Committee Report (1954) and acceptance of its recommendations, nationalisation of major commercial banks (1969 and 1980), establishment of RRBs (1975), establishment of NABARD (1982) and the ongoing financial sector reforms since 1991. Further, several initiatives like Kisan Credit Card Scheme, Special Agricultural Credit Plans, RIDF Scheme etc, are put in place to increase the flow of credit to agriculture sector. An important development in this regard is the phenomenal growth of Self-Help Groups since 1990s.

Present Status
(a) Quantitative Aspect

1.7 As per the Tenth Plan projection, the flow of credit to agriculture and allied activities is expected to be of the order of Rs.7,36,570 crore. However, despite the extensive outreach of rural and semi-urban branch network of commercial banks (about 33,000), cooperative banks (about 1 lakh) and RRBs (about 14,000), the estimated actual flow of credit to agriculture from formal rural financial institutions (RFI) during the first year of the Tenth Five Year Plan, i.e 2002-03, stood at Rs. 69,560 crore against the projected amount of Rs 82,073 crore, i.e 84.8 per cent (Table-1.1). Therefore, there is an urgent need to double the flow of credit to agriculture. This is a formidable challenge.

Table 1.1: Agency-wise Ground Level Credit Flow for Agriculture and Allied Activities

(Rs. Crore)

Agency	1997-98	1998-99	1999-2000	2000-01	2001-02*	2002-03*
Co-operative Banks	14085	15957	18260	20718	23524	23636
Regional Rural Banks	2040	2460	3172	4220	4854	6070
Commercial Banks	15831	18443	24733	27807	33587	39774
Other Agencies	-	-	103	82	80	80
Total	**31956**	**36860**	**46268**	**52827**	**62045**	**69560**

Source**: NABARD Annual Report, 2002-03* *** NABARD

(b) Qualitative Aspect

1.8 The process of globalisation and deregulation of financial institutions have thrown open new challenges and opportunities. The financial institutions need to meet the expanding credit needs of the agriculture sector. In an emerging situation agriculture sector requires higher credit to strengthen primary production base like land and water, support investment in farm machinery and current inputs, in order to enable it to high value addition and export orientation. Thus, qualitative dimensions of the credit delivery channel are equally important. The capability of the institutional credit delivery channel will be severely tested in funding farmers at the extremes of the spectrum; small and marginal holdings with more than a third of the production base, and the large and enterprising farmers. As the credit requirements of different sections of producers have specific characteristics of content, scale, timing, mode of payment and back-up services, the quality of credit delivery by various institutions will determine their competitiveness in a deregulated financial regime

1.9 In view of its immense importance as well as the urgent need to provide credit to agriculture and allied activities in an accelerated manner, Reserve Bank of India (RBI) has constituted the Advisory Committee with Prof. V. S. Vyas as the Chairman, with the following Terms of Reference.

- To assess the progress made in implementation of the recommendations of the Expert Committee on Rural Credit (Vyas Committee) appointed by NABARD in August 2000;
- To suggest measures to reduce the rate of interest on agriculture credit given by Commercial, Co-operative and Regional Rural Banks;
- To examine the role of NABARD as the apex institution for providing and regulating credit for the promotion and development of agriculture and the role of Regional Rural Banks (RRBs) in purveying agricultural credit and suggest measures for improving the same without sacrificing overall viability considerations;
- To study the role and effectiveness of the RIDF mechanism and suggest ways to improve the same, or to suggest alternatives, with a view to increase direct agriculture lending;
- To identify the impediments in the flow of credit to the disadvantaged sections such as small and marginal farmers, tenant farmers, oral lessees and landless labourers and suggest measures to be taken by banks for providing financial assistance to them;
- To suggest short-term and medium-term measures to improve the flow of credit to agriculture, with particular emphasis on
    - direct financing of farmers based on linkages for supply of inputs and sale of outputs and institutional and procedural arrangements required therefor;
    - scope for involving innovative location-specific catalytic agents to bridge the gap between the demand and supply of timely credit in rural areas;
    - the problems faced by banks in extending their outreach;
    - the need to modify the Service Area Approach; and
    - feasibility for harnessing new technological developments in smoothening the process of credit delivery to the rural and agricultural sector.
- To study the role of micro finance in poverty alleviation and adoption of the Self-Help Group (SHG) approach in extending banks' outreach to the disadvantaged sectors.
- To examine the need to regulate microfinance institutions and to suggest appropriate regulatory model.
- To examine the norms relating to NPAs in cases of crop failure where there are seasonality and uncertainity.

1.10 The Committee comprise the following:

Chairman:

Prof. V.S. Vyas

Members:

Shri J.N.L. Srivastava
Dr. N. Mohan Kumaran
Dr. Sardar Singh Johl
Shri P.S. Shenoy
Shri K.R. Ramamoorthy
Dr. B. Samal

Permanent Invitees:

Smt. Ranjana Kumar
Shri Vepa Kamesam

1.11 The Secretariat to the Committee is provided by the Rural Planning and Credit Department (RPCD), Reserve Bank of India.

1.12 The Committee in its first meeting held on 24 February 2004 clubbed various Terms of Reference in the following five broad categories:

- Revisiting the definition of NPAs in agriculture and priority sector norms.
- Expanding flow of agricultural credit and outreach, and Service Area Approach.
- Measures to reduce rates of interest on loans to agriculture and possible use of information technology.
- Identify impediments in flow of credit to disadvantaged sections, micro finance, etc.
- Role of NABARD as apex development bank, RIDF and role of RRBs.

This Interim Report addresses the issues mentioned in the first four categories and the related topics. The final Report of this Committee will deal with the issues mentioned in the last category and refine and fine-tune the issues discussed in this Interim Report.

<<<<>>>>

SECTION II

INCREASING FLOW OF CREDIT TO AGRICULTURE - MANDATORY LENDING TO AGRICULTURE BY SCHEDULED COMMERCIAL BANKS

2.1 Under the system of directed lending, a target of 18 per cent of net bank credit has been stipulated for domestic scheduled commercial banks for lending to agriculture. In order to ensure that the focus of banks on the direct category of agricultural advances does not get diluted, it has been stipulated that the lendings under the indirect category should not exceed one-fourth of the agricultural credit target of 18 per cent, i.e. 4.5 per cent of net bank credit, for the purpose of computing the achievement of banks under the 18 per cent target. Indirect finance to agriculture in excess of 4.5 per cent of net bank credit is, however, reckoned towards total priority sector lending.

2.2 Although the target for lending to agriculture (18 per cent of net bank credit) has not been achieved by most of the public sector and private sector banks, the amount of outstanding advances to agriculture in absolute terms has increased continuously over the years. The growth in outstanding credit to agriculture by public sector and private sector banks during the period 1994 to 2003 is presented in Table 2.1.

Table 2.1
Outstanding credit to agriculture by public sector and private sector banks

(Amounts in Rupees crore)

	March 1994	March 2003	Annual compounded growth rate (%)
Public sector banks			
Net bank credit	140914	477899	14.53
Total agri advances outstanding	21204	73507	14.81
Direct agri advances	19256	51799	11.62
Indirect agri advances	1949	21708	30.71
Private sector banks			
Net bank credit	9545	71761	25.13
Total agri advances outstanding	591	11873	39.57
Direct agri advances	515	5201	29.30
Indirect agri advances	76	6671	64.41

(Source - RPCD, RBI**)**

2.3 Since 1995-96, public sector and private sector banks, with shortfall in lending to priority sector /agriculture, have been contributing to the Rural Infrastructure Development Fund (RIDF) established with NABARD. Nine tranches of RIDF have been established with aggregate corpus of Rs 34,000 crore. The RIDF is utilized for assisting State Governments in quick completion of ongoing rural infrastructure projects. Cumulative sanction and disbursement under various tranches of RIDF stood at Rs 33,357 crore and Rs 19,394 crore respectively as at the end of February 2004. Completion of projects under RIDF is expected to improve the credit absorption capacity in the areas concerned and provide the infrastructural support for agricultural production and development. The Committee's observations relating to RIDF/ Lok Nayak Jai Prakash Narayan Fund will be furnished in a separate chapter in the report.

2.4 The target of 18 per cent of net bank credit for lending to agriculture was introduced in the year 1989 and banks were required to achieve this target by March 1990. However, the banking system as a whole has not reached the level of 18 per cent. In April 2001, private sector banks were asked to achieve the target of 18 per cent of net bank credit for lending to agriculture within a time period of two years. The same time frame was subsequently made applicable to public sector banks (in May 2001). This was without prejudice to the allocation under RIDF for not meeting the targets for lending under priority sector/agriculture during the intervening period. Accordingly, banks were advised by Reserve Bank of India to step up lending to priority sector (including agriculture) so as to reach the stipulated targets by March 2003. However, the data presented in Table 2.2 show that many banks failed to reach the required level by March 2003.

Table - 2.2
Number of banks achieving the 18% target

As on the last reporting Friday of	Public sector banks		Private sector banks	
	Achieving the 18% target	Not achieving the 18% target	Achieving the 18% target	Not achieving the 18% target
March 2001	4	23	1	30
March 2002	6	21	2	29
March 2003	5	22	2	27

(**Source** - RPCD, RBI)

2.5 Indirect finance to agriculture by public sector and private sector banks constituted 4.54 per cent and 8.59 per cent of their net bank credit respectively as on the last reporting Friday of March 2003. Generally, the percentage of indirect lending has been higher in the case of the new private sector banks. As on the last reporting Friday of March 2003, indirect agricultural advances of old private sector banks constituted 4.52 per cent of their net bank credit, while for new private sector banks, the percentage was 12.07.

Special Agricultural Credit Plans (SACP)

2.6 Under instructions from the Reserve Bank, public sector banks have been formulating Special Agricultural Credit Plans (SACP) since 1994-95 with a view to achieving marked improvement in the flow of credit to agriculture. Under SACP, the banks are required to fix self-set targets for disbursement during a year (April-March). Banks have been advised by the Reserve Bank to fix the targets showing an increase of about 20 to 25 per cent over the disbursement made in the previous year. With the introduction of SACP, the flow of credit to the agricultural sector by public sector banks had increased from Rs.10,172 crore in 1995-96 to Rs. 33,921 crore during 2002-03. The amounts disbursed and the year-on-year growth rates in disbursements during the period from 1995-96 to 2002-03 are presented in Table 2.3.

Table - 2.3

Disbursement of credit to agriculture under SACP

(Amounts in Rupees crore)

	Production credit	**Investment credit**	**Total direct lending (2+3)**	**Indirect lending**	**Total disbursement (4+5)**
1	2	3	4	5	6
1995-96	4951.08	4039.52	8990.60	1181.85	10172.45
1996-97	6164.39 (24.51%)	4896.21 (21.21%)	11060.60 (23.02%)	1721.93 (45.70%)	12782.53 (25.66%)
1997-98	7298.79 (18.40%)	5373.28 (9.74%)	12672.07 (14.57%)	2136.28 (24.06%)	14808.35 (15.85%)
1998-99	8204.02 (12.40%)	6062.53 (12.83%)	14266.55 (12.58%)	3521.08 (64.82%)	17787.63 (20.12%)
1999-2000	9903.05 (20.71%)	6119.90 (0.96%)	16022.95 (12.31%)	5890.19 (67.26%)	21913.14 (23.18%)
2000-01	11615.30 (17.29%)	6818.15 (11.41%)	18433.45 (15.04%)	6220.95 (5.62%)	24654.40 (12.51%)
2001-02	15385.60 (32.46%)	7287.60 (6.89%)	22673.20 (23.00%)	6659.19 (7.04%)	29332.39 (18.97%)
2002-03	18319.05 (19.07%)	7831.03 (7.46%)	26150.08 (15.33%)	7770.97 (16.70%)	33921.05 (15.64%)

(Figures in brackets indicate the year-on-year growth rates)
(**Source** - RPCD, RBI)

2.7 It would be observed that in recent years, there has been a drop in the annual growth rate in disbursements under SACP, with the year 2002-03 registering a growth rate of 15.64 per cent over the previous year. Further, the growth rate in investment credit has been generally low.

Recommendation of the earlier committees

a) High Level Committee on Agricultural Credit through Commercial Banks (R.V. Gupta Committee) :

2.8 The Gupta Committee noted that the target of 18% for lending to agriculture was fixed at a time when the reserve requirements were as high as 63%. These have been progressively reduced and total lendable resources of banks have increased substantially over the years. The Committee estimated that the base on which the target of 18% was calculated had doubled, requiring banks to concomitantly double their lendings to agriculture to even maintain the same share in conditions where agricultural production itself was growing at 2.1% per annum.

2.9 The Committee also noted that the system of fixing targets on outstandings had its drawbacks as outstandings decrease as a result of improved recoveries as was the case between 1991 to 1995 during which recoveries improved from 48.8 per cent to 59.5 per cent. The combined effect of improved recovery and write-offs was to reduce the share of lending to agriculture without any deceleration in the pace of lending to the sector.

2.10 Hence, the Committee suggested that banks should have self-set targets for lending to agriculture which should be based on the flow of credit and for this, banks need to prepare special agricultural credit plans, with the Reserve Bank indicating the annual expected increase in the flow of credit over the previous year. Once such a system (i.e., the Special Agricultural Credit Plan) was in place, the Committee felt that the 18 per cent target, based on outstandings would cease to have much relevance.

2.11 However, it may be noted that in spite of monitoring through SACP, the target of 18 per cent has not been reached and various Parliamentary Committees have time and again criticized banks for not achieving the target and have demanded punitive action against the banks which fail to reach the stipulated level.

b) The Expert Committee on Rural Credit (Vyas Committee)

2.12 The Committee appointed by NABARD in the year 2000 recommended in its report dated July 23, 2001 that a review of the mandate of 18 per cent of credit outstanding for agricultural loans and 40 per cent for priority sector loans be made after five years, as it believed that Indian agriculture was likely to experience substantial structural and other changes in this period of five years and the experiences of this period would provide a base for a more realistic reappraisal.

2.13 The Committee also recommended a substantial reduction in the RIDF interest rates to levels just enough to cover the interest cost of deposits. This would spur the banks to achieve the agricultural lending targets, since their margins in lending would normally cover their transaction costs and provide reasonable profits.

2.14 The Committee recommended that the maximum limit of 4.5 per cent on indirect credit should be maintained while reckoning the achievement of 18 per cent target for agricultural lending. The entire indirect credit may, however, be reckoned for meeting the obligation for priority sector lending in view of the importance of items listed under indirect advances.

2.15 Although no review of the scheme was carried out in the intervening period, the Reserve Bank has been regularly advising banks to take steps to achieve the level of 18 per cent in a time-bound manner. As regards RIDF interest rates, these have been restructured and in the case of RIDF-IX operationalised during 2003-04, the interest rates on deposits vary between Bank Rate and Bank Rate minus 3 percentage points (i.e. 6 per cent and 3 per cent on the basis of the current Bank Rate of 6 per cent). The 4.5% ceiling on indirect credit still remains in force.

Assessment of Mandatory Lending

2.16 Several suggestions were received on the subject during the field visits undertaken by the members of the Committee to various States. Banks and other agencies also sent their views on the issue to the Committee. The suggestions received by the Committee in regard to the target for lending to agriculture range between having **no** target at all to raising the target to the share of agriculture in the country's GDP. The Committee has examined all these suggestions. It notes that the stipulation of target of 18 per cent in relation to the net bank credit enjoins upon banks an obligation to lend a part of their total credit to the agriculture sector. The Committee also notes and addresses in the following sections the difficulties faced by banks in achieving the target of 18 per cent, particularly in the context of faster growth in the quantum of net bank credit, the demand side constraints and the cap on indirect finance to agriculture for reckoning the performance of banks against the stipulated target.

2.17 There has also been suggestions from certain quarters to link the target to disbursements rather than outstanding advances. Some have even advocated that moving forward, the banking system's support to overall rural development must be evaluated and in that context all lending by a rural branch of banking system must be captured rather than a limited segment of economic activity. It is, however, heartening that all major actors in the financial system concede that they have to play a proactive role in stepping up flow of credit to rural masses in a cost-effective manner, lest rural-urban divide further widens. The Committee observes that fixing target on the basis of disbursements would not establish a link between the total advances of a bank and the lending to agriculture. **The Committee also feels that the entire issue of fixation of targets for lending to the priority sector including agriculture needs a comprehensive review. Till such a review is attempted, the existing target of 18 per cent of net bank credit for lending to agriculture may continue.**

2.18 The Special Agricultural Credit Plan (SACP) has provided an additional mechanism for credit planning and monitoring at the bank level. This being based on disbursements during a year rather than on outstanding, is a good supplementary indicator of banks' lending to agriculture. **This system may be continued and may also be made applicable to private sector banks, which are treated at par with public sector banks in matters relating to priority sector lending.**

2.19 The Reserve Bank may continue to monitor performance of banks under SACP and indicate the expected growth rate in disbursements over the previous year. The Committee feels that the efficacy of these plans can be better evaluated in the context of direct lending to agriculture and recommends that the framework of SACP may be restricted to direct lending to the agriculture sector, comprising both production credit as well as investment credit, while banks can have their separate review mechanism for indirect lending to agriculture.

2.20 Indirect finance to agriculture includes lending to various intermediary agencies assisting the farmers as also investment in special bonds issued by NABARD and the Rural Electrification Corporation (REC). It also includes deposits placed by banks in RIDF. The growth rate in the indirect lending segment, as reported under SACP by public sector banks, has been between 5.62 to 67.28 per cent. For the last three years, however, the growth rate has dropped in this segment also, with the growth in 2002-03 being 16.70 per cent.

2.21 As regards punitive measures in the case of non-achievement of the stipulated target of 18 per cent in lending to agriculture, **the Committee is of the view that the existing system of relating interest rates on deposits placed in RIDF (now changed to Lok Nayak Jai Prakash Narayan Fund) inversely to shortfall in achieving the agricultural lending target provides adequate punitive measures, as banks with higher level of shortfall get lower rates of interest which would be less than their cost of funds.**

2.22 The Committee has examined various issues relating to direct lending to agriculture by the scheduled commercial banks. It feels that for agricultural production to improve substantially, both direct as well as indirect lending to the sector need to improve. Indirect lending is important for improving credit absorption capacity and expansion in the outreach of banks. However, the Committee also recognizes that certain limitations are necessary on indirect lending lest the finance for direct agricultural production is neglected by the banks which may jeopardize the goal of achieving annual growth of four per cent in agricultural production. **Considering the operational difficulties being experienced by the banks in expanding direct credit to agriculture, and the time required for their resolution,** t**he Committee would like to prescribe road maps for public sector and private sector banks to enable them to reach the required level of direct lending within a period of four years.**

2.23 All public sector and private sector banks should increase their direct lending to agriculture to a level of 12 per cent of net bank credit within two years and to the level of 13.5 per cent within the next two years thereafter. Banks which have already reached this level may at least continue to maintain the position. Better, they should make further improvement in direct lending. While planning for their credit to agriculture so as to achieve the stipulated target, banks should take into account the likely spurt in credit, if any, towards the end of the financial year.

2.24 The indirect lending to agriculture may be reckoned to the extent of 6 per cent for computing the performance of banks under the 18 per cent target during the first two years. Thereafter, the ceiling of 4.5 per cent should apply.

2.25 The Committee would, however, like to make it clear that banks have the option - and some of them are already exercising this - to lend indirectly to agriculture in excess of the proposed ceiling. Lending in excess of this ceiling may continue to qualify for meeting the overall priority sector lending target of 40 per cent.

2.26 Disbursements to small and marginal farmers constituted 26.7 percent of total disbursements under SACP during the year 2002-03. Small and marginal farmers constitute part of the weaker sections in the scheme of priority sector lending. As per the latest available data, landholdings by small and marginal farmers constituted about 80 per cent of total number of holdings and 36 per cent of the total area. Small and marginal farmers would need additional credit support for intensive cultivation for introduction of high value crops and allied activities. **The Committee feels that the share of small and marginal farmers in agricultural credit should be commensurate with their holdings and credit needs and, therefore, recommends that credit to small and marginal farmers should be progressively raised to 40 per cent of disbursements under the Special Agricultural Credit Plan (SACP) by the end of the Tenth Plan period.** As the data now being collected by the Reserve Bank from banks under SACP include disbursement to small and marginal farmers, there would not be additional data reporting requirement.

2.27 At present, loans for construction and running of storage facilities (warehouse, market yards, godowns, silos and cold storages) in the producing areas are treated as indirect finance to agriculture. Further, loans to cold storage units which are mainly used for hiring are treated as indirect agricultural advances, provided the cold storage units are in rural areas and the units are not registered as SSI units. **The Committee feels that the stipulation of treating only those units which are in the producing areas/ rural areas for bank finance under priority sector restricts the flow of credit for building up storage facilities and recommends that the stipulation relating to location of the storage units be removed, subject to these units storing mainly agricultural products.**

2.28 With increasing emphasis on securitisation of assets, banks have the option of purchasing securitised loans from other banks/ companies. At present, such investments by banks are not reckoned for the purpose of computing their priority sector lending. **If, however, all the securitised loans represent direct advances to agriculture, the Committee feels that investment by banks in such securitised assets may be treated as their direct lending to agriculture under the priority sector. Similarly, if the securitised assets represent indirect finance to agriculture, the investment in such assets may be treated as indirect finance to agriculture.**

<<<<>>>>

SECTION III
EXPANDING OUTREACH OF THE BANKS IN RURAL AREAS

3.1 Though the share of agriculture in GDP in our country, like in any other developing country, has declined from 34.9 per cent in 1990-91 to 22.2 per cent in 2003-04, it still continues to be an important sector of our economy. The National Agriculture Policy of 2002 has envisaged that for attaining 7 per cent growth rate in the overall economy, the Indian agriculture has to grow annually at more than 4 per cent. For achieving this target, production credit as well as capital formation in agriculture have to be accelerated.

3.2 At present, institutional agricultural credit is mainly disbursed by commercial banks, cooperative banks and Regional Rural Banks (RRBs) under the multi-agency approach. These banks over time have established an impressive branch network: about 47,000 branches of scheduled commercial banks (including RRBs) and over one lakh outlets of cooperatives in rural and semi-urban areas.

3.3 Despite a well developed credit delivery structure, the outreach of banks has remained restricted for various reasons. Though the ratio of agricultural credit to agricultural GDP increased from 5.4 percent in 1970s to 8.7 per cent in 2001-02, yet agricultural credit as a proportion to total credit has decelerated from 20.5 per cent to 10.5 per cent during the same period indicating lower deployment of credit in agriculture (Table 3.1). This trend appears to be somewhat disturbing considering the likely changes in agriculture mentioned earlier, which would be more capital and credit intensive.

Table 3.1: Ratio of agricultural credit to agricultural GDP and Total Credit

Period	Agricultural credit as a ratio to Agricultural GDP	Agricultural credit as a ratio to total credit
1970s	5.4	20.5
1980s	8.3	20.1
1990s	7.4	14.4
2001-02	8.7	10.5

[Source: Handbook of Statistics, 2002-03, RBI]

3.4 Trends in Institutional credit to Agriculture. The flow of direct institutional credit to agriculture and allied activities increased sharply from Rs.744 crore in 1970-71 to Rs.9,829 crore in 1990-91 registering a growth rate of 7.6 per cent per annum. This was mainly due to the increased participation of Scheduled Commercial Banks (SCBs) in agriculture credit after the 'bank nationalisation' in 1969. The flow of credit further increased to Rs.41,385 crore in 2001-02. Agency wise figures indicate that the share of cooperatives which was 98 per cent in 1971-72 has come down sharply to 44 per cent in 2001-02, while the share of SCBs has considerably increased from 1.9 per cent to 45 per cent during the same period. The RRBs which came into existence in 1975-76 have a share of 11 per cent.

3.5 Crop loan and Investment Credit. The banks purvey two types of credit i.e. short term credit for seasonal agricultural operations and long term credit for creation of assets. As could be seen from the data presented in Table 3.2, the growth rate of aggregate short term credit by all the agencies put together had almost remained constant at about 14 per cent during the three decades, while that of long term credit had decelerated by about 20 per cent in the 1970s to about 12 per cent in the 1990s indicating the differential growth rates in the two types of credit. The deceleration in the growth of investment credit had impaired the credit absorption capacity of the agricultural borrowers. The deceleration in the rate of growth of credit is more pronounced in the credit extended by the commercial banks.

Table 3.2: Decadal Average Growth Rate of Direct Institutional Credit to Agriculture and Allied Activities

Period	Cooperatives		RRBs		Commercial Banks		Total	
	Short-term	Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	Long-term
1970s	10.6	13.9	334.8	426.8	28.2	29.9	14.5	20.2
1980s	12.5	11.0	19.8	18.5	16.3	18.6	13.9	14.8
1990s	11.9	13.1	32.7	10.6	17.8	12.1	14.6	11.9

Source: Handbook of Statistics, 2002-03, RBI

3.6 Region/State-wise Credit Disbursement. Apart from the differential growth rates of agricultural credit by the commercial banks, the regional disparity across the country in the disbursement of agriculture credit by the banks is also significant**.** The Southern region continues to account for the bulk of credit disbursement to agriculture followed by the Northern, Western and Central regions. The share of North-eastern region continues to remain at an abysmally low level (See, Appendix Table).

3.7 Disbursement of credit to different categories of Farmers. Another disturbing feature is the declining share of credit going to small farmers. The data on flow of direct finance to agriculture from scheduled commercial banks (excluding RRBs) over the period 1980-81 to 2000-01 reveals that while small farmers (with landholdings up to 2.5 acres) accounted for bulk of the number of accounts, their share was only around one-fourth of the total amount disbursed. Larger farmers, on the other hand, accounted for one-fourth of the total number of accounts and around 50 percent of the total amount disbursed. There was a decline in both the number of accounts and amount of credit disbursed to small farmers. As large number of small borrowing accounts tends to increase transaction costs for the banks, with a view to shore up their bottom lines, they appear to have reduced their exposures to such accounts. To sum up, the pace of credit disbursement to agriculture is declining, regional imbalance seems to be widening and share of small farmers is declining. This is in the face of several new and emerging opportunities for increasing the flow of credit to agriculture, some of which are listed below.

New Opportunities.

3.8 Scope for integrating investment credit and production credit. The landholders like to avail credit for different production and investment activities such as crop cultivation, purchase or replacement of tractors, farm equipment, digging / deepening of wells, installation of diesel pumpsets as well as electric motors, laying out cement pipelines / field channels, drip / sprinkler irrigation system, construction of farm sheds, purchase of agriculture produce transport vehicles, dairy animals etc. **There is, therefore, need for integration of investment credit and production credit. The banks can expand the flow of farm credit significantly if they consider total credit needs of cultivators.**

3.9 Raising scale of finance. At present, the scale of finance as suggested by the District Level Technical Committees, though only indicative, are adopted by banks as the benchmark. **However, considering the new development in technologies and the need to adopt high quality inputs, the scales of finance need to be reviewed and revised to meet the credit needs of more capital intensive agricultural operations.**

3.10 Strengthening linkages between production, marketing, post harvest activities. The ECRC (2001) had observed an imbalance between financing productions and post-harvest operations, as also poor linkages between credit and marketing, leading to insufficient business development by Rural Financial Institutions [RFIs]. The situation has not improved since then. A more balanced approach to crop production and post-harvest operations will open up new opportunities. The Expert Committee on Strengthening and Developing Agricultural Marketing and Marketing Reforms (Shankar Lal Guru Committee) and the Inter-Ministerial Task Force have identified areas such as contract farming, private market yards, Public-Private partnership etc. for integration of farmers' production with domestic and global markets These measures would enable farmers to access markets beyond local Mandis and help in the promotion of competitive agricultural markets in private and cooperative sectors. **There is also a need for stepping up of pledge financing, credit for marketing and introduction of Negotiable Warehousing Receipt System.**

3.11 Strengthening production base: Land and Water. There is a need to raise the productivity of land and enhance water resources for agricultural development by stepping up public investment in land rejuvenation, irrigation and better water management. In these areas, the importance of private capital formation is progressively increasing. **There is immense scope for the banks to step up their credit disbursement for these activities.**

3.12 Reclamation of waste land/ fallow land. The country has about 24.50 million hectares of wasteland and 16.60 million hectares of fallow land which can be brought under productive use. Sizeable areas of these land resources could be converted into cultivable land through suitable crop selection, improving water-use efficiency, adoption of watershed approach and development of irrigation potential. **State Governments and banking sector could work out a long term plan to develop and bring these land resources under productive use for strengthening the rural economy. In sum, resource development may be treated as an integral part of agriculture lending.**

3.13 Credit expansion in drought-prone areas. Frequent recurrence of drought situation in one or other parts of the country impedes socio-economic progress of rural areas and flow of credit to rural sector. The schemes like (i) micro irrigation (ii) sprinkler irrigation (iii) watershed management (iv) village ponds development (v) farm ponds promotion (vi) dry land farming, which could be jointly implemented by the Governments and the banking sector, offer scope for mitigating or at least softening the impact of drought.

3.14 Hi-tech agriculture and precision farming. Only a few commercial banks have lent to high technology and capital intensive export oriented agricultural projects in the recent past. Some banks have also opened a few specialised hi-tech agriculture branches for financing such projects / schemes. Their experience in this respect is not particularly encouraging on account of failure of projects, especially in the areas of aquaculture, floriculture etc. However, several small to medium size hi-tech projects are proving good business for banks. It is, therefore, necessary to analyse the failures in these sectors in greater depth and overcome the possible weaknesses. With proper credit appraisal and introduction of appropriate management systems, such projects/ schemes can open up vast opportunities for RFIs.

3.15 Credit for Farm Mechanisation. In the wake of transformation of agriculture into a diversified and commercial enterprise, importance of agriculture machinery is progressively increasing. **A few banks have entered into tie up arrangements with major manufacturers of tractors and other farm machinery for financing them in a cost effective manner. This could be explored by other banks as well.**

3.16 Value addition through agro-processing. Although India is a major producer of vegetable, fruits and foodgrains in the world, the performance in the area of food processing has not at all been impressive. Today only two per cent of the annual production of foodgrains is processed for value addition. There is a need for improving food processing activities not only to reduce the wastage but also to help the producers realise better value of their produce.

3.17 Credit needs for expanding agricultural exports. Under the WTO regime, Indian agricultural commodities can enjoy better competitive position in international market provided the quality of the processed food attains international standards. In order to meet these standards, the introduction of processing technology demanding investment of higher order would be necessary. Since some of the corporate bodies are entering into this arena, demand for credit for export oriented processing units for value addition is likely to increase.

Suggested Measures

3.18 Development of Human Resources

The most important impediment in the extension of the outreach of the commercial banks is the staff related issues. The rural branches of banks are inadequately staffed and the officers are frequently transferred. There is a need to post technical officers conversant with areas such as agriculture, veterinary, fishery etc. The ECRC had suggested that commercial banks should post technical staff at HO/ controlling offices to have interface with Government departments etc., post top level executive to be in charge of rural credit and to effect rural posting of officers for a minimum period of 3-5 years. We endorse all these recommendations. We would also like to emphasise the need for absorbing more and more agricultural graduates for manning rural branches of the commercial banks. The most important task, however, is to change the mindset of the bankers. It needs to be emphasised that all over the world, retail banking is emerging as more profitable and less risky proposition. **In the Indian context, there is hardly any better avenue for retail lending than agriculture.**

3.19 Externalising the functions for larger outreach. Approaching a large number of small borrowers spread over an extensive geographical area is always a cost intensive proposition for profit oriented and cost conscious banking sector. The routine functions like accepting and scrutiny of applications, appraisal, supervision and monitoring of loans etc. are cost intensive. Outsourcing some of these functions to agencies operating at the village level such as local SHGs, input suppliers like tractor manufacturing agencies, agriculture extension counters of corporates like HLL, ITC and Mahindra and Mahindra, farmers' clubs, Panchayati Raj Institutions (PRI) may have to be tried by the financing institutions. This would enable them to have a larger outreach without increasing the cost in the same proportion.

Organisational Innovations

3.20 A wheel and spoke model could be tried with a central branch as the hub and points of sale (POS) as spokes. The branch personnel can visit the POS for a few hours for 2-3 days in a week for sanctioning of loans. There can be a resource person e.g., a sarpanch, or panchayat member who can pool and verify the applications and present the same to the bank personnel. Several POS can be affiliated to the nodal branch. Loan disbursements can be made at the nodal branch.

3.21 A number of conduits like school teachers, village postmaster and others in the village who are familiar with the borrowers and could be used for purveying credit without much paperwork. They are also well placed to recover dues on time. **Franchising village post offices to route bank credit, as announced in the Finance Minister's Budget Speech for the year 2003-04 will also go a long way in associating these agencies. NABARD, SBI, etc., have taken up pilot programmes in this regard in Tamil Nadu. Other commercial banks may like to examine this avenue for credit disbursal.**

3.22 Risk mitigation through hedging. With the setting up of National Level Multi Commodity Exchanges (NMCE), a beginning has been made towards minimizing the market and yield fluctuation risks faced by the farmers. Some of the NMCEs are currently working on pilot projects in the states of Punjab, Gujarat, Tamil Nadu and Andhra Pradesh involving cotton farmers. This development would be facilitated with the participation of commercial banks. However, under the extant regulations, the banks cannot participate in the trading of commodities. **The Committee, therefore, recommends that keeping in view the urgent need for offering hedging mechanism to the farmers, select banks willing to participate in the pilot projects may be exempted from the provisions of the Section 6 and 8 of the Banking Regulation Act either through amendment to the Act or by issue of a notification.**

Need for re-examining Legal Provisions.

3.23 Under Securitisation and Asset Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act), taking possession of the agriculture land for recovery of bank loans is not permitted. **Therefore the revenue authorities and the state government officials may have to extend their support in collection of dues.** In a few sates like Karnataka, the land records are computerized to facilitate both the borrowers and the banks . **State Governments may also have to legally recognize the rights of the tenant farmers and share croppers, and enter these in official records, to enable them to have an access to credit.**

3.24 In some states, the borrowers are required to pay heavy stamp duty to execute the documents for availing of credit from non-cooperative channels like commercial banks and RRBs. In order to enhance the flow of credit, State Governments may consider reducing the stamp duty and bringing it at par with the one charged to cooperative banks. In the case of cooperatives, charge on land is created by filling a simple form without any legal fees. However, the commercial banks create charge through mortgage of lands, which involve considerable cost. The notification of mortgage is also done only in a few specified centres to which the farmer has to visit on a given date, incurring additional cost. **To avoid these costs, Governments may have to provide similar facilities for mortgaging to commercial banks as are applicable to the cooperatives.**

3.25 Capacity building of borrowers. Imparting training to the unemployed people in preparing project profiles, product design, product promotion, pricing, marketing, accounting and acquainting them with bank's procedures and formalities, etc. could provide excellent opportunities for profitable self-employment or successful micro enterprises. This would also enlarge the number of potential borrowers for the banks. Few banks have set up Rural Development and Self-Employment Training Institutes (RUDSETI) in some of the States for the purpose of imparting training exclusively to the unemployed people of the rural areas for undertaking micro-enterprises which have bearing on sustenance of micro-enterprises. Some banks, e.g., Punjab National Bank, have set up training centres for the agricultural producers. It was reported to the Committee that such measures evoke very good response from farmers and enlarge the clientele of the banks. **Other banks may consider setting up such training institutes in different regions with the objective of providing training to the farmers.**

Use of Information Technology.

3.26 Developments in information and communications technology have not been properly harnessed by the banking system in extending its outreach and providing innovative ways of access to banking services by the rural people. Assistance in setting up of village kiosks as a distribution channel has distinct advantages. These kiosks can be used for information on the sources of inputs as also outlets for marketing the agricultural produce.

3.27 Communication and Information Technologies have a larger role to play in dissemination of information on several aspects of farming, e.g., organic farming, precision farming, tissue culture, usage of bio-technology as well as information on market and weather conditions. **A core group of officials from banks and State Governments, the latter representing departments such as horticulture, agriculture, animal husbandry together with the experts from agriculture universities may be constituted in each State to look into the scope of communication and information technologies in transforming agriculture into diversified and vibrant commercial enterprises.**

Procedural issues

3.28 Procedural modifications in regard to agricultural advances, e.g., simplification of procedures/forms in respect of applications, agreements etc., rationalisation of internal returns of banks, delegation of more powers to branch managers, introduction of composite cash credit limit to agriculturists, introduction of new loan products with savings components, cash disbursement of loans, dispensation of 'No Dues Certificate', discretion to banks on matters relating to margin/security requirements for agricultural loans above Rs.10,000/- etc. were introduced as per recommendations of the R.V.Gupta

Committee. However, the field visits by the Committee indicated that cumbersome procedures persisted and few banks have complied with the abovementioned directives. Further, several branches of commercial banks insist on unreasonably high margin money or fixed deposits for sanction of loans, sometimes not commensurate with the quantum of loans. Such insistence results in denial of loans to even to the worthy borrowers who may not have adequate cash/ collateral on hand. Controlling authorities of banks may review these lapses and take appropriate steps.

3.29 It is also suggested that RBI may advise banks to waive margin/ security requirements for agricultural loans up to Rs. 50,000/- and in case of agri-business and agri-clinics up to Rs. 5 lakh. The stipulation of minimum acreage of 6 acres fixed by NABARD for financing purchase of tractors may be done away with. This may be left to the commercial judgment of the banks. Similarly, the existing restriction on financing purchase of second hand tractor / power tillers may also be modified for financing purchase of such machines which are not more than five years old. In view of the need to enhance the availability of agricultural machinery, implements, inputs etc., the present ceilings for lending under priority sector to the dealers of agriculture machinery, cattle and poultry feeds and inputs of production may be reviewed.

3.30 At present, scales of finance are adopted by the banks on the basis of traditional inputs. In the context of adoption of new technologies and improved varieties of inputs, there is a need for raising the scales of finance adopted by banks. **The scales of finance may, therefore, be reviewed by the State Level Technical Committees after taking into account costs of inputs, nature of soils, types of crops raised etc. in the respective states.**

3.31 Service Area Approach – Need for Modification.

The Committee was asked to comment on the need to modify Service Area Approach (SAA) in purveying credit in rural areas. Following paragraphs summarise our views on this subject.

3.32 The Service Area Approach for lending to rural sector was introduced in 1989 with a view to achieving planned and orderly development of the rural areas. Several relaxations have subsequently been made to bring in flexibility in the system. Yet there remains a mismatch between the credit potential and deployment of credit primarily due to absence of effective local level planning , available infrastructures and forward and backward linkages.

3.33 The R.V.Gupta Committee had, in its recommendations, suggested significant modifications in SAA, to provide freedom to the borrowers as well as to bank branches in the rural areas. Some of the limitations of SAA presented by the bankers and other knowledgeable persons are as follows.

(i) The borrowers are forced to approach only the service area branch, even if they are not satisfied with quality of its service.

(ii) The private sector banks are also required to comply with the target for lending to agriculture. However, due to absence or limited presence of branch network, they are not in a position to comply with the requirement. They are also not in a position to extend finance in rural areas due to SAA restrictions.

(iii) Despite RBI's instructions, non-Service area branches wait for 'no-objection' certificate from the Service area branch even beyond 15 days, thereby inordinately delaying the providing of finance to agriculturists.

(iv) In some of the states, few branches have been allotted unmanageably large number of villages, with the result that the resources of the branches are thinly distributed and the credit needs of certain villages are not adequately served.

Some of the public sector banks have represented to the Committee that due to the limitations imposed by the SAA , they are not in a position to comply with the target for agricultural lending.

3.34 While certain features of SAA could act as constraints in the expansion of business of banks, one feature that would be difficult to remove/ replace is the planning and monitoring mechanism it has put in place over a period of time. Under the 'bottom-up' approach to credit planning started with the SAA, branch credit plans get aggregated into block level credit plans and subsequently into district level plans. The Block Level Bankers' Committees established under the Scheme provide the first tier monitoring mechanism, not only for reviewing performance of banks, but also for coordinating with local level government agencies engaged in development administration. Thus, while there is a case for reviewing the SAA, the positive features need to be maintained in the modified version. The Committee suggests the following modifications in the existing set up.

3.35 Service Area Approach should be mandated only for government sponsored programmes

In view of the drawbacks enunciated earlier, the SAA may be dispensed with so far as lendings outside the government sponsored schemes are concerned. This will ensure competition and improve customer service. For the purpose of lending under government sponsored schemes, however, the SAA may be continued.

3.36 Need to Change the Format of Village Surveys. The Village Survey Formats introduced way back in 1989 are still in vogue. This format needs to be revised for collecting information about the linkages to achieve integration between the credit deployment by the banking system and the non-credit support services required for proper utilisation of credit.

3.37 Strengthen Credit Monitoring and Information System
We concur with the recommendations of ECRC that the monitoring mechanism through Service Area Monitoring and Information System (SAMIS) may be strengthened and wherever necessary may be modified. Various new loan products and schemes have been introduced by the Banks subsequent to introduction of Service Area Approach. **The Reserve Bank of India may factor these while modifying SAMIS to facilitate monitoring the progress of the credit disbursement under Annual Credit Plan in a more focused and effective manner.**

3.38 Review of Lead Bank Scheme. The organisational set up of lead banks at District level and State level was considered as a key factor in contributing to all round development of rural economy in a planned and orderly manner. As such, the Lead Bank will continue to coordinate the preparation of credit plans, implementation of the poverty alleviation programmes, submission of returns under SAMIS etc. The Committee was informed by several knowledgeable persons that the Lead Bank set up is currently not equipped adequately in terms of technical and non-technical manpower and other supportive facilities to be an effective arrangement. There is, therefore, a need to review the Lead Bank Scheme.

****

Appendix Table

Disbursement of loans for Agri. and Allied Activities(ST and LT) - Share in Total Disbursements (%)

Region/State	1990-91	1995-96	2001-02
Northern Region	**12.9**	**11.6**	**19.9**
Haryana	2.8	2.2	4.4
Himachal Pradesh	0.2	0.4	0.6
Jammu and Kashmir	0.2	0.1	0.2
Punjab	6.3	5.7	10.4
Rajasthan	3.2	2.5	3.6
Chandigarh	0.1	0.6	0.5
Delhi	0.1	0.1	0.1
North-Eastern Region	**0.4**	**0.4**	**0.5**
Assam	0.2	0.3	0.3
Manipur	0.0	0.0	0.0
Meghalaya	0.0	0.0	0.0
Nagaland	0.0	0.0	0.0
Tripura	0.0	0.0	0.1
Arunachal Pradesh	0.0	0.0	0.0
Mizoram	0.0	0.0	0.0
Eastern Region	**8.3**	**6.4**	**7.4**
Bihar	2.4	2.0	2.2
Jharkhand	0.0	0.0	0.4
Orissa	3.0	1.5	1.0
Sikkim	0.0	0.0	0.0
West Bengal	2.8	2.9	3.8
Andaman & Nicobar Islands	0.0	0.0	0.0
Central Region	**16.9**	**16.4**	**14.1**

Madhya Pradesh	7.5	9.0	3.9
Chhattisgarh	0.0	0.0	0.5
Uttar Pradesh	9.4	7.5	9.3
Uttaranchal	0.0	0.0	0.5
Western Region	**13.6**	**17.1**	**14.4**
Gujarat	5.1	9.8	7.2
Maharashtra	8.3	7.0	7.1
Daman & Diu	0.0	0.0	0.0
Goa	0.1	0.3	0.1
Dadra & Nagar Haveli	0.0	0.0	0.0
Southern Region	**47.9**	**48.0**	**43.8**
Andhra Pradesh	14.5	15.5	13.5
Karnataka	6.3	8.8	9.7
Kerala	8.2	6.2	5.5
Tamil Nadu	18.6	17.1	14.9
Pondicherry	0.3	0.3	0.3
Lakshadweep	0.0	0.0	0.0
All-India	**100.0**	**100.0**	**100.0**

Source RPCD, RBI

SECTION- IV

REDUCING COST OF CREDIT TO AGRICULTURAL BORROWERS

Introduction

4.1 Interest rate is an important component of cost to agricultural producers and will become more important as backward and forward linkages are strengthened. The committee has, however, come to the conclusion that in the present circumstances a mandated rate of interest will affect different RFIs in dissimilar ways, and most of them adversely. At the same time committee suggests that there are several measures of reducing cost of funds, transaction costs and the risk costs, which if properly implemented would reduce the cost to the borrowers without impairing viability of RFIs..

4.2 Interest rate on loans given to agriculture sector by commercial banks, as per the current interest rate policy of Reserve Bank of India, are linked to the size of the loan. While the interest rate on loans up to Rs 2 lakh should not exceed the Prime Lending Rate (PLR) of the banks, commercial Banks are free to determine their lending rates on loans above Rs 2 lakh. Banks generally arrive at the PLR by adding together cost of funds, transaction cost, risk cost and profit margin. During the year 2002-03, the PLR of commercial banks ranged between 9 and 12.25 per cent. In the case of RRBs and cooperative banks, however, interest rates on loans stand totally deregulated and the concept of PLR is not applicable to them.

4.3 With a view to providing the benefit of declining interest rates to agriculture sector in general and to small and marginal farmers in particular, the Union Finance Minister announced on July 16, 2003 a reduction in the lending rate for agriculture. The Indian Bank Association has since advised all public sector banks to reduce their lending rate to a single digit rate of not more than 9% per annum on crop loans up to a ceiling of Rs.50,000/-. NABARD has also issued appropriate instructions to cooperative banks and RRBs.

Recommendations of Earlier Committees

4.4 Earlier committees addressed the issues related to rates of interest. Recommendations of some of the committees , in brief, are given below.

a) The R.V. Gupta Committee on Agricultural Credit through Commercial Banks

This Committee had noted that viability of lending for agriculture depended on a number factors such as appropriate volumes, acceptable levels of recovery and a margin to cover cost of funds as well as expenses in sanctioning, supervising and recovery of loans. The Committee had observed that commercial banks were offering lower rate of interest on loans up to Rs. 2 lakh through cross subsidization of rates of interest, which implied that an extra loading of interest cost was being given to loans above Rs 2 lakh. The Committee viewed this as an inefficient form of fixing interest rates and recommended that commercial banks should be free to fix their rates for small loans of all amounts as has already been done in the case of cooperative banks and RRBs.

b) The Expert Committee on Rural Credit (TheVyas Committee)

The committee had observed that cooperatives were free to fix their rates of interest on deposits as well as loans and advances. Cooperatives in most of the states had taken advantage of this relaxation and had hiked the interest rates by as much as 3 percentage points as compared to commercial banks. The higher interest cost to borrowers, however, did not normally translate into higher net profits for these institutions, because of their own payment of higher interest on deposits, high transaction costs and higher credit risks in many states. The Committee had also observed that if commercial banks were free to choose the rate of interest even on loans up to Rs 2 lakh, they would have possibly made such loans at 2 or 3 percentage points higher than their PLR. This would have improved their earnings substantially.

c) The IBA Working Group on Agriculture Credit (The Samal Committee)

The Committee had examined the need for a change in the regulatory guidelines regarding interest on small loans up to Rs 2 lakh and had felt that then existing guidelines were flexible enough and enabled banks to charge interest below PLR. Some of the banks were already offering interest at PLR on loan to agriculture up to Rs 5 lakh and had also introduced sub-PLR lending under this segment. The Committee had expected that market competition would bring down interest rates on farm credit and had recommended that the banks to review their interest rates structure for agriculture credit to make their lending schemes more attractive.

Recommendations

Costs and margins of banks

4.5 While the commercial banks have reduced their interest rates on crop loans up to Rs 50,000 to 9 per cent and below, RRBs and cooperative banks, for various reasons, have not been able to bring down their rates of interest on lending to any appreciable extent. This has put them at a disadvantage as compared to the commercial banks.

4.6 In the three-tier cooperative credit structure, each tier adds its costs and margins to the interest rates and ultimately, the borrower gets credit at relatively higher rate of interest. The interest rate structure in the case of cooperatives varies from state to state. In several states, the margin charged by DCCBs is around 2 -2.5-percentage points, while the SCBs charge around 0.5 to 0.75-percentage point. With PACS adding another 2 – 2.5 percentage points, the cumulative impact of all this is much higher cost to the ultimate borrower. To ameliorate this problem partially, the NABARD Act, 1981 was amended in September 2003 to enable NABARD to provide refinance directly to DCCBs provided these banks and their respective State governments adhere to certain stipulated conditions. This may enable the cooperatives to bring down, to some extent the rate of interest charged to the ultimate borrowers.

4.7 With a view to examining whether banks enjoy positive margins on loans to agriculture and, if so, the extent of such margins, their sustenance and their impact on their economic viability, an attempt is made at aggregate level to analyze the margins, cost of funds, transaction and risk costs of bank and margins available to them. The findings of the analysis are presented in the Annexure. This analysis seeks to simulate the impact of a further reduction of rate of interest on "agricultural loans" by 2 % below what was prevailing at the end of the respective reference year.

4.8 As may be seen from the Annexure, there could be a differential impact on the profitability of the different categories of banks as their costs and revenue streams differ very widely. The sustenance of profitability of banks depends on magnitude of the profits earned in the pre reduction situation, relative weight of agriculture portfolio in the total loans and advances and other associated factors. While the commercial banks at aggregate level appear to be in a position to absorb reduction of rates by 2 per cent on their agriculture lending, profit-making RRBs can sustain such a reduction in the rate of interest on their agriculture lending provided their accumulated losses are ignored. With reduction of 2 per cent in the interest rates RRBs earning a slender net margin of one per cent or less (59 RRBs) would become loss making. The health of loss making RRBs would, however further deteriorate if any reduction in lending rate was to take place. DCCBs at the aggregate level seem to break even at the existing rates of interest. Any further reduction in interest rates on their agriculture loan portfolio may lead to deterioration in their financial position.

4.9 The Committee feels that interest rate is an important aspect of credit. The Committee takes cognizance of the growing expectations of uniformly lower interest rates on loans by different agencies i.e. commercial banks, RRBs and cooperatives, extending credit to agriculture. However, in the present set-up, there cannot be a single mandatory rate of interest for all banks as the capacity of different agencies to deliver agricultural loans at lower rates of interest varies because of their differential cost structure. What ultimately matters to the borrower beside rate of interest is timeliness and adequacy of credit. Further he has to consider the concomitant costs that may have to be incurred in availing of credit. **Therefore, attention needs to be given by the banks to their systems and procedures, so that their lending becomes more cost effective and measures which would save the borrower avoidable expenses for getting a loan sanctioned.**

Components of cost of credit

4.10 Cost of credit to farmers could be further brought down provided the banks contain the various components of the cost of credit. The important components of cost of credit are a) cost of funds b) transaction cost, and c) risk cost

Cost of funds

4.11 The committee has examined the cost of deposits as this provides the predominant source of working funds of banks. With southward movement in rates of interests on deposits, the cost of funds of commercial banks is on the decline. At present their rates of interest on term deposits are in the range of 5% to 6% per annum while their savings deposit rate is at 3.5 per cent.

4.12 Cost of funds in RRBs is somewhat higher as compared to that of commercial banks as RRBs in the past had accepted long-term deposits by offering higher rates of interest; these deposits are yet to mature. Credit from the sponsor banks, one of the components of working funds of RRBs is available, reportedly, at higher rate of interest than the prevailing market rates. NABARD refinance is also reported to be comparable with their term deposit rates, consequently restricting their ability to reduce their lending rates. However, to compete successfully, RRBs too have to bring down their lending rates in line with interest rates of commercial banks.

4.13 The rates of interest charged to the ultimate borrowers by the cooperatives have been in the range of 12 per cent to 14 per cent. Even in the northeastern states where two-tier cooperative structure exists the rates of interest are in the range of 11 per cent to 13 per cent, comparable with rates prevailing in some of the states having three-tier system. Only in a few states like Andhra Pradesh where the state government is subsidizing interest to the extent of 5 per cent, ultimate rate charged to the final borrower is 7 per cent. The committee does not favour the States subsidizing rates of interest and distorting the interest rate structure unless there are some extraordinary and compelling reasons.

4.14 The higher rate of interest charged by cooperatives is partly due to cumulative impact of the margins retained by the different tiers of the structure, and partly due to higher cost of funds. Working funds of cooperatives consist of deposits (80 per cent) and refinance from NABARD (20 per cent). Cost of deposits of cooperatives is also relatively higher because of higher proportion of term deposits, which carry relatively higher rates of interest. Besides, cooperatives also offer slightly higher rates than their counterpart commercial banks in order to attract the depositors. The proportion of low cost funds i.e. refinance, forms only 20 per cent which does not provide them much leverage to dispense credit at lower rates of interest.

4.15 The cooperatives apprehend paucity of funds in the near future as the depositors are shifting to other saving channels like post offices, as recent scandals in a few urban cooperatives seem to have tarnished the image of cooperatives. Limited scale economies due to operational area being confined to one or two villages in the case of PACS and one or two districts in the case of DCCBs, also seem to be not providing scope for reduction in the rates of interest of the cooperatives.

4.16 Considering the fact that the old high cost deposits will be retired in a couple of years there appears a possibility of cost of funds going down by 0.5 % to 1.0 % across the banks. This decline would be more pronounced in case of DCCBs and RRBs, given their large share of high cost deposits. However, in view of the fact that 40 RRBs and 105 DCCBs have negative net margins, such a decline in the cost of fund may not immediately get reflected in the reduction in their rates of interest on agricultural loans. Therefore, availability of funds at reasonable cost may continue to be an important element of cost reduction for a large number of DCCBs and RRBs.

4.17 In the case of SCARDBs (LDBs), till such time they are in a position to mobilize low cost deposits, their costs will continue to be influenced by extent and rate of refinance.

Transaction Cost

4.18 The transaction costs of banks also include the establishment cost and cost of management / manpower. The possibilities for reduction in transaction cost could come either from (i) increase in volume of business per employee or (ii) reduction in expenditure on establishment and manpower. While some of the commercial banks have taken initiatives for introduction of innovative loan products for expanding their loan portfolio, most of the RRBs and DCCBs have yet to take any concrete steps in this regard. Further simplification of loaning procedures, documentation, use of KCC, single window approach for meeting all the credit requirements, including consumption credit, village level planning, project formulations, etc. could contribute to the expansion of credit business and bringing down the transaction cost per unit of employee.

4.19 Given the issues facing rural credit such as wide territorial spread, large number of clients, small loan requirements, difficulties in asset verification and absence of social pressure for timely repayments it is not easy to reduce transaction costs. However, some of the banks have been successfully trying various approaches such as associating Farmers' Clubs, NGOs and even individual rural volunteers in reaching out to the clients in the cost effective way. Some of the banks like Prathama Bank [UP] and Avadh Gramin Bank [UP] have demonstrated that such approaches can yield significant reduction in transaction cost and also help in business expansion with the same number of staff. The Koraput RRB in Orissa, with limitations of credit expansion in view of backward nature of its area of operation, has engaged the services of rural volunteers in promotion of SHGs with successful results. Notwithstanding successes in different parts of the country, the idea of externalizing some of the rural credit functions has not extensively been adopted by the banks, except in the case of a few the private sector commercial banks, which have been piloting such initiatives aimed at using NGOs as business development agents on payment basis. **The committee therefore recommends that the banks may have to devise innovative ways so that such facilitating agents can act as links between the branch and rural clients.**

4.20 While addressing the reforms in cooperative credit structure, the focus has been on 'revitalization' of weak cooperatives at the district and the state levels. With increasing number of weak cooperative banks, many of the good working PACS are experiencing difficulties of inadequate access to credit and / or delayed access to DCCBs. A weak higher financial structure also leads to weakening of lower tiers. **In this context, possibilities of building synergy between good working PACS and commercial banks need to be explored. Even the credit support / guarantees for marketing of inputs / outputs could be extended by commercial banks to the identified PACS.** Detailed measures to be adopted for increasing the business volume are given in the earlier section on outreach.

4.21 The Committee's views on structural issues relating to RRBs are furnished in a separate chapter. As regards cooperatives, the rigidity of the three-tier system leads to addition to the cost of credit to the ultimate borrower. **The Committee feels that if three tiers do not contribute to the improvement in efficiency and ultimate reduction in cost of credit to the borrower, there would be a case for elimination of one of the tiers.**

4.22 Recent product innovations of financial institutions include the issue of KCCs to the farmers. It has been decided to include all the eligible farmers under KCC scheme by the end of this year. Different commercial banks have introduced the variants of KCCs having value-added services like SBI's Gold card, Bank of India's Suvidha card etc. **These cards could be made ATM enabled and converted into smart cards to reduce the transaction costs as also to provide better customer service.**

Information technology (IT)

4.23 Information technology (IT) holds key to reduction in transaction cost and increase in business volumes of banks. The impact of IT is at two levels: (i) in the internal management and accounting/ record-keeping/ MIS in the banks and (ii) in reaching out to the clients outside. While the first would include computerization of the operations of bank branches and connectivity through networking, the second would include setting up of information kiosks etc. in rural / semi-urban areas which would help banks in reaching out to a larger number of existing/ potential customers and provide them with access to information at various levels (ITC's e-choupal experiment is an example).

4.24 Reducing transaction costs in urban areas and metropolis through new information technology has facilitated banks to provide banking facilities "any time and anywhere". The introduction of this technology to a large extent has reduced the cost of manpower in these centres. **The pace of the adoption of this technology in the rural areas, however seems to be very slow partly because of its cost intensive nature and partly because of the non- availability of the basic infrastructure like electricity. However, the low cost ATM machines operated on the diesel generator sets could be used in the rural areas for cash dispensation. Wherever volume of business justifies, the computers in the rural branches of banks may be networked for a free flow of intra branch and inter bank information. This may obviate the necessity of staff moving to various offices and give them more time for servicing the clientele. However for this, certain constraining factors like reliable power supply, reliable connectivity, and problems associated with bandwidth, facility management and facility maintenance in the rural areas, etc. need to be taken care of. The banks must formulate a time bound programme for use of IT in their rural branches.**

Risk Cost

4.25 Risk costs are one of the cost drivers, which play a decisive role in determining the rate of interest charged by banks to ultimate borrower in the rural areas. Risk costs emanate from a host of factors including failure of investments, wilful defaults, weather aberrations, improper appraisal of loans, diversion of funds, inadequate follow up and inability to realize the securities available. If credit risk could be disaggregated into factors such as failure of rainfall, price fluctuations, poor health and death of the borrower, etc., these could be mitigated through non-credit financial products like insurance and derivatives. This could facilitate the banks to provide credit at a lower rate.

4.26 The prompt repayment of loans by the borrowers to banks will not only enable the banks to recycle the funds but also help them to reduce the transaction cost. While various factors both on demand side and supply side such as inadequate loan amount, lack of timeliness, problem of multiple borrowing and weather aberrations seem to have been adversely affecting recovery of loans in varying degrees, the implementation of loan / interest waivers announced by Central and various State Governments from time to time have been vitiating the repayment culture among the borrowers. Such polices have to be desisted in order to inculcate prompt repayment culture among the borrowers. At the same time, there is a need to devise a proper incentive structure for prompt repayment of loans. **The Committee, therefore, recommends that banks may decide on the incentive structure for prompt repayment with the approval of their Boards. Further, to overcome some of the supply side factors contributing to non-recovery of loans banks may review and revise their project appraisal procedures. Proper appraisal of loan proposals and post disbursement supervision will reduce the risk costs. There is therefore a need for further sensitizing and training the rural branch staff in this regard.**

Risks in agriculture

4.27 The risk faced by the farmers could be systemic or covariate i.e. common to a large group of farmers/ producers, or they could be individual or idiosyncratic.

Individual risk

4.28 The farmers on their own adopt many risk mitigation mechanisms to meet idiosyncratic risks such as selling stored produce, liquidating assets, participation in the labour market, etc. Other individual level strategies include adoption of technology pertaining to inter-cropping or drought resistant crops and contractual share cropping which reduce income variation. The personal insurance arrangement more often offers protection against individual risks. The life insurance products appropriate to the economic condition of the agriculturists are not available to most of the borrowers except KCC cardholders. There is therefore an urgent need for more innovative products in this category. Under SHG model of lending in some states, the borrower enjoys life insurance cover for self and his / her dependents. The insurance products that provide protection against accidents and critical illness can help retain the borrowers ability to repay.

4.29 The other major reason for impairment of the repaying capacity of the farmers is the wide fluctuations in the market prices of the commodities. Though Minimum Support Price (MSP) mechanism aims to provide some protection to the farmers, it has limitations of spatial coverage, as it is a subsidy-based programme. **Contract farming is another private mechanism that helps the farmers to cope with private risk as it provides a guarantee of buy back of the produce from the farmers at a predetermined price and transfer the market risk to the contractors.**

4.30 The derivative markets and commodity markets provide insurance against the price volatility through which the farmers can hedge market risks. However, these markets are not yet well developed in India because of absence of linkages between geographically dispersed commodity markets, absence of systematic processes and facilities for cleaning, grading, sorting, warehousing and transportation of commodities. Commodity exchanges enable a better price discovery and access to better price risk management mechanism. Derivative contracts could be cost effective for managing price and weather risk. Dematerialized warehouse receipts could themselves be traded directly on exchanges in a manner similar to the equities. Establishment of NCDEX is a right step in the direction to hedge risk through market mechanism. **Farmers' participation in the commodity exchanges could be increased through education, dissemination of index price information, investing in rural connectivity and building warehousing capacity.**

Systemic Risk

4.31 The systemic risk i.e. common to a large group of farmers/ producers could be mitigated through crop insurance. The traditional crop insurance based on the claims verification does not seem to have proved to be highly successful except in certain pockets and that too for a few cash crops. Further under this scheme the premium to be charged to the farmers was not computed on 'actuarial basis' but at a flat rate, resulting effectively in an increased rate of interest on the credit availed. While for crops like paddy and wheat the premium rate was 2 per cent due to subsidy provided the State Governments, in the case of cash crops like cotton, tobacco, etc. it was as high as 7 per cent and 8 per cent which would raise interest rate up to

19 per cent. **While the present crop insurance scheme, to some extent, covers the production risks, there is a need to devise innovative farmer friendly insurance products without involving high overheads and supervision costs like index based rainfall insurance being experimented on pilot basis by an insurance company. To cover market risks particularly during years with bumper crops, price risk exposure could be covered by the banks, taking forward-trading positions to the extent of the perceived risks, and by taking advantage of the commodity exchanges in operation now.**

4.32 While restructuring of loans, as discussed in Section V of the report, may give some temporary relief to the farmers, it is necessary to have a long term remedy to take care of impairment of repaying capacity of the farmers due to continuous external adversities like droughts and floods. **The committee, therefore, recommends setting up of an "Agri-Risk Fund" with equal contribution from the Central and State Governments and the participating banks. Such a fund, the committee feels, would mitigate risk of the lending banks as they can have recourse to the fund in the event of genuine default and it would also mitigate the hardships of the farmers.**

ANNEXURE

Aggregate margins available to the banks

Agency	Financial Margin	Cost of Management	Mis. Income	Risk Costs	Net Margin
CBs [2002-03]	2.91	2.24	1.66	1.35	0.98
RRBs [2002-03]	3.48	2.98	0.76	0.34	0.92
DCCB [2001-02]	2.99	1.69	0.60	1.91	-0.01

[**Source** : Report on Trends and Progress 2003 for CBs, NABARD data for RRBs and CBs]

Estimate of likely impact at aggregate level on Costs and Margins of Public Sector Commercial Banks (2003) in the event of reduction of rate of interest on agricultural loans by 2 %

(% age to total assets)

	Description	Actual %	Revised %
A.	Financial Return Cost Margin	 8.34 5.44 2.90	 8.20 * 5.44 2.76
B.	Transaction Cost total	2.25	2.25
C.	Miscellaneous Income	1.66	1.66
D.	Gross Margin	2.31	2.17
E.	Risk Cost (Provisions Total)	1.36	1.36
F.	Net Margin	0.95	0.81

Source : Report on Trend and Progress of Banking in India 2002-2003

* Based on the percentage of direct agriculture credit outstanding as a percentage of Net bank Credit of the public sector banks, the absolute figure of agriculture outstanding has been arrived at assuming that in the agriculture sector also the slab wise loan composition is almost same as that of the aggregate level agriculture loan outstanding was multiplied by the weighted average of interest rate on the loans and advances. The revised figures have been worked out by reducing 2% flat rate from weighted average interest rate

Costs and Margins of Profit and Loss Making RRBs (2003)

[%] to total assets]

Description	Profit Making		Loss Making		Total	
	Actual %	Revised %	Actual %	Revised %	Actual %	Revised %
Financial i) Return ii) Cost iii) Margin	 9.93 6.12 3.81	 9.57 6.12 3.45	 7.98 6.23 1.75	 7.66 6.23 1.43	 9.62 6.14 3.48	 9.26 6.14 3.12
Transaction Cost total	2.42	2.42	3.53	3.53	2.59	2.59
Misc. Income	0.40	0.40	0.52	0.52	0.76	0.76
Gross Margin	1.80	1.43	-1.63	-1.96	1.25	0.9
Risk Cost (Provisions Total)	0.26	0.26	0.72	0.72	0.34	0.34
Net Margin	1.54	1.17	-2.36	-2.68	0.92	0.56

(46 % percent of the total outstanding have been assumed to be direct agriculture advances).
[**Source :** NABARD]

Costs and Margins of DCCBs (2002)

[% ages to total assets]

	Description	Actual %	Revised %
A.	Financial Return Cost Margin	 10.13 7.14 2.99	 9.58 7.14 2.44
B.	Transaction Cost total	1.69	1.69
C.	Miscellaneous Income	0.60	0.60
D.	Gross Margin	1.90	1.35
E.	Risk Cost (Provisions Total)	1.91	1.91
F.	Net Margin	-.01	-0.56

(50% of the total outstanding have been assumed to direct agriculture advances)
[**Source** : NABARD]

SECTION V

NPA NORMS IN AGRICULTURAL FINANCE

5.1 As part of the prudential norms framework for banks, norms for income recognition, classification of assets and provisioning for Non-Performing Assets (NPA) were introduced by the Reserve Bank of India in the year 1992-93. These norms are aimed at identifying non performing assets, which have ceased to earn interest at the stipulated rates or in respect of which instalments of principal which have fallen due have not be repaid within the stipulated time, and ensuring that unrealized income therefrom is not factored into the income stream of the bank for the purpose of preparing the profit and loss account. Further, current prudential norms on classification of non-performing loans track loan defaults not only to the specific loan account, but, also to the borrowers; recognition of any single loan account of a borrower as NPA automatically leads to classifying of all the other loans due from the same borrower as NPA, even if repayment on other loans is regular.

5.2 The extant norms for classification of agricultural loans as NPA for the commercial and cooperative banks are as follows :

Commercial Banks

5.3 In respect of advances granted for agricultural purposes, where interest and/or instalment of principal remains unpaid after it has become overdue **for two harvest seasons but for a period not exceeding two half years**, such an advance should be treated as NPA. These norms are applicable to direct agricultural advances only.

5.4 In respect of agricultural loans, other than those specifically mentioned in the Master Circular No. DBOD. No.BP.BC.15./21.04/048/ 2003-04 dated 22 August 2003, identification of NPAs **would be done on the same basis as non-agricultural advances.** Such advances attract the 90 days delinquency norm with effect from March 31, 2004.

Cooperative Banks

5.5 In respect of agricultural advances of SCBs and DCCBs where interest payment is on a half-yearly basis synchronising with harvest, the banks have been advised to adopt the agricultural season as the basis. **It is stipulated that if interest is not paid during the last two seasons of harvest (covering two half-years) after principal has become overdue, such advance should be treated as NPA.**

Need for revisiting the current NPA guidelines

5.6 Agriculture as an economic activity suffers from uncertainties mainly on account of fluctuations in rainfall, pest attacks, floods, droughts and other natural calamities. Such uncertainties are particularly severe in rain-fed areas. Inadequate rainfall, for example, results in restricted income flows to the farmer, leading to impairment of capacity to repay. However, over a period of the cycle (which may be different in different agro-climatic zones) the cash flow may get smoothened. While during some years in the cycle the loans may not be repaid, there is always the possibility of the dues being cleared over a period, provided of course, the farmer's cash flow is not debilitated by successive droughts. Agricultural loans support livelihood activities of the farmers. Normally, they would not behave in a manner which would permanently jeopardize the credit support required to earn their livelihood. Seen from this point of view, an agricultural loan, even if it is not repaid on time in the same season on account of climate related problems, could eventually be repaid out of income in subsequent seasons, if the borrower is able to sustain himself during the intervening period and his overall debt burden does not financially annihilate him. In this background, it is considered necessary to reckon the cash flows of the borrower from farm activities and accord differential treatment for the purpose of recognition as NPAs and the extant guidelines be revised to be in tune with the ground realities and to capture the seasonal uncertainties.

5.7 The present norm of NPA of non-recovery of interest / principal up to two crop seasons or covering two half years after the due date, does not fully mirror the differing crop maturities, some of which may extend up to 18 months. There are also regional disparities in the duration of the crops. The logic of fixing the repayment dates in tune with harvesting is to link it with the cash flow of the farmer, coinciding with the harvesting/marketing of the crop. In the case of longer duration crops, the current prescription of two half years would not be adequate. **It is, therefore, recommended that while the current norm of default for "two crop seasons" could be retained for classification of loan as a non-performing loan, the norm of "two half years" be removed. The "crop season" for this purpose means the period required for the crops to mature for harvesting. To avoid adoption of arbitrary norm by any individual bank, the duration of the crop season for different crops in a given area could be determined by the technical committee appointed for the purpose of fixation of scales of finance, in consultation with agricultural scientists and be ratified by DLCC/SLBC.**

For the purpose of arriving at "two crop seasons after the due date", only those two consecutive crop seasons may be reckoned during which the farmer borrower normally undertakes crop production.

5.8 As regards the long duration crops, it is suggested that while the cap of "two half years" may be removed, a loan may be treated as non-performing, if interest or principal remains unpaid for one crop season after becoming due.

5.9 Both the crop loans and the agricultural term loans are repaid out of the income generated from the crops grown. In the event of failure of crops due to natural calamities like earth quake, floods and droughts if the crops are affected badly not only the crop loan recovery gets affected but also that of the term loans. **Therefore, the relaxations suggested in respect of crop loans may also be, *mutatis mutandis*, made applicable to the agricultural term loans.**

5.10 The advances to allied agriculture activities at present are treated on par with non-farm activities for the purpose of asset classification without any linkage to the crop situation. The allied agriculture activities pursued by the farmers are closely linked to the agriculture sector. Further, income from these activities is also not evenly spread throughout the year. The income received from allied activities to agriculture, which are taken as subsidiary activities to augment income of a cultivating family may not be adequate to repay the bank loan and interest besides sustaining the family, once the principal activity of the farmer is adversely affected. Further, the uneven spread of surplus cash generation from these activities bring in temporary distortions in cash flows at times leading to delayed repayment of loans. The present 90 day norm for classification of NPA as applicable to these activities, does not take into account such temporary disruptions in cash flows at the farmer level. **Therefore, it is suggested that the earlier delinquency norm of 180 days default for classifying a loan as NPA may be continued in respect of loans for activities allied to agriculture.**

5.11 Generally, the farmers who avail of agricultural term loans also borrow for crop production. As per prevailing guidelines on classification of assets, outstanding amount of all the loan accounts of a borrower are classified as NPA even if there is a default in one of these accounts. Distinguishing between crop loan account and term loan account would facilitate the banks in ensuring availability of credit for production process. **It is recommended that in such cases, where farmer has availed both production loans and investment loans, only that loan account in which default has occurred may be considered for NPA classification and outstanding in those loan accounts which are regular not be included as NPA.**

5.12 The procedure of declaration of *annawari* by the State Government is cumbersome and takes a long time. As a result, conversion of the existing loan and sanction of fresh credit to the farmers also gets delayed and results in loans being classified as NPA, even where it is possible to restructure these loans. To avoid such delays, the Lead District Manager of the Lead Bank, should arrange to get timely information on crop losses in the district due to flood / drought, etc. from the district authorities. **On the basis of such information, a committee headed by the District Manager of the Lead Bank, with District Development Manager of NABARD, District Agriculture Officer and a few major banks operating in the district may, in consultation with agricultural scientists / local agricultural university, consider the crop losses due to weather aberrations, e.g., deficit in rainfall, etc., in the district and take a decision on conversion / restructuring of agricultural loans. All the banks operating in the district should be able to extend the facility of restructuring of loans to the eligible farmers on this basis once such a decision is made. Such a decision should be promptly reported to the convenor of the SLBC and may be recorded in the proceedings of the immediate following meeting of the SLBC. The banks may authorise their branches to take up conversion / rescheduling of loans based on the recommendations of the above mentioned district level committee.**

5.13 Apart from large-scale calamities, some farmer-specific events beyond their control impair the repayment capacity temporarily. Major ailments affecting any member of the farm family, damage to house and agriculture assets through fire, localized pests, etc., are some illustrations of such events that could temporarily impair the repayment capacity. **In such cases, the banks may have the freedom to allow restructuring of loans on a case-to-case basis, ensuring that this does not lead to ever greening. Such a restructuring of loans should be with the specific approval of the controlling authority of the branch.**

5.14 The conversion and restructuring of farm loans should be done at reasonable rates of interest. Restructuring of any loans involves sacrifice of interest on the part of banks to ensure that the units remain viable after restructuring. **Applying this logic in the case of restructuring of agricultural loans, banks need to fix the rate of interest on restructured loans at a level lower than the original loan.** This would ensure that the farming operations continue to be viable and that the farmers are able to service the restructured loans as well as the fresh loans that would be extended by banks.

****

SECTION VI

IMPEDIMENTS IN FLOW OF CREDIT TO DISADVANTAGED SECTIONS

Background

6.1 Despite a wide network of rural bank branches which implemented specific poverty alleviation programmes seeking creation of self-employment opportunities through bank credit for almost two decades, a very large number of the poor continue to remain outside the fold of the formal banking system. It is also noted that the banking systems and procedures, and deposit and loan products are perhaps not ideally suited to meet the most immediate needs of the poor. There is a wide recognition of the fact that the poor need better access to timely financial services at affordable costs, rather than subsidised credit.

6.2 A recent Rural Financial Access Survey [RFAS - 2003] conducted by the World Bank and NCEAR has revealed that only 19.4 % and 24 % of the rural households accessed credit from the formal sources in the states of Uttar Pradesh and Andhra Pradesh, respectively, as against 44.1 % and 32.6 % of such households depending on non-formal sources in the respective states. The share of formal sources in total debt of the borrowing households was again low at 55.7 % and 51 %, respectively in UP and AP. Further, as may be seen from the table below, of the borrowing households, the access to formal credit by marginal and small size households was extremely low. This certainly, does not reflect a desirable situation.

Access to formal credit, total and by type of household
(percent of households)

	Marginal	Small	Medium	Large	Others	Total
AP	11.8	33.8	41.9	56.3	20.7	24.0
UP	13.5	24.7	30.8	36.1	17.7	19.4

Source: Rural Finance Access Survey (2003)

6.3 As part of the extant guidelines, the domestic commercial banks are required to extend not less than 10 per cent of net bank credit [NBC] to weaker sections comprising small and marginal farmers, landless labourers, artisans, borrowers of government sponsored poverty alleviation programmes, etc. Further, 1 per cent of net bank credit has to be extended to the very poor borrowers [having income less than Rs.6,500 p.a.] under the Differential Rate of Interest [DRI] scheme. As on 31 March 2003, as against the mandate of 10 per cent, the public sector banks had extended credit only to the extent of 6.76 per cent of net bank credit [Rs.32,304 crore] to weaker sections. Only 6 out of 27 public sector banks had achieved the 10 per cent goal for financing weaker sections while the remaining banks had achieved between 9.4 per cent and 1.97 per cent of the targets. The banks have been reporting declining trends under the weaker section financing over last few years in terms of number of borrowers, which declined from 1.76 crore as on 31 March 2000 to 1.43 crore as on 31 March 2003. The reasons for these trends could partly be attributed to write-offs made by banks, erstwhile small borrowers migrating to higher loan bracket, increasing coverage of the poor under the SHG-Bank Linkage Programme, etc. Thus, the disadvantaged sections of the society are increasingly getting sidelined when it comes to access to credit from the commercial banks.

Impediments to the credit flow to the disadvantaged sections

6.4 The major impediments to the flow of institutional credit to the disadvantaged sections are as follows

- higher transaction cost to banks and borrowers,
- procedures, systems and documentation formalities not being client friendly,
- inability of borrowers to provide tangible collateral securities
- distortion of the normal banking principles on account of linking of credit with capital / interest subsidies under various poverty alleviation programmes,
- announcements of interest / loan waivers vitiating the recovery climate,
- legal difficulties in foreclosure of loans,
- non availability of tenancy agreements / updated land records,
- inadequate risk mitigation mechanism available to small borrowers in the events of failure of their micro-enterprises and to the banks in the event of loan failures, and
- the mindset that banking with the poor is not profitable.

6.5 On the positive side, the emergence of NABARD led SHG-Bank Linkage Programme in the rural areas, with credit linkage of over 10 lakh SHGs by 31 March 2004, as the largest and fastest growing microFinance programme of the world is a major break-through achieved by the banks in the last few years. Similarly, the microFinance initiatives of SIDBI and

Rashtriya Mahila Kosh have also been showing positive results in providing access to microFinancial services to the poor through different models of credit delivery.

6.6 The following suggestions are made for addressing some of the impediments in reaching out to the disadvantaged sections of rural society :

a) **In view of the higher costs of servicing small borrowers, while institutionalising various measures discussed in Section III to improve the efficiency of credit delivery, the banks may pass on the benefits of such measures to the small borrowers by charging reasonable rates of interest on small loans.**

b) It has also been observed that for the poor, the dividing line between production and consumption needs is very thin. In the absence of access to short term consumption loans, the productive investments are impaired. It is, therefore, important to provide the small borrowers with a credit mechanism to fall back on for meeting their emergent and consumption needs. Further, it has also been brought out by various studies that the repayment of loans by the poor does not come necessarily from the 'incremental' income from the investment alone, but also from their other sources of income. **Therefore, it is recommended that banks should provide a separate flexible revolving credit limit to the small borrowers of production or investment loans for meeting their temporary shortfalls in family cash flow. Banks may evolve suitable credit products / packages in this regard.**

c) The general lack of information about the procedures followed by banks among the clients is one of the reasons for the poor to shy away from the formal institutions. **It is, therefore, suggested that banks may adopt mechanisms to reduce such information gap. The application for different loan products may contain a comprehensive check-list of documents / information to be furnished as also the procedural requirements to be complied with for availing of loans.**

d) **Availability of individual volunteers, farmers' clubs or NGOs / SHGs as 'direct selling agents' in every village would go a long way in bridging the information gap. Banks may explore the possibilities of externalising loan appraisal and monitoring functions of the branches using such facilitators as business partners.**

e) **In recognition of the growing importance of Panchayati Raj Institutions [PRIs] in the development process, it is recommended that a branch advisory committee comprising select elected representatives of the local PRIs hailing from the service area of a branch, which may include women leaders of PRIs , may be established at every rural branch which should meet at least once in a quarter. These meetings may be made mandatory and must be attended by the controlling official of the bank.**

f) **Issues in improving quality and outreach under SGSY**

The Committee was informed by the Ministry of Rural Development about the declining trends in financing under SGSY over the last few years. The Committee notes with concern the inadequate response of the banking system to the SGSY. **Based on the feedback received during the field visits by the Committee, it is felt that there is a need to have a relook into the design of the programme, especially with emphasis on moderating the timing and quantum of subsidies. As regards the emphasis on using group approach for financing, it is suggested that an in-depth study may be taken up to ensure that the issues concerning the group dynamics are properly factored in the programme design.**

SHG-Bank Linkage Programme

6.7 The SHG-Bank Linkage Programme, which was evolved by NABARD to meet the needs of disadvantaged sections of the rural society in relation to their access to financial services from the banking system, has met with significant success in southern states and states like Orissa, West Bengal, UP and Rajasthan. By March 2004, over 10 lakh SHGs were credit linked providing access to the micro finance services of savings and credit to nearly 1.50 crore rural poor families. The experience of banks, NGOs and the poor has been excellent with nearly 95 % repayments of loans. The SHG-Bank Linkage Programme has helped in credit delivery even to some landless tenants and is also found to be working well even in the areas affected by militancy.

Issues under the SHG-Bank Linkage Programme :

6.8 In the recent years, the SHG Bank Linkage Programme has been making inroads in the regions with large percentage of rural poor. However, the outreach achieved in these states is inadequate. Table 6.1 presents the region wise position of the bank linkage of SHGs during last three years as also cumulative performance as on 31 March 2004.

Table 6.1 Region wise spread of the SHG-Bank Linkage Programme

Region	2001-02	2002-03	2003-04		
	No. of new SHGs	No. of new SHGs	No. of new SHGs	Cum.No of SHGs as on 31/03/04*	Cum. Bank Loan as on 31/03/04*
					[Rs. Lakh]
Northern	10,309	15,602	16,357	51,280	12,242
North Eastern	1,013	2,579	8,137	12,206	1,986
Eastern	23,640	45,001	53,155	144,048	22,163
Central	19,330	33,402	45,426	127,009	27,633
Western	13,775	12,862	12,635	54,815	14,088
Southern	129,586	146,436	163,825	627,537	278,833
TOTAL	**197,653**	**255,882**	**299,535**	**1,016,895**	**356,944**
* Provisional data					

Source : NABARD

6.9 The banks need to gear up their rural branches for facilitating bank linkages of SHGs in states where the programme has not shown satisfactory progress. **For this it is recommended that banks may evolve a three-year plan of action at each controlling unit level for scaling up the programme.** Such plans may include, *inter alia*, a strategy for sensitizing and training of the staff, a plan for facilitating promotion and nurturing of SHGs through networking with NGOs, and other SHG promoters. Some of the banks have already earmarked officials to work in 'microFinance cells'. **The committee feels that such special attention to microFinance will go a long way in expanding this segment of business. Further, to give focussed attention to this successfully growing business segment, it suggests that all banks may set up adequately staffed microFinance cells at central offices and also in each state.**

6.10 The field visits to different states have revealed that even in those states where sizeable number of SHGs are financed, the quality of linkage as reflected in terms of client satisfaction continues to be low, with complaints such as (a) delays / refusal to open savings bank accounts of SHGs, (b) large number of visits required to be paid to branches for credit access, (c) inadequate credit support being extended by banks, (d) delays in renewal of credit limits, and (e) impounding of savings of the SHGs as collateral of loans, etc. are still a common place. **The banks need to address these issues urgently, to make access to financial services hassle-free.**

6.11 With increasing outreach under the SHG-Bank Linkage Programme, many of the older SHGs now manage sizeable resources. Studies have shown increasing demand for diversified savings and credit products. **The Committee recognises the need for offering need based savings and credit products to the older SHGs. Further product innovations will therefore be required in this direction. The banks may explore the possibilities of offering Credit Cards on the lines of KCC and Swarojgar Credit Cards to the SHGs.**

6.12 Given the low literacy rates among the members of SHGs, it is observed that the quality of books of accounts being maintained by the SHGs is an area of concern. **It is, therefore, recommended that banks may encourage local book writers in association with concerned agency which has promoted these SHGs.** These book writers could be drawn from some of the literate members of SHGs, their families or others such as anganwadi workers, rural teachers, etc. Ideally, such an arrangement has to be on cost sharing basis, with some support coming from the banks**.**

6.13 With the growth of the programme, a large number of successful SHGs have mobilised sizeable owned funds through member savings and interest collected, besides the bank loans. Such SHGs need the escort / hand holding services in taking up higher level microenterprises. **All development agencies including governments, banks, NABARD and NGOs need to converge on these SHGs and provide necessary skills, market linkages, technological support, etc.** Also important is the need for building enterprise promotion capacities of the 3,000 odd NGO partners under the programme. **This needs to be addressed by building their capacities and also bring in specialized enterprise promotion agents / agencies / corporate entities, etc.. NABARD may continue to take the lead role in this regard.**

6.14 The share of cooperatives under the SHG-Bank Linkage Programme is limited. The District Cooperative Banks such as Hoogly DCCB, Bidar DCCB, South Canara DCCB, Ajmer DCCB etc., which have taken up banking with the poor through SHGs have demonstrated that this could be an important tool for revitalising even the dormant cooperative societies. Some of these banks have also taken up promotion of SHGs directly through their own staff and staff of PACSs. **It is, therefore, recommended that cooperative banks may take up SHG banking on a significant scale with active support from NABARD and State Governments.**

Financing oral lessees, marginal farmers

6.15 Another major challenge for the rural financial institutions is that of financing oral lessees and marginal farmers, the number of which is already assuming larger proportions and would continue to grow in the next decade with increasing fragmentation of land.

6.16 The committee has examined various issues relating to financing of oral lessees and is of the opinion that the Joint Liability Group approach [JLG] and the SHG approach have the potential of addressing the issues relating to these sections. Till such time the State Governments address the issue of legalising tenancy, the banks may have to explore the potential of financing models such JLGs through pilot projects.

Contract farming

6.17 The concept of contract farming is of late attracting the attention of corporate entities, banks, state governments and farmers. The committee considers that the approach has the potential for expanding credit outreach, especially to the small / marginal farmers and oral lessees. However, it is observed that the initial contract farming initiatives have experienced legal difficulties in enforcing the contracts between the buyers and sellers, as also in relation to the Agricultural Produce Marketing Acts. Rather in some states which have restricted definition of 'market place' making difficult the direct procurement of produce from the farmers by the contractors. Instances have been noticed of disputes regarding quality of the produce leading to differential payments by the contractors to the farmers. A mechanism for proper certification of quality of the produce needs to be put in place to ensure minimization of such disputes between the farmers and the contractors. **The State Governments may have to play an active facilitation role in this regard.**

6.18 Banks have reported mixed experiences in their initial association with contract farming. They opine that for contract farming to succeed, the 'stake' of contracting agencies need to be critical. **Subject to availability of proper legal and regulatory framework in different states, the banks may increasingly look at the potential available under contract farming, especially for reaching out to the small and marginal farmers and oral lessees.**

Emerging federations of Self Help Groups

6.19 With the growth of SHGs, some of the NGOs are promoting the federations of SHGs. Two main types of federations of SHGs have emerged so far, viz., (i) federations which provide umbrella support to member SHGs including book writing / audit services, conflict management, monitoring and cross learning, engaging paid employees, value added services such as insurance, supplementary education, health care, etc, and (ii) federations which undertake resource balancing among SHGs and also do financial intermediation.

6.20 The committee feels that as long as the federations evolve in response to the well-considered demand and views of the SHGs, they [non-financial intermediary type] need to be encouraged to provide umbrella support to member SHGs. However, it is felt that more experimentation of the financial intermediary type federations of SHGs would be required on the issues relating to (i) cost of promotion of such federations, (ii) capacity building of federations required, (iii) organizational and financial sustainability of the federations and (iv) above all, the quality of value addition being achieved by these federations for the member SHGs, etc.

NGO - MFIs

6.21 Parallel to the mainstream banks, another set of players called microfinance institutions have also emerged in India to provide microfinance services to the poor, both in rural and urban areas. It is estimated about 800 NGO-MFIs are undertaking financial intermediation in India. These, however, include a handful of commercial MFIs which account for bulk of the outreach.

6.22 The committee has looked into the role of microfinance institutions in dispensing microCredit and the need for their regulation and supervision. The key issue brought to the notice of the Committee by representatives of the sector was about allowing access to public / member deposits, besides other issues such as lack of equity funding, soft loans, capacity building needs, etc. To address the issue of need for a differential regulatory framework, the committee sought answers to the following questions and concerns :

(i) Is non-existence of a separate differential regulatory framework a critical bottle-neck hindering the growth of the sector ?
(ii) Will MFIs be sustainable in medium term ? If so, will they continue to focus on the poor?
(iii) Is access to public / member deposit the key issue for their sustainability ?
(iv) Can MFIs finance loans for income generation at interest rates which are sustainable by the rural poor ?
(v) Is it possible to evolve commonly agreed standards for MFI sector covering performance, accounting and governance issues, which can open up possibilities of self-regulation ?
(vi) Has the sector reached a critical mass where regulation becomes important ?

6.23 After due discussions with the stakeholders, it is observed that while a few of the MFIs have reached significant scales of outreach, the MFI sector as a whole is still in evolving phase as is reflected in wide debates ranging around (i) desirability of NGOs taking up financial intermediation, (ii) unproven financial and organizational sustainability of the model, (iii) high transaction costs leading to higher rates of interest being charged to the poor clients, (iv) absence of commonly agreed performance, accounting and governance standards, (v) heavy expectations of low cost funds, including equity and the start up costs, etc.

6.24 If the MFI route is to be strengthened, the regulatory and supervisory framework may have to be strengthened. This is all the more necessary because savings is an important financial service that needs to be provided by the MFI to its clients, and may be even to others who live in the operational area of the MFI, and unless certain minimum precautions are taken, these savings can always be at risk. The concept of "regulatory framework" represents a dynamic situation which would continue to evolve with time. While the focus needs to be on building "good governance" within the MFIs, the policy environment would have to take care of supervising and regulating the crucial factors related to governance.

6.25 The current debate on development of a regulatory system for the MFIs focuses on three stages. Stage one - to make the MFIs appreciate the need for certain common performance standards, stage two - making it mandatory for the MFIs to get registered with identified or designated institutions and stage three - to encourage development of network of MFIs which could function as quasi Self-Regulatory Organisations (SROs) at a later date or identifying a suitable organisation to handle the regulatory arrangements.

6.26 It appears that significant work on stage one i.e., development on performance standards, which are commonly agreeable by a wide range of players, need to be carried out. In the meantime, it is recommended that while the MFIs may continue to work as **wholesalers of microCredit by entering into tie-ups with banks and apex development institutions, more experimentation has to be done to satisfy about the sustainability of the MFI model**. **Such experimentation needs to be encouraged in areas where banks are still not meeting adequate credit demand of the rural poor, such as north-eastern states and tribal dominated areas such as Jharkhand, Chhattisgarh and Orissa.**

6.27 The committee recognises the importance of offering thrift products as one of the microFinance services to the clients of MFIs. **However, it feels that, while the NGO-MFIs can continue to extend micro credit services to their clients, they can play an important role in facilitating access of their clients to savings services from the regulated banks. As regards allowing NGO-MFIs to access deposits from public / clients, the Committee considers that in view of the need to protect the interests of depositors, they may not be permitted to accept public deposits unless they comply with the extant regulatory framework of the Reserve Bank of India. As no depositors' interest is involved where they do not accept public deposits, MFIs need not be regulated by the Reserve Bank of India.**

6.28 As regards the high interest rates being charged by the MFIs, it is felt that the lenders to MFIs may ensure that these institutions adopt a 'cost-plus- reasonable-margin' approach in determining the rates of interest on loans to clients.

****