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Rural Credit

Introduction

The preamble to the Reserve Bank of India (RBI) Act enjoins the Bank to operate the credit system to the advantage of the country, a country where most of the population lives in rural areas. Further, the Bank is required to 'study various aspects of rural credit and development' as it may consider necessary to do so for promoting integrated rural development. From the 1970s, this aim was achieved by means of directed credit, mainly 'priority sector lending'. The policy directed banks to lend to agriculture, small enterprises, retail trade, microcredit, education and housing, subject to certain conditions. It started with nationalised banks in 1974 and was extended to private banks in 1978. In 1985, 40 per cent of bank credit was directed to flow to priority sectors, within which 25 per cent (10 per cent of the total advances) was to go to the 'weaker sections' of society. Weaker sections included small and marginal farmers with landholdings of less than 5 acres, landless labourers, artisans and 'tiny' enterprises with loan limits up to ₹50,000, beneficiaries of the government's poverty alleviation programmes, Scheduled Caste/Scheduled Tribe (SC/ST) borrowers and members of self-help groups (SHGs). A separate sub-target of 16 per cent was fixed for agriculture in 1985 and raised to 18 per cent in 1990.

The financial sector reforms from 1992 underscored that banks and other financial institutions (FIs) had to become strong and efficient (see Chapter 10.1). The report of the Committee on the Financial System (Narasimham Committee I, 1991) recommended that the directed credit programme, being an anomaly in a 'free market competitive system', should be phased out. The Committee on Banking Sector Reforms (Narasimham Committee II, 1998) observed that 'a high incidence of NPAs [non-performing assets or advances] could be traced to policies of directed credit'.[1] Other reviews also recommended reforms and scaling down.[2] But neither the government nor the Reserve Bank was ready to deprioritise the priority sector.

Still, as more emphasis was laid on operational freedom and profitability of banks, the Reserve Bank was under pressure to pause or go soft on directed lending and its rural focus. While it avoided a reversal of its policies, occasional wavering in its resolve could be observed. As seen in this chapter, the Bank managed a tight-rope walk with some success, trying to balance the aim of reinventing the banking system as a strong market player while serving the not-easily-bankable rural poor. The chapter will outline the steps taken to increase the flow of credit to the rural sector through the institutional purveyors of credit, namely commercial banks, cooperative banks and regional rural banks (RRBs), which included much-needed reforms in institutions, financing, governance and technological standards.

Objectives of Banking Policy with respect to Rural Credit

The directed credit policy was based on an implicit ideology that banking service was a public good because banks depended on the support of the government – after they were nationalised in 1969 – and were institutions of public trust. They ought to function in the common man's interest. Once it was defined as a public good, no citizen could be excluded from its consumption or use. Creating a strong and vibrant banking system could not be an end in itself but only a means to bring about the good of all, especially the poor. In 2004, the government reiterated the conviction that 'the fruits of the improved performance of the financial sector … should not be denied to farmers and weaker sections'.[3] There was possibly another belief behind directed credit, which was that the private sector operators were somehow incapable of serving the rural poor. The distrust of the 'moneylender' was widespread and deeply entrenched and apparently based on impressions because little concrete information was known or collected on the institutional aspects of private providers of rural credit. Together, the two beliefs translated into a policy of directing the banks to fund the needs of specific groups in society.

Maintaining the public goods perspective was a difficult proposition in the post-reform environment while the Reserve Bank was at the same time trying to make banks more profit-oriented. Before the economic reforms, commercial banks followed the 'accommodation principle'. But now assets were created on risk–return considerations as the 'profit maximising principle' dominated their portfolio behaviour. With the application of stringent income recognition and asset classification norms, the gross NPAs of commercial banks were disconcertingly high at 15.7 per cent in March 1997. This, together with inadequate headroom in the capital to risk-weighted assets ratio (CRAR) at that time, made banks reluctant to undertake high-risk activities and directed credit was perceived to be risky. The impounding of banks' resources through reserve requirements was also sizeable in April 1997 with the cash reserve ratio (CRR) at 10 per cent and the statutory liquidity ratio (SLR) at 31.5 per cent, though reduced later to 25 per cent.

The profit motive sometimes impacted regulatory behaviour as well. For instance, the thrust of the Bank's branch licensing policy immediately following nationalisation of large banks in 1969 was towards opening more branches in unbanked semi-urban and rural areas. But there was a shift since 1991 as the Bank allowed banks to close 'persistently loss-making branches' or merge with other branches. The revised branch licensing policy stated that 'further growth of bank offices should be guided only on the well-established need for offices and financial viability of proposed branches'.

This shift resulted in the reduction of rural branches of commercial banks from 35,206 to 32,915 and to 31,076 as at the end of March 1991, 1997 and 2008, respectively. The ratio of rural branches to all branches fell from 52 per cent in March 1997 to 41 per cent in March 2008.[4] No doubt reclassification of settlements from 'rural' to 'semi-urban' in the successive decennial census contributed to the reduction in the number of 'rural' offices, but the fall also owed to shifts in policy. However, the branch authorisation policy was again modified in 2006–07 as the Reserve Bank prioritised financial inclusion, which entailed ensuring availability of banking service in almost every village of the country.

With the setting up of the National Bank for Agriculture and Rural Development (NABARD) in 1982 as the designated apex institution for agricultural and rural development, the direct responsibility of the Reserve Bank to promote rural credit eased substantially. One area of adjustment was a change in the relationship between these two bodies.

The Reserve Bank and NABARD

The Bank was earlier providing refinance to state cooperative banks against production credit financed through their lower tiers, namely the district central cooperative banks and primary agricultural credit societies. Since 1982, this function was vested with NABARD.

From 1992–93, the Reserve Bank did not transfer any money to the National Rural Credit (NRC) Fund maintained with NABARD. The government assured NABARD (a telex message on 14 May 1992) that 'they would consider providing explicit budgetary subsidy for the additional cost in case NABARD raised resources from the market, corresponding to the level of support expected from NRC funds'. NABARD could raise low-cost funds from the market by issuing 'capital gain' and 'priority sector bonds'. This was disallowed from April 2006. The Reserve Bank was not very accommodative in its dealings with NABARD. Since 1997–98, the development financial institutions (DFIs) came under an 'umbrella' annual limit for raising resources from the market. The Monetary Policy Department (MPD) was about to fix an umbrella limit for NABARD too.[5] But the regulatory department for NABARD, the Rural Planning and Credit Department (RPCD), was not in favour and suggested that the existing practice of scrutinising each proposal of NABARD to raise resources from the market should continue.[6] In January 2000, however, NABARD was sanctioned with the umbrella limit on a par with other FIs.

In March 1995, and again in March 1999, NABARD had requested the Reserve Bank to sanction a short-term facility of ₹5 billion and ₹4 billion, respectively, to meet refinance and repayment commitments. It was also requested that the rate of interest be fixed at 7 per cent as their average earnings on refinancing worked out to just over 7 per cent. In 1995, the Reserve Bank sanctioned ₹3 billion at an interest rate of 14 per cent. In 1999, the Bank did not sanction the facility and asked NABARD to 'raise resources by selling their surplus government securities'. The reason given was that the short-term facility would lead to an increase in reserve money and money supply.

To enable NABARD to provide concessional finance to RRBs and cooperatives to support their seasonal agricultural operations, the Reserve Bank extended a general line of credit since its inception in 1982.[7] From the late 1990s, there was much uneasiness in the Reserve Bank on continuing the general line of credit, in the context of efforts to raise NABARD's resources.[8] Between 1996 and 1999, the government and the Reserve Bank had contributed annually to raise its paid-up capital. Office notes revealed the fear that large and highly-subsidised accommodation from the Bank would 'breed inefficiency' and 'moral hazard'. Further, the Bank continued to maintain that lines of credit to FIs led to 'an expansion of money supply'. One of the tenets of the financial reform process was that concessional finance should be gradually phased out. Therefore, NABARD, like other DFIs, must borrow from the market.

In April 2006, the Bank took the view that 'direct lending to government-owned FIs would amount to indirect borrowing by the government and would be in contravention of FRBM Act [Fiscal Responsibility and Budget Management Act, 2003], in terms of which RBI cannot subscribe to government borrowing in the primary market'. The general line of credit limit was reduced in 2005–06, and the Bank advised NABARD that from July 2006–07, the general line of credit support would not be available. The requests for reconsideration of the decision were not heeded.[9] Thus, during the time span of the book, NABARD was forced to borrow from the market. Its market borrowings formed 5.5 per cent of its total liabilities in 1997, which increased to 33 per cent in June 2008.

The Reserve Bank formed an advisory committee in 2004 with V. S. Vyas, a noted agricultural economist, as chairman, to study the flow of credit to agriculture and related activities from the banking system. The committee held that NABARD should have full autonomy in the areas of credit and developmental interventions. By the provisions of the NABARD Act, NABARD had to seek approval of the Reserve Bank for adding to eligible purposes, institutions and bodies for extending its finance, and the committee wanted powers to be vested with the board of NABARD.[10] The committee also said that NABARD need not be driven by commercial considerations alone. The Reserve Bank did not agree because, 'considering that NABARD has to access market for funds, the need and importance of strong financials cannot be ignored'.

NABARD was subjected to Reserve Bank inspection under the RBI Act, 1934. At the end of the inspection exercise, there would be a supervisory discussion at the senior executives' level in which one of the points invariably raised was an increase in NABARD's average cost of funds.[11] In a meeting held in March 2004, the then Executive Director, Usha Thorat, suggested to NABARD officials that in case they needed funds, they 'may approach other banks for getting funds at market rates and not to depend too much on RBI funds.' In 2008, the union cabinet approved the government's acquisition of the Reserve Bank's stake in NABARD, in line with the view of the Narasimham Committee II that the 'regulator owning the institution it governed was inconsistent with the principles of effective supervision'.

Although NABARD was under pressure throughout, it had conceptualised two of the most significant innovations in rural credit during the 1990s –

the SHG–bank linkage programme and the Kisan Credit Card (KCC). The Reserve Bank implemented these schemes (see later). But first, let us consider the priority sector lending policy and changes therein.

Lending to the Priority Sector

Compliance with the priority sector guidelines was an important issue. For example, a differential rate of interest scheme (DRI scheme), in operation since 1972, required banks to lend 1 per cent of the total advances to borrowers falling below the poverty line at a concessional interest rate.[12] Banks in general and private banks in particular did not take the target seriously.[13] In March 1997, commercial banks had fallen short of the target set for priority sector lending. The shortfall was larger with agricultural credit. The position did not improve for the next three years. On 22 November 2000, the *Financial Express* ran an article, 'Data Shows Social Banking Getting a Burial'. The record was worse for lending to weaker sections. When the Reserve Bank took up the issue with the banks, they pointed out the high level of NPAs, recoveries and write-offs. When a bank effected substantial recoveries or write-offs in the accounts, the aggregate outstanding came down, and bankers pointed that out as one of the reasons for not meeting the target. The Reserve Bank did not consider introducing a penalty or disincentive for not meeting the targets. However, banks did somewhat improve their performance in lending to weaker sections by March 2008.[14]

Advisory Committees

In 1997, a committee recommended simplifying the procedures at the branch level, and to enhance the flow and quality of credit to agriculture.[15] The major recommendations included imparting more flexibility and discretion for the lending banks, the delegation of powers to the branch-level officials, the introduction of composite cash credit type of facility, the introduction of simpler loan procedures, disbursement of loans in cash, and simplification of procedures for loan agreements. The Reserve Bank accepted the recommendations and asked the banks to implement them.[16]

A second review was done by the Vyas Committee, to which mention has been made before. The committee found that only a few banks had implemented the recommendations, that the poor often shied away from formal institutions for want of information about procedures, and that the borrower worried about, in addition to the cost of credit, the timeliness and adequacy of credit. The committee recommended that banks should be asked to waive margin and security requirements for small agricultural loans. This was implemented, along with a series of other procedural changes.[17]

Components of Lending

What should be a good indicator of a bank's performance when credit targets were set? Linking the targets to 'outstanding credit' was not a good idea because a portion of the outstanding credit could be NPAs. Therefore, the Reserve Bank saw disbursement during a given period to be a better indicator of performance. Though the disbursement was monitored through the mechanism of special agricultural credit plans introduced for public sector banks, by and large the Bank continued to rely on outstanding credit to measure performance.[18]

The target of 18 per cent fixed for lending to agriculture was bifurcated in 1993, with a minimum of 13.5 per cent for direct loans and a maximum of 4.5 per cent for indirect loans. Since then, the scope of activities under 'agriculture and allied activities' expanded significantly, particularly under the indirect category. Loans for financing distribution of inputs for allied activities in agriculture, such as cattle feed and poultry feed, were included in indirect credit and the loan limits were raised. Loans to dealers in drip irrigation systems, sprinkler irrigation systems and agricultural machinery were included. Until 2003, only the dealers located in rural or semi-urban areas fell within the definition of indirect credit, but thereafter, all dealers, irrespective of their location, were included. Advances for construction and maintenance of storage facilities for storing agricultural produce were considered as indirect lending to agriculture from 2002. Financing of 'agri-clinics' and 'agri-business centres' were included first under the indirect category and, from August 2002, under direct lending.[19] Trends in outstanding direct and indirect credit to agriculture and allied activities are set out in Table 12.1.

The Reserve Bank decided in April 2000 that lending by banks to non-banking finance companies (NBFCs) for on-lending to finance agricultural activities should be classified as indirect lending to agriculture. Lending through the cooperative credit institutions and state-sponsored corporations for onward lending to agriculture and weaker sections, and 50 per cent of refinancing to RRBs by the sponsored banks were treated as indirect lending to agriculture.

Table 12.1 Credit Outstanding to Agriculture and Allied Activities (Short Term and Long Term) as of End of March

(₹ billion)

	Direct Finance			*Indirect Finance*			*Total Credit to Agriculture and Allied Activities*		
	SCBs	*RRBs*	*Cooperatives*	*SCBs*	*RRBs*	*Cooperatives*	*SCBs*	*RRBs*	Cooperatives
1997	263.27	40.38	205.56	49.86	0.49	197.04	313.13 (41.4)	40.87 (5.4)	402.60 (53.2)
1998	284.45	46.83	213.90	63.35	0.13	208.17	347.8 0 (42.6)	47.01 (5.8)	422.07 (51.6)
1999	298.19	53.89	221.99	81.17	0.25	220.22	379.36 (43.3)	54.14 (6.2)	442.21 (50.5)
2000	334.42	59.91	419.50	129.68	0.29	673.61	464.10 (28.7)	60.20 (3.7)	1093.11 (67.6)
2001	382.7	72.49	461.35	188.25	Nil	795.67	570.95 (30.1)	72.49 (3.8)	1257.02 (66.1)
2002	451.06	82.86	521.10	182.38	Nil	890.92	633.44 (29.8)	82.86 (3.9)	1412.02 (66.3)
2003	538.04	102.61	590.64	236.90	Nil	929.2	774.94 (32.3)	102.61 (4.3)	1519.84 (63.4)
2004	681.03	117.21	714.03	285.20	Nil	1023.07	966.23 (34.3)	117.21 (4.2)	1737.10 (61.5)
2005	955.19	167.09	788.22	360.71	Nil	1101.32	1315.90 (39.0)	167.09 (4.9)	1889.54 (56.1)
2006	1356.03	215.1	823.27	571.75	Nil	1199.32	1927.78 (46.3)	215.10 (5.2)	2022.59 (48.5)
2007	1690.18	274.52	894.43	825.64	Nil	1363.92	2515.82 (49.8)	274.52 (5.4)	2258.35 (44.8)
2008	2027.96	332.16	656.66	934.43	Nil	1479.82	2962.39 (54.5)	332.16 (6.1)	2136.48 (39.4)

Source: RBI, *Handbook of Statistics on the Indian Economy*.

Notes: Figures in brackets are the percentage of the total. SCBs: scheduled commercial banks. RRBs: regional rural banks.

Lending by banks to food and agro-processing sectors was brought under priority sector in February 1999. The government did not specify any loan limit for advances to this sector despite references from the Reserve Bank. This led bankers to claim that advances to big companies, such as Britannia Industries, ITC and Hindustan Lever, could be classified as a priority sector, which drew criticisms from the media. From August 2001, units in food and agro-based processing sectors with investments in plant and machinery below ₹50 million would only be covered under priority sector.[20]

The Bank introduced the General Credit Card Scheme in December 2005 to cover the general credit needs of banks' clients up to ₹25,000 in rural and semi-urban areas. The objective of the scheme was to provide hassle-free credit based on the assessment of cash flow without insistence on security, purpose or end-use of the credit. It was in the nature of overdraft or cash credit and the cardholder was entitled to draw cash from the specified branch of the bank up to the limit sanctioned. The entire advances under the scheme came under 'indirect finance to agriculture'. It served two goals: promoting the product and enabling banks to meet the target for agriculture.

Following these relaxations, portfolios of many banks expanded. Six public sector banks and eleven private sector banks had exceeded the limit of 4.5 per cent as of March 2000. They were advised that advances in excess of 4.5 per cent would *not* be reckoned for computing their performance under agriculture. Despite requests from banks to relax the sub-limit of 4.5 per cent, the Reserve Bank did not relent but allowed indirect agricultural advances in excess of 4.5 per cent to be treated as part of priority sector advances.

There were relaxations in respect of direct lending to agriculture as well. Apart from crop and working capital loans, all medium- and long-term loans extended to farmers for allied activities, such as dairy, fishery, piggery and poultry, were included in the direct category. Financing of plantations and horticulture were included. Loans to farmers for purchase of land was treated as direct lending to agriculture, subject to certain conditions. Loans extended to distressed farmers who were indebted to non-institutional lenders were included. The Reserve Bank was not unaware of the implications of these changes. As early as in 2001, Y. V. Reddy, Deputy Governor, commented in a speech that 'coverage of definition of priority sector lending has been broadened significantly in the recent years, thus overestimating credit flows to actual agricultural operations in recent years'.[21]

Broadening the scope of agricultural credit by including new activities and increasing the loan limits brought about four disquieting outcomes. First, the share of institutional credit to total credit in rural areas declined between 1991 and 2002 from 64 per cent to 58 per cent, and the share of non-institutional agencies went up correspondingly. As per the findings of the Debt and Investment Survey, carried out as part of the 59th round of the National Sample Survey in 2002, while 13 per cent of all rural households were indebted to institutional agencies, 16 per cent were indebted to non-institutional agencies. However, the next survey, in 2013, showed a higher share of institutional credit of 60 per cent, with 64 per cent among all rural cultivator households and 52 per cent among all rural non-cultivator households.[22]

Second, the share of agricultural credit disbursed by urban and metropolitan bank branches (against rural and semi-urban branches) was increasing. Their share in direct and indirect agricultural credit went up from 14 and 60 per cent, respectively, in March 1997 to 22 and 77 per cent in March 2008.[23] This indicated that more loans were being sanctioned to borrowers outside the traditional definition of the agricultural sector. Third, and somewhat strangely, loans sanctioned tended to bunch in March, which was not the sowing or the harvesting season in large parts of India. Fourth, the share of bigger loans in total agricultural credit increased over the period under review.[24] A government task force (2010) observed that despite 'the doubling of agricultural credit, [credit] did not reach a large number of small and marginal farmers'.[25]

The Reserve Bank recognised that bank transaction costs were high and took several steps to reduce these costs.[26] It also wanted the banks to be considerate towards loan defaults in the farm sector due to crop failure and factors beyond the control of the farmers.[27] The Reserve Bank advised banks to give fresh loans to farmers even if the previous loan was closed through settlements involving write-offs. As for farmers affected by natural calamities, such as drought, cyclones or floods, the Reserve Bank had advised in 1984 relief measures to be considered by banks. These guidelines were modified in June 1998 by incorporating specific facilities such as the conversion of short-term production loans into medium-term loans, rescheduling or postponement of term loan instalment, provision of additional crop loans, and relaxations in security and margin norms. The Reserve Bank advised banks in November 2006 that they should frame transparent one-time settlement policies for farmers who had suffered natural calamities. The initiatives in legislative and institutional reforms are as outlined in Box 12.1.

Box 12.1 New Directions in Legislative and Institutional Reforms

Money-Lending Activities

In 2006–07, the Reserve Bank Governor announced in the Annual Policy Statement that a technical group would be set up to review the existing legislative framework governing money-lending. The technical group (Chairman: S. C. Gupta) had, apart from senior Reserve Bank officials, three members from the Governments of Bihar, Andhra Pradesh, and Rajasthan. There were also eleven invitees from eleven other state governments. A survey was conducted using a structured questionnaire, covering 177 districts in 25 states, through focus-group discussions with bankers, borrowers, moneylenders, formal institutions and non-governmental organisations (NGOs) and district administrations.

The group recommended a model law. The group also recommended some modifications in the existing legislation to create an informal and speedy dispute resolution mechanism and insert mandatory provisions for registration to undertake money-lending activity in states that had no such provisions. It recommended that the word 'licence' may be substituted by 'registration' as the expression 'licence' carried the connotation of control, that registration be made compulsory and that the prescription of interest rates under the statute may be done away with, and a provision be made to the effect that the maximum rates of interest that could be charged by moneylenders are to be notified by the state government from time to time.

Rural Cooperatives

In terms of the memorandum of understanding (MoU) proposed to be signed by the state governments with the Government of India and NABARD, the state governments were to carry out certain legal and institutional reforms, undertake to supersede the boards or wind up a cooperative bank at the request of the Reserve Bank, and to take steps to generally empower the boards, ensure audits through chartered accountants, appoint qualified executives and improve technological standards.

Rural Infrastructural Development Fund (RIDF)

Although priority sector targets for public sector and private sector banks were prescribed in 1974 and 1978, respectively, no penalties were imposed on banks for not achieving them. The RIDF provided an escape route instead. In 1995, the government announced the setting up of the RIDF for the purpose of assisting state governments and state-owned corporations to fund projects of rural infrastructure. The RIDF was established with NABARD. Commercial banks made contributions to the RIDF equivalent to their shortfall in agricultural lending.[28] The deposits by banks were for five years at a relatively attractive interest rate. The period of deposits for later tranches was increased, whereas the interest rates were reduced. In 2001, the interest rate was inversely linked to the extent of shortfall in agricultural lending of the bank concerned.

Two banks ran up arrears of payment to RIDF. The Jammu and Kashmir Bank Ltd (J&K Bank) and ING Vysya Bank Ltd had arrears for many years. In the case of the former, the state government wanted to appropriate the funds directly instead of their being routed through the RIDF. ING Vysya Bank said that the deposits would exceed the prudential exposure ceiling fixed for single borrower though the Reserve Bank had specifically relaxed single borrower limits for RIDF deposits kept with NABARD. On being threatened with regulatory action, ING Vysya Bank deposited the defaulted amount of ₹1.95 billion with NABARD on 3 July 2008. The chief executive officer of J&K Bank made certain submissions to the Reserve Bank in his letter dated 30 June 2008 addressed to the Deputy Governor. Among other things, the bank sought time up to five years to clear the backlog of arrears. However, the bank was advised in July 2008 to deposit the arrears.[29]

Foreign Banks and the Small Industries Development Bank of India (SIDBI)

Small-scale industries were a component of the priority sector. Foreign banks were not given any targets for agricultural lending, but they were required to lend 32 per cent of the total advances to priority sector, within which 10 per cent and 12 per cent were fixed as sub-targets for small-scale industries and export sectors, respectively. The amount equivalent to the shortfall had to be deposited with the Small Industries Development Bank of India (SIDBI) for one year.[30]

From the start of the scheme in 1995 until 2000, the interest rate paid by SIDBI to the foreign banks was an attractive 10 per cent and, thereafter, it was reduced to 8 per cent when the Bank Rate was 7 per cent. Interestingly, some banks deposited more than the required amount with SIDBI, and the Reserve Bank had to call for clarification. SIDBI, on the other hand, repeatedly requested the Reserve Bank to reduce the rate of interest payable on such deposits. As the Reserve Bank was unwilling to relent, SIDBI sought government intervention. The Secretary in the Ministry of Finance wrote to Deputy Governor Rakesh Mohan on 14 May 2003 that 'such rates of interest will be an incentive giving an impression that we may be favouring foreign banks' (see Appendix 12A.1). The Parliamentary Standing Committee on Finance expressed the fear that foreign banks would borrow cheaply from the market, invest at profitable rates and still fulfil priority sector obligations. The committee felt that the inability of private or foreign banks to fulfil priority sector obligations should attract a penalty.[31]

In the following month, interest payable by SIDBI was made equal to the Bank Rate, which was 6 per cent at that time. The *Economic Times* (23 March 2004) carried a story with the headline 'Foreign Banks Hit A Jackpot for Going Short on Priority Lending', which mentioned that the deposits with SIDBI were still seen as an incentive for some banks. It was only in 2005–06 that the interest rate structure for deposits placed with SIDBI was treated in a similar fashion to the system followed for deposits of domestic banks with NABARD.

Priority Sector: New Activities

The Reserve Bank recognised the difficulties faced by banks in achieving moving targets. Since the targets were unclear and variable until the last day of the financial year, non-priority advances usually surged in the last month of the financial year. To overcome this difficulty, the Bank considered an absolute target, based on the total advances of the previous year-end instead of the current year, which could facilitate better credit planning by banks. However, the idea was dropped, 'as it is likely', said Deputy Governor Jagdish Capoor, 'to invite criticism in view of reduction in absolute terms'. Deputy Governor Y. V. Reddy said in April 2000 that the priority sector policy had lost its rationale, but if the Bank could not change the policy, 'it is better to let sleeping dogs lie still, rather than attempt improvements'. Governor Jalan, too, observed that 'for the present let us leave things as they are'.

A change came nevertheless, mainly in the form of relaxations made in the definition and scope of priority sector. New activities such as software and venture capital funds were brought under the priority sector in 1999 (subject to conditions). Direct subscriptions made by banks and purchases in the secondary market of bonds issued by SIDBI, Khadi and Village Industries Commission, National Small Industries Corporation Ltd, Housing and Urban

Development Corporation, State Financial Corporations, State Industrial Development Corporations, and National Housing Bank were allowed to be classified as priority sector lending until 2007.

Following the recommendations of Narasimham Committee II (2000) and Vyas Committee (2004), investments by banks in securitised assets, representing loans to various categories of the priority sector, would be eligible for classification under respective categories of the priority sector.[32] While submitting the 'action taken report' to the government on Narasimham Committee II, the Bank stated that this would 'not help in augmenting the flow of credit to the priority sector nor will it help in addressing the question of regional imbalances'. On a decision taken to treat bank credit to NBFCs for financing truck operators as lending to the priority sector, one of the leading NBFCs pointed out in a representation to the Reserve Bank that the decision had 'not really benefited the NBFC sector or the transport sector. It had only helped banks to reach the target for priority sector without any additional flow of funds.'

Further, outright purchases of any loan asset eligible to be categorised under priority sector from banks and FIs, and investments by banks in 'inter-bank participation certificates' on a risk-sharing basis would also be eligible for classification under certain conditions. In fact, there were continuous and insistent demands from various quarters, government departments, pressure groups, diverse associations and federations to include new industries and activities to the priority sector. In May 1999, there were demands to treat credit to infrastructure and tourism under priority sector, which was firmly turned down by the Reserve Bank as they involved 'large outlays' which might 'result in shrinkage' in other components of the priority sector. There were also demands to exclude certain advances such as loans to infrastructure from total credit (numerator) while computing percentage of priority sector advances. Again, the Reserve Bank did not accept these (Box 12.2).

Education loans for pursuing studies in India and outside India, subject to conditions, were treated as lending to the priority sector. The Supreme Court, while delivering an order in a case in 1998, directed the Bank to formulate a scheme for granting education loans to students undertaking studies in private professional colleges, which was submitted to the Court and brought into effect from August 1999. Banks were advised by the Bank in April 2001 to implement the new education loan scheme prepared by the Indian Banks Association (IBA) and approved by the government. The rate of interest was not to exceed the prime lending rate of the bank. Housing loans sanctioned to borrowers up to ₹2 million were considered as lending to the priority sector. But banks found it advantageous to lend to large housing companies. For example, State Bank of Hyderabad advanced ₹5.10 billion to the Housing Development Finance Corporation (HDFC) and classified it as lending to the priority sector and the Reserve Bank deemed it to be in order.

If the priority sector presents a mixed picture, there was good news for rural credit in the shape of new institutional innovations and products.

Box 12.2 Revised Guidelines on the Priority Sector – 2007

The Reserve Bank constituted an internal working group, with the Chief General Manager of its RPCD as Chairman, to examine, review and recommend changes in the existing policy on priority sector lending. After examining the recommendations made by the group in a technical paper and placed on the Reserve Bank's website in September 2005, and after considering the feedback and suggestions received from the banks, FIs, the public and the IBA, the Reserve Bank issued the revised guidelines in April 2007. The government was not consulted as the Bank deemed it as not necessary. The highlights of the new guidelines were the following three.

- First, the treatment of banks' investment in bonds issued by various government corporations and deposits kept with NABARD under the RIDF as priority or agricultural lending was withdrawn.
- Second, the targets and sub-targets under the priority sector were linked to adjusted net bank credit, or ANBC (which is arrived at by adding banks' investments in non-SLR bonds held in 'held to maturity' category to total advances). It was also decided not to deduct the outstanding non-resident deposit balances from total bank credit for computation of ANBC.
- Third, and arguably the most significant decision, was to arrive at the priority sector targets with reference to the total credit outstanding as on 31 March of the *previous* year instead of the current year, as was done until then. This was no doubt favourable to banks in terms of credit planning as the target was known beforehand. As already mentioned, banks were not able to predict the advances as would be at the end of the year because a lot of lending and window dressing activities happened at the year-end and, therefore, it was a challenge for banks to achieve moving targets. However, as there was no simultaneous upward revision in the targets to neutralise the effect of this change, it was seen as a retrograde step, which did not receive the attention it deserved from stakeholders, media and the government.

Two Innovations: Self-Help Groups–Bank Linkage Scheme and Kisan Credit Card

Despite nationalisation, banks were unable to cater to the credit needs of the poor. A strategy had to be evolved to make the poor bankable and to render banking services in a cost-effective manner. In response to this need, NABARD conceptualised the self-help group, or SHG, and bank linkage programme in 1992. The SHGs facilitated collective decision-making and 'doorstep banking' and banks in turn provided credit and other services. This model proved to be a cost-effective, transparent and flexible mechanism. Recoveries were better and it reduced transaction costs for banks and borrowers. Studies revealed that group members tended to shift to more productive activities.

In 2000, the Reserve Bank set up a Micro Credit Cell to liaise with NABARD and microfinance institutions better. Based on this experience, the Reserve Bank issued guidelines to banks in February 2000.[33] It asked banks to incorporate microcredit in the branch-, block-, district- and state-level credit plans. Though no target was fixed for microcredit, the Reserve Bank wanted it to become an integral part of a bank's corporate credit plan and be reviewed at the highest level on a quarterly basis. Banks were given the freedom to formulate their own models and choose any conduit or intermediary for extending microcredit. Governor Jalan directed the RPCD in August 2002 that a fresh impetus be generated for microfinance, and that it should be an area of priority for the next year. The Reserve Bank arranged a meeting with the chief executives of banks and microfinance institutions in October 2002.[34] In that meeting, Ela R. Bhatt, Chairperson of the NGO Self-Employed Women's Association (SEWA), referred to the positive impact the Reserve Bank guidelines had made on microcredit provision.

By then, 2,155 NGOs were associated with the SHG–bank linkage programme, which continued to be the dominant microfinance dispensation model in India. Between 1997 and 2008, this scheme witnessed significant growth and, as of March 2008, there were 3.62 million SHGs linked to banks, with aggregate loans outstanding at ₹170 billion. The share of public sector banks in lending to SHGs stood at 64.3 per cent, followed by cooperative banks at 26 per cent.

The intermediaries organised the poor into groups, built capacities and facilitated their transactions with banks. Some 'non-profit' entities began to purvey microcredit to SHG members from their own funds. When they found themselves unable to raise adequate resources for rapid growth, they converted themselves into 'for-profit' organisations and raised loans from banks. In 1999–2000, the Reserve Bank announced that the interest rates on loans the banks gave to microcredit organisations or these organisations gave to their members and beneficiaries would be left to their discretion. This relaxation was one of the reasons for the proliferation of microfinance institutions. The spread available between bank interest rates and the rates charged to the beneficiaries was an attraction.

From early on, the Reserve Bank did not want to regulate microfinance institutions.[35] Only microfinance institutions registered with the Reserve Bank as NBFCs were regulated by the Bank. The minimum net-owned funds limit fixed by the Bank for all non-deposit-taking NBFCs was ₹20 million. The government wanted the Bank to lower the entry capital norms for microfinance institutions that did not accept public deposits as a separate category of NBFCs. This was not acceptable to the Bank. The microfinance institutions incorporated as 'not-for-profit NBFCs' were exempted from registration and prudential requirements.[36]

In 1998, the government announced that NABARD would design a scheme for the issue of Kisan Credit Cards (KCCs) to farmers based on their landholdings. NABARD prepared a scheme, and the Reserve Bank issued a circular to banks for implementation. KCC enabled the small farmer to get loans over a three-to-five-year timeframe as revolving credit entitlement. It greatly reduced transaction costs for the client, and at the branch reduced workload. Both made for better banker–client relationship.[37] Initially, KCC covered only crop loans and working capital but in October 2004 the scheme was enlarged to include term credit for agriculture and allied activities, including a reasonable component for consumption needs.[38]

The government was dissatisfied with annual monitoring of achievement and wanted the Reserve Bank to set monthly targets for banks and report the performance to the government on a monthly basis. On receiving month-wise targets from the Reserve Bank, several banks, including State Bank of India (SBI), wrote to the Reserve Bank asking for a reduction of the target as they were not based on past performance. On investigating the matter, the Reserve Bank found that the target was 75 per cent of the number of cards issued by the banks in the previous three years and was higher than the eligible borrower accounts. By March 2008, public sector banks alone had issued cumulatively over 31.22 million cards, involving disbursement of ₹1,542.94 billion.

Small-Scale Industry

In 1998, the government set up a committee to suggest improvements in the delivery of credit to the small-scale industry.[39] The Reserve Bank accepted the major recommendations, which were: delegation of more powers to branch officials for grant of loans to small industrial units, simplification of loan application forms, opening of specialised small industries branches, grant of composite loans (term loan and working capital), greater attention to backward states, training of branch managers in credit appraisal, and transparent machinery for redressing borrowers' grievances.[40] The Bank conducted its own review of flow of credit to the sector.[41]

Between 2000 and 2006, the Reserve Bank framed guidelines in several related areas, such as loans to 'tiny' units, sick units, medium-scale units and the institutional set-up to monitor the flow of credit to the small and medium enterprises.[42] In response to demands by the borrowers and pressure groups that creditworthy borrowers should not be deprived of bank credit for want of collateral, the collateral rules were relaxed. The problem of wilful default remained unresolved. Apparently, the Reserve Bank had relaxed collateral rules not out of conviction but under duress. Governor Reddy wrote on 14 January 2004, 'Is there any justification at all for any instruction from us on collateral; should it not be left to the Boards concerned?' The prescriptions, however, continued.

A letter to the editor in *Financial Express* (1 January 2002) on the guidelines issued by the Reserve Bank on the rehabilitation of sick small-scale industry units pointed out that 'there have been rampant violations of these guidelines by banks since the guidelines do not have any penalty clause in case of violations'. The government wanted the Bank's comments. The Bank's reply (2 May 2002) was that

> the circulars issued by RBI are either mandatory or directory or advisory depending upon the tenor, contents, intent, and provisions under which they are also expected to be followed by banks. In the guidelines under reference [rehabilitation of sick small-scale industry units] RBI permits banks to exercise their own commercial judgment, discretion and operational flexibility in the matter. The discretion thus exercised by banks in the light of guidelines will not expose the banks to any regulatory action.

The response clarified that priority sector guidelines were 'advisory' in nature. There was, however, a note at the end of the guidelines which indicated that 'non-achievement of priority sector targets and sub-targets will be taken into account while granting regulatory clearances/approvals for various purposes'.

A similar ambiguity could be observed in monitoring. The Reserve Bank monitored priority sector lending on a half-yearly and annual basis through statements submitted by banks. Letters were issued to banks that did not achieve targets. There was, however, no system in place to check the accuracy of classification and reporting by banks. The RPCD did not carry out on-site scrutiny or audit of banks. The Lead District Officers attached to regional offices did undertake 'visits' to rural and semi-urban branches on a random basis, spending a day or two on each occasion. The Reserve Bank decided in March 1998, at the behest of the Bank's Inspection Department, that the follow-up action on such visit reports should be dealt with by the controlling offices of the banks concerned. The regional offices were instructed to advise the banks that they need not furnish the compliance report to the Reserve Bank.

The *Economic Times* (13 March 1998) printed an article, 'Priority Sector Lending Not a Priority for RBI'. The article was a critique of the decision of the Department of Banking Supervision (DBS) not to cover performance on priority sector lending during their inspection of banks. In August 2004, the DBS came to know that some of the banks were sanctioning advances to agro-processing units whose investments in plant and machinery were above the then limit of ₹50 million and classifying them as priority sector advances. Instructions were, therefore, issued to the regional offices of the DBS to carry out quick scrutiny.

The investigation revealed widespread irregularities in the classification of priority sector lending by banks. In the case of Punjab National Bank, for example, of ₹11.88 billion sanctioned to food and agro-based industries and classified under priority sector, ₹9.92 billion was sanctioned to units whose investments in plant and machinery were above ₹50 million. Vijaya Bank had treated all housing loans, including those above the cut-off limit, as priority sector lending. On further discussions regarding the implications of the wrong classification of priority sector advances, the RPCD wrote that they had

> already advised the domestic commercial banks which have not achieved priority and agricultural lending targets, their share of contribution to RIDF. The special scrutiny done by the officers of the Department of Banking Supervision was only in respect of some areas of priority sector lending. We may therefore not change the allotment under RIDF, even if the banks submit the revised returns.

In effect, no action was taken against the banks.[43]

Lead Bank Scheme

The lead bank scheme introduced in 1969 provided for the allotment of districts to banks to enable them to assume leadership in bringing about banking development in the districts. The designated lead bank would identify credit gaps and evolve a coordinated programme for credit deployment in the district, in concert with other banks. A three-tier structure was created at the block, district and state levels for coordination of activities of commercial banks and other financing agencies on the one hand, and government departments on the other. The Reserve Bank, through its Lead District Officers, monitored the preparation and consolidation of annual credit plans at all three levels and reviewed the achievement on a quarterly basis.

There were 160 Lead District Officers to cover 580 districts in the country. Though the norm was to have three districts for one officer, in practice it worked out to an average of four districts per officer. There were instances of Lead District Officers handling up to six districts apart from functioning as the Reserve Bank's nominee director on the board of an RRB. In some cases, the same Lead District Officer was on the board of two or three RRBs. Several studies were taken up at the regional office level mostly of their own volition. The Lead District Officers had been proactive and received commendation of the government officials and media for their work in the aftermath of the 1999 super cyclone in Odisha and the 2004 tsunami in Tamil Nadu.

For all the additional responsibility and deployment of manpower and infrastructure devolving on the lead banks, there was no compensation or in-built incentive mechanism in the scheme. As a result, whenever new districts were formed by subdivision of larger districts, there were generally no takers for assuming the lead responsibility and the Bank had to thrust it on banks that had more branches in that district.

Discussions on the lead bank scheme often focused on the credit–deposit ratio. The Reserve Bank advised that the State-Level Bankers' Committee should monitor the credit–deposit ratio and identify measures to improve it.[44] But then states and regions had their peculiarities that needed to be given weight when assessing the performance of banks. For example, in the state of Kerala, 40 per cent of bank deposits were from expatriate Keralites as non-resident deposits, which kept the state's credit–deposit ratio down. In Bihar, too, the issue came to the fore periodically from the state government officials and elected representatives. In north-eastern India, the credit absorptive capacity was low and, hence, the Reserve Bank gave special attention to the region.

It appointed task forces in Bihar, Uttar Pradesh, West Bengal, Rajasthan and Kerala and their recommendations were implemented. The Bank also set up a Committee on Financial Sector Plan for the North Eastern Region to examine the issues and recommend action plans for improving credit flow in the region. The Regional Director of the Reserve Bank, Guwahati office, followed up with banks on the implementation of the committee's recommendations.

Private sector banks, such as ICICI Bank, HDFC Bank and Axis Bank, did not take an interest in the lead bank scheme. The Reserve Bank could not take any effective measure to ensure their active involvement. In fact, HDFC Bank told the Reserve Bank that priority sector targets were to be achieved only at the national level and not at the district or block level. This caused heartburn among public sector banks as they had to share the extra burden at state and district levels in implementing government schemes.

In April 2002, Governor Jalan expressed concern about reported complaints regarding refusal by bank branches to open accounts and suggested that bankers' committees comprising middle-level officials study the problems faced by customers by visiting a cross-section of branches.[45] An attempt was made to consolidate the findings and suggestions, and the case papers moved between officers of the Rural Planning and Credit Department for about a year. The suggestions did not merit any action in their opinion except for one suggestion relating to simplification of know-your-customer guidelines.

Elected representatives wanted to be associated with the meetings on the lead bank scheme. The Ministry of Finance asked the Reserve Bank to ensure that they were invited to the biannual meetings of the District-Level Review Committee. The Reserve Bank issued a circular to the banks asking them to comply. The lead banks were advised to fix the dates of the District-Level Review Committee meetings after checking the convenience of Members of Parliament (MPs) and Members of the Legislative Assembly. In 2001, the Bank reported to the government that the attendance of peoples' representatives was 'very poor'. They attended one out of five meetings in the second and third quarters of 2002. In October 2002, the MPs complained in the House Committee that banks fixed the dates of meetings without consulting them. In January 2003, the Reserve Bank instructed banks to take note of these remarks. The matter dragged on and resurfaced in 2006.[46] There were other frictions. The regional offices of the Bank reported that some MPs insisted on chairing the meetings, though the District Collector was the chairman according to the guidelines of the scheme.[47] After the bifurcation of Madhya Pradesh and formation of Chhattisgarh, the Reserve Bank recommended (December 2000) to the government that Central Bank of India should carry on being the convener bank of the State-Level Bankers' Committee for Madhya Pradesh, a responsibility the bank had held for several years. But the Ministry of Finance advised that Bank of India would be the new convener of the state. The move faced many protests from the state and the decision was dropped.[48]

Was the lead bank scheme useful at all? In March 2001, former Reserve Bank Governor I. G. Patel suggested that the Bank 'examine the need for continuation of the Lead Bank Scheme as they are operating in a different competitive environment as compared to pre-liberalisation days'.[49] The matter did not progress at that time. It was only in October 2007 that the Reserve Bank decided to form a committee to review the lead bank scheme in the light of developments in the banking sector. The committee, chaired by Deputy Governor Usha Thorat, submitted its report in August 2009, highlighting 'the need for enhancing the scope of the Scheme, measures to be taken for its strengthening and suggesting a decentralised approach for facilitating financial inclusion'.

Cooperative Institutions

Rural cooperative credit institutions have a wide outreach in the rural and vulnerable segments of society. Institutions providing short-term credit were arranged in three tiers at the state, district and block levels, namely state cooperative bank, district central cooperative bank and primary agricultural credit society. There were 31 state cooperative banks, 371 district central cooperative banks and 94,942 primary agricultural credit societies at the end of March 2008. The long-term credit structure had two tiers with 20 state cooperative agriculture and rural development banks and 697 primary cooperative agriculture and rural development banks as of March 2008. Of the total credit outstanding with the cooperative structure in 2007–08, the short-term credit structure had a dominant share of about 88 per cent.

With the nationalisation of large commercial banks in 1969 and 1980, their presence in rural areas expanded. At the same time, the share of cooperatives in agricultural credit declined, which was due to the structural and financial weaknesses in the cooperative system. The average cost of funds of these banks was high on account of the multi-tier structure. They suffered from excessive governmental interference and lack of professionalism and good governance.

The Registrar of Cooperative Societies of the state governments looked after management-related activities of these banks, whereas the Reserve Bank and NABARD regulated banking and related activities. The former's record was poor. In many states, elections to the boards had not been held for several years and the cooperatives were run by government officials. The elected boards had been superseded by the state governments concerned in 11 state cooperative banks and 159 district central cooperative banks as on 31 March 2008. The cooperative banks were often found to be diverting their funds to the state government under orders and the Reserve Bank issued directives to these banks to desist from such practice. A fresh infusion of capital was needed but not made, and technology was behind the times. Operational efficiency and solvency were in poor shape.[50]

A change did come. Prudential norms for asset classification and income recognition were made applicable to state cooperative banks and district central cooperative banks from 1996–97. In 1999–2000, a committee recommended restructuring of cooperatives, business diversification, recovery management, professionalisation, and a supervisory and regulatory framework.[51] However, formal acceptance of the recommendations was apparently not received from the government. Instead, after four years, the government formed another committee.[52] The report called for sweeping reforms to convert cooperative banks into democratic, member-driven, self-reliant, self-governing and professional bodies. Based on the report, the government approved a package for revival of the rural cooperative credit structure. The states willing to implement the package had to sign an MoU with the government and NABARD, which was the designated agency for overseeing the implementation. In terms of the MoU, state governments had to carry out certain legal and institutional reforms. The revival package included a financial outlay to be shared by the central government, state governments and cooperative institutions in the ratio of 68:28:4.[53]

Until June 2008, twenty-five states and union territories had executed MoUs with the Government of India and NABARD, as envisaged under the package. Eight states had made necessary amendments to the Cooperative Societies Acts. An aggregate amount of ₹33.48 billion had been released by NABARD as the central government's share and state governments had released their shares aggregating ₹3.39 billion to seven states for recapitalisation assistance of primary agricultural credit societies. A task force was set up in each state for monitoring the implementation of the revival package in which the Reserve Bank's Regional Director was a member.[54]

The government entrusted the study of the long-term cooperative credit structure to the same committee in 2006.[55] The Bank agreed with the view of the task force that there was no justification for having two parallel cooperative credit structures and ideally both the short- and long-term credit structures should converge and merge, but not through a forced merger. The task force had recommended that the Bank might be associated with the monitoring of the implementation of the financial package suggested for the long-term structure levels. But since the Reserve Bank was neither the regulator nor the supervisor, it did not want to associate with its implementation.[56]

By the end of the period, the cooperative banks were urgently in need of revival.[57] The Union Budget 2008–09 stated that the central and state governments had reached an agreement on the content of the package for the revival of the long-term structure. As an agent of the Reserve Bank, NABARD was entrusted with the power to carry out on-site and off-site supervision and surveillance of these banks. However, the combination of supervisory and refinancing functions posed a conflict of interest, which remained unaddressed.

Regional Rural Banks

The RRBs were established not as another set of commercial banks, but with the mandate to make available affordable institutional credit to the weaker sections of society, who would form the sole clientele of these banks. They were to combine the local feel and familiarity of cooperative banks with the sound organisation and resource base of the commercial banks. There were originally 196 RRBs in the country, promoted and sponsored by 28 sponsor banks, of which 25 were public sector banks. The central government, the sponsoring bank and the state government concerned held share capital in each RRB in the ratio of 50:35:15.

Their transformation began in the 1980s and speeded up in the 1990s, which brought them almost on a par with commercial banks. Their targets were relaxed, target groups expanded, and interest rates charged by them deregulated. They were no longer low-cost FIs as their cost of funds and salary bill increased, thanks to active trade unionism.[58] The Reserve Bank liberalised the branch licensing policy for RRBs as they were permitted to merge, relocate, open branches and also convert branches into satellite offices. Freedom was given to adopt appropriate information technology solutions including setting up of ATMs and switching over to core banking models.

They were permitted to make use of lines of credit from sponsor banks and access repo and collateralised borrowing and lending obligation (CBLO) markets (see Chapter 3).[59] In 2007, the Reserve Bank advised the sponsor banks to extend support for expanding the business activities of their RRBs.[60]

The Reserve Bank took several other measures to improve the performance of these banks.[61] Despite these measures, the RRBs had to reckon with their ambiguous identity. The guarantees issued by them were not accepted by government departments and agencies as they were not 'nationalised' banks. Government funds were not deposited with them. The RRBs were not covered under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. Further, proposals to merge them with sponsor banks, convert them into wholly owned subsidiaries of sponsor banks, consolidate all RRBs into one National Rural Bank, and so on, were brought to the table time and again, which impacted the morale of the rank and file in these banks.

The Reserve Bank introduced capital adequacy norms in 2007. RRBs needed to disclose the level of CRAR in their balance sheets and notes on accounts to their financial statements. The asymmetrical implementation of the ratio among different categories of banks did lead to some problems. For example, the risk weights to be assigned by commercial banks for loans given to banks with negative net worth were high. In March 2008, twenty-two RRBs had a negative net worth. SBI, which had given refinance assistance to the RRBs sponsored by it, pointed out that in one case, it had to buffer up its own capital for a loan to an RRB. When the RPCD raised the issue with the Department of Banking Operations and Development, the latter replied that 'the remedy would seem to lie in strengthening the Regional Rural Banks sponsored by the public sector banks rather than trying to dilute the rigour of the CRAR norms'. The sponsor banks were, however, allowed to value their investments in RRBs at carrying cost without recognising diminution if any in the value of such investments.

Local Area Banks

In January 1993, the Reserve Bank issued guidelines for setting up new private sector banks with a minimum start-up capital of ₹1 billion and ten 'new generation' banks received licenses and commenced operations, catering mostly to metropolitan and urban areas. It was in this context that the proposal for setting up new private banks in *rural* areas was mooted. In 1996, the Union Finance Minister in his Budget speech announced that 'it has been agreed with RBI to promote the setting up of new private local banks with jurisdiction over two or three contiguous districts. This would enable the mobilization of rural savings by local institutions and at the same time make them available for investments in local areas'. These banks were expected to bridge the gaps in credit availability, enhance the institutional credit framework in rural and semi-urban areas and provide efficient and competitive financial intermediation.

The Reserve Bank issued guidelines in August 1996 inviting applications for the setting up of local area banks. The minimum start-up capital was fixed.[62] The banks would be subject to prudential norms. The Reserve Bank received 227 applications. There was pressure from the government to expedite approvals. There were at the same time letters of protest from trade unions, cooperative bodies and associations. The Cooperation Minister from Kerala wrote to the Union Finance Minister that 'merely adding a new institution like the Local Area Banks will make the present mess [in rural credit] more confounded. It could even prove counter-productive. Let it be noted that the government and the people of Kerala are totally opposed to the sanctioning of any Local Area Bank in the State at this juncture'. Eventually, six local area banks started functioning.

Meanwhile, in June 2000, the Reserve Bank wrote to the Special Secretary (Banking) in the Ministry of Finance suggesting a review of the scheme, and added that 'pending such a review, we propose to discontinue receipt of further applications for setting up of Local Area Banks and issue a press release'. The government replied in February 2001, stating that 'it was perhaps too early for a review'. The Reserve Bank nevertheless appointed a review group in July 2002.[63] The group drew attention to the weaknesses in the concept of local area bank mode, particularly its size and capital base. The group added that until a more sound framework was implemented, 'there should be no licensing of the new Local Area Banks'.[64]

The other recommendations were that the four local area banks must raise their capital, and 'need to be treated like any other commercial bank' for the purpose of regulation.[65] This was accepted and implemented in 2004. A proposal to convert the four local area banks into NBFCs was considered but given up. As of March 2008, the four banks had forty-four branches and aggregate assets of ₹6.54 billion, of which Capital Local Area Bank Ltd alone had ₹4.66 billion.

The decision not to license any more local area banks had its share of criticism. In its report entitled 'A Hundred Small Steps', the Committee on Financial Sector Reforms appointed by the government in 2009 and chaired by Raghuram G. Rajan observed, 'The Local Area Bank scheme was never given a serious try.'[66] With Raghuram G. Rajan joining the Reserve Bank as Governor in 2013, guidelines were issued in 2015 for setting up 'small banks'. The largest among the four local area banks, the Capital Local Area Bank Ltd, applied for conversion to a small bank and it was accorded approval.

Conclusion

It is tempting to conclude from this narrative that rural credit regulation has been, to cite the Cooperation Minister of Kerala again, 'a mess'. But that would be a harsh judgement. The mission to find a way through the mess, revive banks, and supply credit to the priority sectors was challenging, to say the least. How well this balance was achieved will have to be judged against several benchmarks. The continuing problem of bank NPAs and reports of farmer distress suggest a broadly negative assessment, whereas diversification of priority sector borrowers, reforms initiated in key local players, including cooperatives and local area banks, and technological and institutional changes, such as microfinance and the KCCs, suggest a more positive assessment. An impartial review will take us beyond the period of the study.

Notes

1. Government of India, *Report of the Committee on Banking Sector Reforms* (New Delhi: Ministry of Finance, 1998), p. 2.
2. In the same vein, the working group appointed by the Bank in 1997 for Harmonising the Role and Operations of Development Financial Institutions and Banks (Chairman: S. H. Khan, Chairman and Managing Director, IDBI) recommended an alternative mechanism for priority sector lending '[r]ather than imposing the priority sector obligation on the entire banking system....' (Annexure I of the RBI discussion paper on the subject released on 28 January 1999). The Asian Development Bank (ADB), while extending a loan to India in 1992, had stipulated that the Reserve Bank should undertake a 'review of the priority sector credit program toward a rationalization of the priority credit'. In the Program Completion Report filed in November 1997, the ADB observed that the 'efficiency gains of banking sector could have been

also augmented if RBI had taken a more aggressive approach to dismantle the priority credit programs'.

3. Letter dated 5 April 2004 from N. S. Sisodia, Secretary (Financial Sector), Ministry of Finance, Government of India.
4. RBI, Basic Statistical Returns of Scheduled Commercial Banks in India, various years.
5. The limit was fixed at 100 per cent of their net-owned funds and NABARD had net-owned funds of ₹22.80 billion at that time.
6. In June 1998, NABARD was sanctioned a term money limit of ₹2 billion and a term deposit limit of ₹3 billion. NABARD was not allowed to raise certificates of deposit or inter-corporate deposits at that time.
7. The credit limit, which was ₹12 billion in 1982–83, rose to ₹66 billion by 2000–01, proportionate to the refinancing requirements of NABARD.
8. The Executive Director in charge of the Rural Planning and Credit Department (I. D. Agarwal) had recorded in June 1999 that 'the present arrangement cannot continue in its present form indefinitely. NABARD should make a beginning of involving itself in meeting the short term credit needs of the cooperative sector out of its own resources'.
9. But the Reserve Bank allowed the operation of the line of credit for six more months until December 2006, which was extended up to January 2007 in view of the difficulties faced by NABARD in raising the required funds from the market at that time. When the request for extension was referred to the MPD, they observed, in a note put up to the Governor in May 2006, that their 'estimates showed that delaying GLC repayment [by NABARD] would expand primary liquidity beyond the projected level for nearly six months and would imply an increase of nearly 0.6 percent to 0.7 percent in money supply (M3) during the deferred period, which is within the tolerable limits'.
10. Had this recommendation been acted upon, the protracted correspondence on NABARD's proposals to include specific institutions for extending refinance (RABO India Finance Ltd, National Cooperative Development Corporation, EXIM Bank of India) could have been avoided. Such requests were not usually agreed to by the Reserve Bank.
11. There was a joint coordination committee (JCC) between the Reserve Bank and NABARD officials at the level of Chief General Managers for sharing of views and taking a coordinated approach to policy. Though the committee was to meet every six months, after a lapse of three years, it met in February 2000, and thereafter it met again only in October 2004. Subsequently, it met in June 2005, September 2006 and June 2008. There were coordination meetings at the regional office level as well.
12. Loan limit was kept at ₹6,500 (for housing loans ₹20,000), with a repayment period of five years, and no margin money or security could be taken by banks. The scheme continued without effective enforcement.

13. As of March 2008, the performance of public sector banks was 0.05 per cent. According to bankers, there were no takers for the loans under DRI as the potential beneficiaries preferred to take loans under subsidy-linked government-sponsored schemes where the loan quantum was much higher. The government was not in favour of scrapping the DRI scheme.
14. With effect from April 2009, the shortfall in lending to weaker sections would also be taken into account for the purpose of allocating amounts for contribution to the Rural Infrastructure Development Fund (RIDF) (see later).
15. High-level committee (Chairman: R. V. Gupta, Deputy Governor) set up in 1997 to suggest measures for improving the credit delivery system and simplification of procedures for agricultural credit. The committee submitted its report in April 1998.
16. Banks do not normally pay interest on the credit balances in the cash credit accounts. However, in respect of such accounts of farmers, the Reserve Bank permitted banks in 2000 to consider payment of interest on credit balances. The committee also recommended giving discretion to banks to fix the scale of finance for different crops. NABARD, however, was not agreeable to this, when the matter was referred to them, as they had the technical expertise to fix the scale of finance for crops on a yearly basis.
17. In regard to NPA norms for crop loans, the Bank accepted the committee's recommendation that two crop seasons instead of two half years should be reckoned for determining default. The committee stated that the 'service area approach' introduced in 1989 might be dispensed with for all lendings other than loans under government-sponsored schemes. This was done in December 2004. Of the ninety-nine recommendations of the committee, only four were *not* accepted. Banks were advised to implement the accepted recommendations.
18. This was also in line with the observation by the Vyas Committee that 'fixing targets on the basis of disbursements would not establish a link between the total advances of the bank and its lending to agriculture'.
19. The deposits kept with NABARD under the RIDF scheme were treated as indirect lending to agriculture. This provision was withdrawn from April 2007 in respect of fresh deposits with NABARD, and outstanding deposits were reckoned as indirect finance to agriculture until maturity or March 2010, whichever was earlier.
20. With the revised guidelines on priority sector lending issued in April 2007, loans sanctioned to these units were brought under indirect finance to agriculture, and ceiling limit for plant and machinery increased to ₹100 million from ₹50 million.
21. Address at the Conference of Indian Society of Agriculture Marketing, Visakhapatnam, 3 February 2001, p. 5.

22. Government of India, *Debt and Investment Survey: NSS Forty-Eighth Round* (New Delhi: Ministry of Statistics and Programme Implementation, 1991); Government of India, *Debt and Investment Survey: NSS Fifty-Ninth Round* (New Delhi: Ministry of Statistics and Programme Implementation, 2003); Government of India, *Debt and Investment Survey: NSS Seventieth Round* (New Delhi: Ministry of Statistics and Programme Implementation, 2013). The Reserve Bank constituted a technical group in 2006 to review the efficacy of the existing legislative framework that governed money-lending. The model legislation proposed by the group was sent to state governments in 2007 for considering enactment. State governments, however, did not exhibit much enthusiasm to enact or replace the existing statutes.
23. RBI, Basic Statistical Returns, 1997, 2008.
24. The outstanding credit in respect of scheduled commercial banks with limits above ₹100 million as a percentage to total agricultural (direct and indirect) credit had gone up from 3.8 per cent in March 1997 to 18.4 per cent in March 2008.
25. Report of the Task Force on Credit Related Issues of Farmers (Chairman: U. C. Sarangi, Chairman, NABARD).
26. For agricultural advances, banks were advised not to compound interest on current dues as well as on instalments not falling due in respect of term loans. Further, banks had to ensure that the amount of total interest debited to an account did not exceed the principal amount in respect of short-term advances to small and marginal farmers, and banks should charge interest on agricultural advances only at annual or longer rests. Banks were advised that all loan applications up to a credit limit of ₹25,000 should be disposed of within a fortnight and those up to ₹500,000 within four weeks.
27. Public sector banks were advised in March 2002 to formulate a scheme of the hassle-free settlement of chronic overdue of defaulting farmers, with loans up to ₹50,000, with appropriate relief on accumulated interest.
28. Subject to a maximum of 1.5 per cent of their total credit.
29. Of ₹10.83 billion forthwith and the balance amount of ₹4.56 billion in two equal instalments on 1 April 2009 and 1 April 2010. The J&K Bank Ltd did not deposit any amount and on a request made by the bank for permission to deposit the arrears in four equal instalments, the bank was advised in December 2008 to pay the arrears in three instalments in December 2008, March 2009 and June 2009 but the bank again defaulted. By April 2009, the aggregate shortfall in the contribution under various tranches of the RIDF increased to ₹26.83 billion. It was, therefore, decided in May 2009 vide Deputy Governor Usha Thorat's orders to 'take regulatory action including holding back the applications for branch licences'. The regulatory department in the Reserve Bank was advised accordingly in the matter.

30. Since NABARD also had schemes for non-farm activities, they asked for these funds to be kept with them but it was not acceded to by the Reserve Bank for the reason that 'it was more in the nature of punitive measure than a resource mobilisation exercise for FIs'.
31. The Secretary (Financial Sector) wrote to Governor Reddy on 15 October 2003 stating such interest rates should be disadvantageous to the banks so as to act as a deterrent.
32. Direct or indirect, depending on the underlying assets, provided the securitised assets were originated by banks and FIs and fulfilled Reserve Bank guidelines on securitisation.
33. Also useful were the recommendations of the Task Force on Supportive Policy and Regulatory Framework for Micro Credit set up by NABARD.
34. Presided over by Vepa Kamesam, Deputy Governor.
35. In the Central Board meeting of the Bank held in December 1999, Governor Jalan mentioned that microfinance institutions would not be regulated or supervised by the Bank.
36. The government introduced in the Lok Sabha in March 2007 the Micro Financial Sector (Development and Regulation) Bill, 2007, which sought to promote the sector and regulate microfinancial organisations. NABARD was identified as the regulator for the microfinance sector. However, the Bill was not passed and was allowed to lapse. Taking advantage of the regulatory vacuum, 'not-so-fit and proper' entities entered the space and in the wake of problems faced by borrowers in Andhra Pradesh and certain other states, a new Bill was mooted in 2011. It was revised and redrafted many times before it took shape as the Micro Finance Institutions (Development and Regulation) Bill, 2012. The Bill was considered and rejected by the Standing Committee on Finance in 2013–14, and it also lapsed eventually.
37. 'Report of the Internal Group to Examine Issues Relating to Rural Credit and Microfinance', July 2005, para 2.21.
38. SBI and its associate banks wanted to be exempted from the revised KCC as they had their own Kisan Gold Card scheme, which was not acceded to by the Bank.
39. Chairman: S. L. Kapur.
40. The banks were advised to calculate working capital limits to small-scale industrial units based on the turnover of the unit. To ensure an adequate level of credit, banks were instructed to sanction working capital limits equivalent to 20 per cent of the annual turnover for small-scale industrial units with turnover up to ₹40 million.
41. Working Group on Flow of Credit to Small-Scale Industries Sector under the chairmanship of A. S. Ganguly, member of the Reserve Bank board, which submitted its report in 2004. Its recommendations for facilitating

credit flow and availability of timely finance to the sector at the right price were commended to the banks for implementation.

42. With a view to ensuring that the smaller units within small-scale industries were not squeezed out, banks were advised to lend 40 per cent of their total lending to small-scale industries to 'tiny' units with plant and machinery costing up to ₹0.5 million and ₹0.2 million for manufacturing and service enterprises, respectively. A further 20 per cent of the small-scale industries advances were earmarked for units with plant and machinery valued between ₹0.5 million and ₹2.5 million and ₹0.2 million and ₹1 million for manufacturing and service enterprises, respectively. In August 2000, a group of ministers decided that the Bank should draw up transparent and non-discretionary guidelines for the rehabilitation of sick and potentially viable small-scale industrial units. The Bank appointed in November 2000 a high-level working group on rehabilitation of sick small-scale industrial units, with S. S. Kohli (Chairman and Managing Director, Punjab National Bank) as Chairman and a Deputy Governor as one of its members, to review the existing guidelines on the subject. Based on the group's recommendations, the Bank issued detailed guidelines in January 2002 for providing timely assistance to potentially viable sick units. When the government enacted the Micro, Small and Medium Enterprises Development Act, 2006 (April 2007), the Reserve Bank advised banks that loans given to medium enterprises (defined as those manufacturing units with value of plant and machinery from ₹50 million to ₹100 million, and service enterprises with cost of equipment between ₹20 million and ₹50 million) would *not* be covered under priority sector lending. A 'standing advisory committee' under the chairmanship of one of the Deputy Governors was monitoring the flow of institutional credit to the small and medium enterprises, or SMEs. The committee met regularly to take stock of the developments, analyse the problems being faced by the sector, and suggest corrective measures. The Bank constituted 'empowered committees' at its regional offices to review the progress in SME financing by banks and rehabilitation of sick units. It also formulated a one-time settlement scheme for NPAs below ₹100 million and issued detailed guidelines to public sector banks for implementation. A debt restructuring mechanism for units in the SME sector, on the lines of the corporate debt restructuring (CDR) mechanism, was formulated and guidelines issued for implementation.

43. Not surprisingly, inspecting officers from the DBS again noted, in 2007, that Federal Bank Ltd – a private sector bank based in Kerala – had granted fifty-nine loans to borrowers who were not small and marginal farmers for purchase of tea estates and agricultural land, and classified them as direct lending to agriculture. On being asked to clarify, the bank maintained the classification was indeed in order. Inspecting teams also came across instances of pre-shipment and post-shipment credit to corporates in food and agro-processing

sectors being wrongly classified as direct finance to agriculture. A random check during the annual inspection of the Indian Overseas Bank revealed that seven accounts amounting to ₹7.90 billion were wrongly classified as indirect advances to agriculture. The bank, which had reported having achieved the targets for agriculture and priority sectors, would be falling short of targets by 1.5 per cent if this amount were to be excluded.

44. The banks were also advised to set up special subcommittee of the District Consultative Committee in districts with a credit–deposit ratio of less than 40 per cent in order to draw action plans to increase it. In State-Level Bankers' Committees and District-Level Review Committee meetings, the elected representatives, and sometimes the government officials, were labouring on this issue. This was unnecessary as the Reserve Bank had advised that 'while it is not necessary that this ratio should be achieved separately branch-wise, district-wise and region-wise, the bank should, nevertheless ensure that wide disparity in the ratios between different states and regions is avoided'.
45. It was accordingly decided to take three districts in each state and ten branches in each district for detailed enquiry. Forty-five committees were formed in fifteen states, with the Lead District Officers acting as conveners, and 450 branches were visited by the team of officials and roughly 4,500 customers were met during the study. Detailed reports containing the findings of the committees, along with their suggestions, were received in the central office in June–July 2002.
46. In December 2006, the Ministry wrote to the chairman of NABARD that 'it had been brought to our notice that banks while organising functions do not consult the concerned public representatives in advance and banks are not suitably inviting them to attend such functions. The Finance Minister has taken a serious view on this'. On receipt of the letter from NABARD, the Reserve Bank again took it up with the banks.
47. The Madhya Pradesh government wanted the chairman of the *zilla parishad* and the Kerala government wanted the chairperson of the district *panchayat committee* to head the District Consultative Committee in place of District Collector. The Reserve Bank, however, did not agree to such demands.
48. There were a few other administrative issues discussed in relation to the scheme. For example, in August 2005, the Reserve Bank through its College of Agricultural Banking, Pune, conducted two workshops for the benefit of 'lead bank managers' of commercial banks. In their feedback, the 'lead district managers' informed the college that many of them had not been provided with separate offices and infrastructure support. They were often asked to do other ad hoc items of work by the controlling offices. It also transpired that the State-Level Bankers' Committee had over time become an unwieldy forum with too many members, besides a number of permanent invitees and special invitees, which was not conducive to meaningful deliberations and decision-making.

49. I. G. Patel asked SBI to take up the matter with the Reserve Bank. He was a director on the board of SBI, which had lead bank responsibility in roughly one-third of the districts.
50. It was commented by the International Monetary Fund team during the Article IV Consultation with India in October 2004 that 'the strength of the banking system should not be undermined by the weakness of the cooperative banking system'.
51. Task Force to Study the Cooperative Credit System and Suggest Measures for Its Strengthening, under the chairmanship of Jagdish Capoor, Deputy Governor. It had also recommended a revival package covering financial, operational, organisational and systemic issues.
52. Task Force on Revival of Rural Cooperative Credit Institutions (Long Term) with A. Vaidyanathan, economist, as chairman. The Reserve Bank was not part of the task force except that two officials were included as permanent invitees. The task force submitted its final report on the short-term structure in February 2005.
53. The government also set up a National Implementing and Monitoring Committee under the chairmanship of the Governor in April 2006 to oversee the implementation of the revival package. The committee had three meetings which were chaired by the Governor. But the committee was reconstituted in 2007 with the Secretary (Financial Sector) in the Ministry of Finance as chairman in place of the Governor.
54. As on March 2008, only 14 state cooperative banks and 75 district central cooperative banks had been issued licences by the Reserve Bank and 16 state cooperative banks were included in the second schedule to the RBI Act. Six state cooperative banks and 121 district central cooperative banks did not comply with Section 22(3)(a) of the Banking Regulation Act, 1949, with respect to their capacity to pay their depositors in full and 14 state cooperative banks and 342 district central cooperative banks did not comply with Section 22(3)(b) of the Act as the affairs of these banks were stated to be conducted in a manner detrimental to the interests of their depositors. The aggregate accumulated losses of state cooperative banks and district central cooperative banks as on 31 March 2008 were ₹4.29 billion and ₹61.06 billion, respectively.
55. With A. Vaidyanathan as chairman.
56. The government was further advised that as long-term structure had aggregate public deposits of only ₹10.45 billion with a highly diverse structure comprising 717 banks, the cost of regulating and monitoring them would be disproportionately high.
57. The accumulated losses of the state cooperative agriculture and rural development banks and primary cooperative agriculture and rural development banks as of 31 March 2008 were ₹13.54 billion and ₹32.83 billion, respectively. NABARD, *Annual Report 2008–09* (Mumbai: NABARD, 2009), p. 78.

58. Initially, RRBs were permitted to finance borrowers outside the target group to the extent of 40 per cent. This was raised to 60 per cent in April 1997, and they were required to lend only 40 per cent of their advances to the priority sector. The Narasimham Committee II had 'strongly urged' that 'the basic feature of Regional Rural Banks as low-cost credit delivery institutions should not be diluted any further'. In 2002, the target for lending to the priority sector was reviewed again and restored at 60 per cent.
59. With the process of consolidation and amalgamation of state-level sponsor-bank-wise RRBs commencing from September 2005, the number of RRBs had declined to 91, with 14,788 branches by 31 March 2008.
60. The RRBs were allowed to introduce facilities such as remittances at par and issue of demand drafts and also participate in consortium financing in collaboration with their sponsor banks. They were allowed to open and maintain non-resident external/non-resident ordinary (NRE/NRO) accounts in rupees. They were permitted to act as authorised dealers for handling limited foreign exchange transactions. Approvals were given to RRBs on merits to issue debit/credit cards, handle pension and government business as sub-agents, and set up currency chests, subject to conditions. They were also permitted to undertake, without risk participation, distribution of insurance products.
61. The Reserve Bank constituted empowered committees in its regional offices with members drawn from NABARD, sponsor banks, RRBs in the state, conveners of State-Level Bankers' Committees and the state government with Reserve Bank's Regional Director as the chairperson. The committee was required to ensure that RRBs in the state adhered to good governance and complied with prudential regulations. The committee was advised to focus on operational constraints and provide clarification on regulatory issues. In 2004, the Governor had a series of meetings with officers of RRBs and the sponsor banks to inform the officials of the need for improving governance and also to enhance the flow of rural credit. To address the governance issues in RRBs, the Reserve Bank set up a task force under the chairmanship of NABARD managing director, K. G. Karmakar, to deliberate on empowering the RRB boards. The task force submitted its report in February 2007.
62. At ₹50 million to be brought upfront by the promoters.
63. With G. Ramachandran (former Finance Secretary) as chairman which submitted its report in September 2002.
64. The Reserve Bank submitted the recommendations before the Board for Financial Supervision and decided to accept them for implementation, including the recommendation not to license any new local area bank. Before the issue of the press release, the Reserve Bank referred the matter to the government in February 2003, which accorded its approval in April. The press release was issued in August 2003.

65. From ₹50 million to ₹250 million over a period of five to seven years, and maintain a minimum CRAR of 15 per cent.
66. Government of India, *A Hundred Small Steps: Report of the Committee on Financial Sector Reforms* (New Delhi: Planning Commission and Sage Publications, 2009), p. 74.