Regional Rural Banks: The Past and the Present Debate

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The institution of Regional Rural Banks (RRBs) was created to meet the excess demand for institutional credit in the rural areas, particularly among the economically and socially marginalised sections. Although the cooperative banks and the commercial banks had reasonable records in terms of geographical coverage and disbursement of credit, in terms of population groups the cooperative banks were dominated by the rural rich, while the commercial banks had a clear urban bias. In order to provide access to low-cost banking facilities to the poor, the Narasimham Working Group (1975) proposed the establishment of a new set of banks, as institutions which "combine the local feel and the familiarity with rural problems which the cooperatives possess and the degree of business organization, ability to mobilize deposits, access to central money markets and modernized outlook which the commercial banks have". The multi-agency approach to rural credit was also to subserve the needs of the input-intensive agricultural strategy (Green Revolution) which had initially focused on `betting on the strong' but by the mid-seventies was ready to spread more widely through the Indian countryside. In addition, the potential and the need for diversification of economic activities in the rural areas had begun to be recognized, and this was a sector where the RRBs could play a meaningful role. The RRBs Act, 1976 succinctly sums up this overall vision to sub-serve both the developmental and the redistributive objectives:

The RRBs were established "with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs, and for matters connected therewith and incidental thereto"

Table 1: Expansion of Regional Banking: 1975-1990

	Dec. 1975	Dec. 1980	Dec. 1985	Mar. 1990[1]
Banks	6	85	188	196
Branches	17	3,279	12,606	14,443

Source: NABARD Reports.

The following one-and-a-half decades saw large-scale efforts to increase the number of banks, bank branches, and disbursements nationwide. (see Table 1) By 1991, there were 196 RRBs with over 14,000 predominantly rural branches in 476 districts with an average coverage of three villages per branch. These banks had disbursed over Rs. 3,500 crore in credit and mobilized over Rs. 4,100 crore in deposits. Perhaps the most significant achievement of the RRBs during this period was in enabling the weaker sections of the rural community access to institutional credit. The bulk of the loans from RRBs were to the priority sectors, which accounted for over 70 per cent of the total. Agriculture and allied activities took up more than 50 percent of the total advances. (see Table 2) In addition, the RRBs were instrumental in extending credit for poverty alleviation schemes

[1] The year 1990 marks the end of the expansion phase of regional banking, beyond which there has been no growth in the number of Regional Rural Banks (including branches), as we shall note in the next section.

(e.g., IRDP) and disadvantaged area (drought-prone regions and deserts) development programmes.

The expansionary phase of the late seventies and the eighties while more focused on outreach was not devoid of a blueprint for viability of the RRBs, unlike what the mainstream academia and press claim to be the case. It was understood that the RRBs to survive as credit institutions could not remain unviable for a long time, though the RRBs might not become viable in the initial years. This expectation was, however, tempered by the prevalent situation on the field and the ultimate objectives for which these specialized institutions were created.[2] It was realized early that the question of viability of the RRBs could not be the same as other business ventures. A business unit has all the freedom to take decisions on many matters such as opening branches, deploying its resources, staff recruitment, its purchases, methods of rendering services etc. But the RRBs could not be flexible in many of their affairs; even their clientele was specific, scattered, remote and not assisted by anyone. Keeping in view the objectives, structure and the nature of operations of the RRBs, these institutions could certainly not be evaluated on the basis of mere financial viability. There was a general agreement that the viability of the RRBs had to be assessed in terms of a composite criteria including increase in business per branch, recovery rate, productivity of staff, cost effectiveness of operations, closer monitoring, socio-economic upliftment and improvements in the standards of living of the clientele. Again in respect to the viability question, there was considerable flexibility accorded to banks on the time dimension. It was estimated that the RRBs would need about seven years to become viable, though for the RRBs with a large number of infant branches even this period might not be adequate. Between 1980 and 1987, while the number of RRBs increased a little more than two-fold, the number of branches of RRBs increased more than four-fold. It was not totally unexpected therefore that by the end of the 1980s several of these banks were showing losses on their books.

Table 2: Purposewise Advances of RRBs, Outstanding (end of Sept, 1990)

Rs. Crores

1	Short Term (crop Loan)	615
2	Term Loan and Agriculture Activities	669
3	Allied Activities	555
4	Rural Artisans, Village & Cottage Industries	277
5	Retail Trade and Self-employed etc.	1052
6	Consumption Loan	54
7	Other purpose	290
8	Indirect Advances	43
	Total	3555

Source: Report on Trend and progress of Banking in India, 1990-1.

[2] See Velayudham and Sankaranarayanan (1990) for a nuanced account of the concerns and debates on the RRB issue during the late 1980s. Velayudham, T.K. and V Sankaranarayanan (1990) `Regional rural banks and rural credit: some issues' Economic and Political Weekly, September, 22.

The willingness to allow the RRBs these specific considerations notwithstanding, there were serious attempts to redress the prevalent problems of these banks, the principal one at the time being the low recovery rates and loan overdues. These had not only led to capital erosion but more importantly had resulted in non-recycling of funds, which in turn necessitated increasing dependence on external sources of refinancing. The internal factors identified as contributing to low recovery were: weak monitoring and supervision, apathy towards recovery, failure to link lending with development and to ensure end use of the loan. The external factors were: political interference, willful default, drought and floods, underdevelopment, lack of legal and administrative support from the state government in the matter of recovery, etc. Generally, recovery was low in respect of loans sanctioned under IRDP and other poverty alleviation programmes. Besides there were certain organizational problems such as low capital base, multiple ownership and divided responsibility, lack of adequate training for the RRB staff, etc. which called for intervention.

Taking note of these lacunas, inter alia, the Kelkar Committee (1986) made comprehensive recommendations covering both the organizational and operational aspects. Several of these were incorporated as amendments to the RRB Act, 1976 such as: (a) enhancement of authorized capital of RRBs from Rs 1 crore to Rs 5 crore and paid-up share capital from Rs 25 lakhs to Rs 1 crore; (b) appointment of Chairman of RRBs by the concerned sponsor bank in consultation with NABARD; (c) provision of assistance to RRBs in greater measure by sponsor banks in training RRB staff and giving financial assistance to RRBs in their first five years of their existence; (d) provision for amalgamation of RRBs in consultation with all the concerned parties; and (e) empowering the sponsor banks to monitor the progress of RRBs and also to arrange for their inspection, internal audit etc. Though the progress of implementation was tardy (the amended act came into force only by end-September, 1988), there was enough scope for improvement thereon. Velayudham and Sankaranarayanan (1990) were optimistic that `a faithful implementation of Kelkar Committee recommendation in toto should definitely change the course and outlook for RRBs over the next five years.' More generally, the Kelkar Committee's recommendations reaffirmed the faith in the institution of regional rural banks: `RRBs as part of the multi-agency approach to rural credit are eminently suitable to do the job envisaged for them, that as district level organizations, they can be trusted to take banking closer to rural households.'

RRBs and Economic Reforms

In the year 1989 for the first time, the conceptualization of the entire structure of Regional Rural Banks was challenged by the Agricultural Credit Review Committee (Khusro Committee), which argued that these banks have no justifiable cause for continuance and recommended their mergers with sponsor banks.[3] At the time such a policy move was politically unthinkable, so the Reserve Bank and the Government of

[3] The Committee was of the view that "the weaknesses of RRBs are endemic to the system and non-viability is built into it, and the only option was to merge the RRBs with the sponsor banks. The objective of serving the weaker sections effectively could be achieved only by self-sustaining credit institutions."

India quite prudently pushed the Khusro Committee report under the carpet without a public debate. With the onset of the neo-liberal economic reforms and the liberalization of the financial system, the RRBs came under the scanner once again, but this time in a policy regime that was too willing to let the market principles rule. The Committee on Financial Systems, 1991 (Narasimham Committee) stressed the poor financial health of the RRBs to the exclusion of every other performance indicator. 172 of the 196 RRBs were recorded unprofitable with an aggregate loan recovery performance of 40.8 percent. (June 1993) The low equity base of these banks (paid up capital of Rs. 25 lakhs) didn't cover for the loan losses of most RRBs. In the case of a few RRBs, there had also been an erosion of public deposits, besides capital. In order to impart viability to the operations of RRBs, the Narasimham Committee suggested that the RRBs should be permitted to engage in all types of banking business and should not be forced to restrict their operations to the target groups, a proposal which was readily accepted. This recommendation marked a major turning point in the functioning of RRBs as we shall see below. For the timebeing though, the suggestion of mergers of the RRBs with their sponsor bank, which the Committee on Financial Systems had put forth in a slightly modified form – `sponsor banks might decide whether to retain the identities of sponsored RRBs or to merge them with rural subsidiaries of commercial banks to be set up on the recommendation of the committee' – was put on hold.

In the ensuing years, reforms of the RRBs largely followed the same format as that of the commercial banks, irrespective of the fact that their very role in the society required a special status and a different set of policies. Since the early 1990s, there was a complete freeze on recruitment of new staff in the RRBs. As a part of comprehensive restructuring programme, recapitalisation of the RRBs was initiated in the year 1994-95, a process which continued till 1999-2000 and covered 187 RRBs with aggregate financial support of Rs.2188.44 crore from the stakeholders.[4] Simultaneously, prudential norms on income-recognition, asset classification and provisioning for loan-losses following customary banking benchmarks were introduced. From 1996/7, there has been a tendency to allow greater role and larger operational responsibilities to sponsor banks in the management of RRBs. The rest of the section discusses a few of the major policy changes and their observed outcomes.

- *Provision for rationalization of branch network including relocation and merger of loss-making branches:* One of the regulations that the RRBs faced was regarding the limited area of operations and their narrow client base. In 1993, RBI gave permission to RRBs to relocate branches that were consistently making losses for more than three years. This policy provided an opportunity to the RRBs to shift branch premises to more commercially promising areas from localities where they had incurred sustained losses. As Table 3 indicates, between 1996 and 2003, about 459 offices of RRBs were closed and relocated to semi-urban and urban centers so that the overall number of branches of RRBs would remain constant. In addition, there were relocations within

[4] The infusion of fresh capital was in the same proportion as the issued capital by the different stakeholders, so that the ownership structure remains unchanged. The issued capital of a RRB is shared in the proportion of Government of India (50%), the concerned State Government (15%) and Sponsor Banks (35%).

the rural areas from remote locations to commercial places (not captured by the data). The transfer of banking business to semi-urban and urban centers was even more drastic with a 6 percent decline in share of rural areas in credit amount outstanding, over the seven years, as the banks adjusted their clientele.

Table 3: Relocation of RRBs' Business from Rural to Semi-Urban & Urban Areas

Location	Number of Offices		Distribution of Credit Outstanding (%)	
	1996	2003	1996	2003
Rural	12448	11989	77.45	71.51
Semi-Urban	1844	2183	17.72	21.76
Urban	373	477	4.78	6.50
Metropolitan	7	22	0.06	0.24
All-India	14672	14671	100.00	100.00

Source: RBI, Basic Statistical Returns, March 1996 and March 2003.

- *Permission to lend to others outside target groups and deregulation of interest rates:* Before the initiation of banking reforms, lending from the RRBs was largely restricted to the priority sector. From September1992 onwards, the RRBs were allowed to finance non-target groups to the extent not exceeding 40 percent of their incremental lending. This limit was subsequently enhanced to 60 percent in 1994. As a result, the RRBs diversified into a range of non-priority sector (NPS) advances, including jewel and deposit-linked loans, consumer loans and home loans. The RRBs adopted new innovations for credit delivery with lower risk of default such as Self-help Group linked lending, non-priority sector collateralized lending, Kisan Credit Card scheme for landed agriculturists, etc. As a proportion of total advances, priority sector lending dipped from around 70 percent in 1990 to 57 percent in 2001. Even among the categories that were eligible as priority sector, the attempt was to minimize credit risk and make easy loans. Between 1995 and 2003, while short term agriculture credit under the priority sector increased at about 29 percent per annum, term loans declined by 2.6 percent a year. [5]

  Sinha et al (2003) in a field study of 5 RRBs find that non-priority sector advances increased sharply in the second-half of the 1990s for all the sample banks.[6] Of these 4 banks have a significant 25 percent of their portfolio invested in non-priority sector loans. The interviewed RRB managers agree that this was a deliberate strategy to improve viability. Non-priority sector advances are mostly collateralized and therefore carry low risk; they are generally market-based and of a higher value extended to higher-income clients or to low income clients through deposit and jewelry linked loans; and banks have freedom to charge cost-covering interest rates

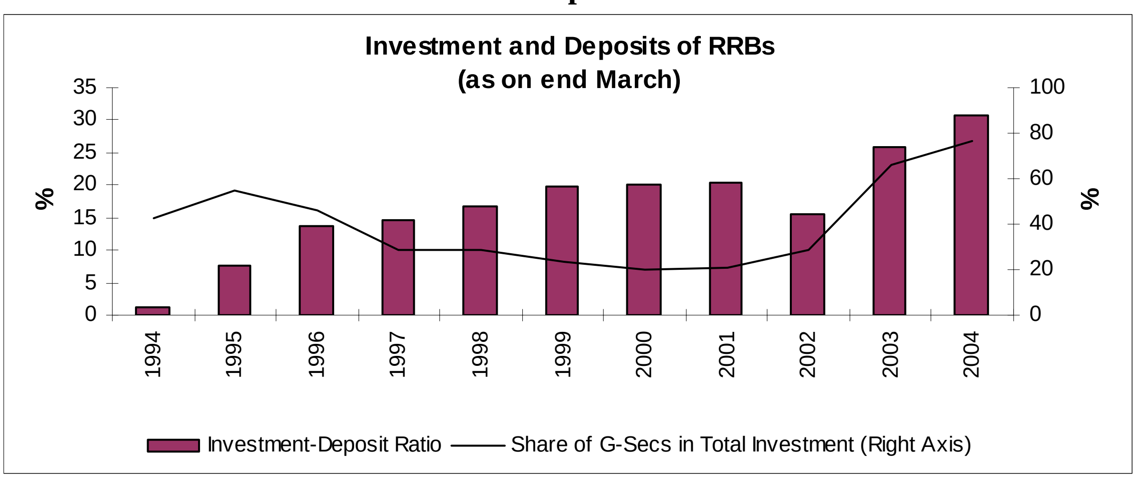
[5] Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System, RBI, June 2004. (Vyas Committee, 2004)

[6] Sanjay Sinha, Tanmay Chetan, Orlanda Ruthven and Nilotpal Pathak (2003) `The Outreach/Viability Conundrum: Can India's Regional Rural Banks Really Serve Low-Income Clients?' ODI Working Paper No. 229, ODI, London.

on non-priority sector advances. The bank managers candidly accept that the RRBs have been able to raise their profitability by refusing to serve low-income clients!

- *Rising investments in banks' portfolios:* The RRBs in following the trend set by the commercial banks increased the share of investment assets in the portfolio. Not only did the share of investments in government securities increase beyond the SLR norms, simultaneously there was a diversion of an increasing share of the investment portfolio into other approved securities such as PSU bonds and debentures. (see Graph 1) The importance of investments in the portfolio of the RRBs can be gauged from the fact that the interest on investments was about 52 percent of the total income in 2003 while interest on advances was 37 percent of the income.[7] Mujumdar (2001) attacks this reverse flow of funds from the rural to the urban areas as the most retrogressive policy initiated by the RBI. Priority sectors — including agriculture, small industry, retail trade, the whole range of non-farm activities in the rural sector — have no access to the capital market and hence the emphasis should be to promote flow of resources from the urban to the rural areas. However, an indulgent RBI has yielded to the biased perspective that there aren't enough avenues to invest bank resources in the rural sector.[8]

Graph 1



<u>*Note:*</u> In the monetary and credit policy 2002-03 it was announced that the RRBs should maintain their entire SLR holdings in the form of government and other approved securities by converting existing deposits with sponsor banks. Accordingly, RRBs have rapidly expanded their investment in government securities in the recent years.
<u>*Source:*</u> Report on Trends and Progress of banking in India, RBI, various issues.

- *Meager Growth of Credit Advances:* Notwithstanding the few new instruments of credit delivery, the growth of credit disbursements by the RRBs dipped to very low levels in the 1990s. During the first half of the decade, credit growth fell from an annual rate of around 20 percent in the eighties to negligible levels, and remained at

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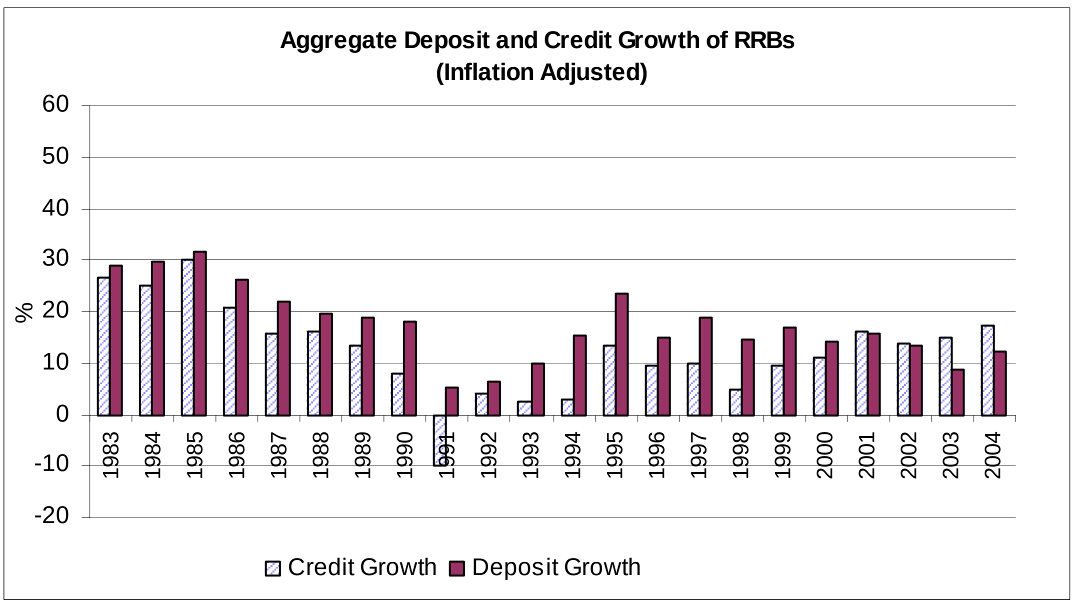
[7] Vyas Committee (2004)
[8] `Co-op banks and market: The vicious link', by N. A. Mujumdar in Hindu Business Line, Friday, April 27, 2001f

below 10 percent level during the rest of the decade. (see Graph 2) As noted above, in order to cut costs and improve the profitability of their operations, the RRBs were restricting credit advances, particularly advances to the target group borrowers, and instead investing in risk-free government and other approved securities.[9] Investment-deposit ratio of the RRBs steadily climbed up from very low levels (see Graph 1), whereas the credit-deposit ratio of the RRBs declined sharply. In fact, credit-deposit ratio of the RRBs, which in 1990 stood at more than 80 percent compared to 65 percent for the scheduled commercial banks, fell to 43 percent by the year 2002-3! This was even lower than the credit-deposit ratio of 49 percent recorded for the scheduled commercial banks in the corresponding year. The Estimates Committee, 2002-3 notes that the credit-deposit ratio of RRBs declined steadily at an annual rate of 3-4 percent from 1992 to 1999. In another important observation, the Committee notes that the ratio was higher than 60 percent only in 41 RRBs (out of 196) in 2001.[10]

Graph 2



Source: RBI, Handbook of Statistics on the Indian Economy, 2003-4.

While the circumstances during the 1990s are most often described as a supply-constrained situation with credit rationing by the RRBs that created a great deal of

[9] For an analysis of why the commercial banks reduced their credit activities at a time when preemption on banks' resources in the form of statutory requirements had been lowered, see the discussion on `Changes in Banking Practices' (pp. 12-13) in the Interim Report of the Independent Commission on Banking and Financial Policy available at:
http://www.macroscan.org/pol/may05/pol160505Independent_Commission.htm

[10] The Estimates Committee, 2002-3, 'Regional Rural Banks' Sixteenth Report on the Ministry of Finance and Company Affairs, Department of Economic Affairs, Banking Division. (Chairman: Prof Ummareddy Venkateswarlu)
The Estimates Committee is a Parliamentary Committee consisting of 30 Members, elected every year by the Lok Sabha from amongst its Members. The Chairman of the Committee is appointed by the Speaker from amongst its members.

unfulfilled demand for credit especially among the lower-income clients, the demand for loans from the RRBs was also affected by the high interest rate charged on loans. The RRBs which are meant to provide `low cost banking facilities to the poor' after the deregulation of interest rates in 1996, maintained the highest interest rate structure on loans among rural institutional credit sources.[11] For instance, RRBs in Jan. 2005 were attracting about 11-12 percent rate of interest for the non-priority sector lending, while the sponsor banks were charging an interest rate of an average 8 percent.

Managers cite high operational costs as the reason for not being able to reduce the loan rates.[12] There are atleast two sets of evidence to doubt this assertion.
(a) An important finding from the work of Hulme and Mosley is that in a cross country study of rural credit institutions the lowest cost of administration, 8.1 percent of the portfolio, were incurred by the RRBs in India.[13] (b) Among banking institutions within the country, the RRBs per employee handle 885 accounts (small but large volumes of borrower accounts) as against the national average of 464 accounts per employee in the banking industry.[14] Structurally then, these banks are not high cost institutions.[15] It is more likely that the new freedom accorded to these banks, coupled with the challenges of a competitive environment are instrumental in producing the high RRB lending rates. The strategy of high interest rates to shore up bottom lines, however, has proved to be a double edged sword as the RRBs are reported to be losing business to the commercial banks.

- *Inequities between Regions and Borrower-types in the Distribution of Credit:*
  Two underlying tendencies of the rural disintermediation phenomenon have been: the growing credit exclusion of low income clients with small loan accounts; and the rising regional imbalances in credit distribution.

  More than 99 percent of the account-holders with the RRBs have traditionally been small borrowers – loan accounts with credit limit of Rs 25,000 or less. These borrowers have accounted for nearly as much of the outstanding credit. All through the nineties, there's been a marked stagnation and decline in the number of small borrowers' credit accounts with the RRBs. As Table 4 indicates, between March 1996

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[11] See Government of Andhra Pradesh, Report of the Commission on Farmers' Welfare (Chairman: Prof. Jayati Ghosh), Chapter 4 titled `Rural Credit' Dec. 2004.
(Available at http://www.macroscan.org/pol/apr05/pol070405Andhra_Pradesh.htm)
[12] See `Merger of regional rural banks within a state under study' in The Financial Express, January 21, 2005
[13] Cited in Ramachandran,V.K. and Madhura Swaminathan (2002) `Rural Banking and Landless Labour Households: Institutional reforms and rural credit markets in India' Journal of Agrarian Change, Vol. 2 (4), pp. 502-544.
[14] See `Strengthen RRBs to meet the target', in People's Democracy, Vol. XXVIII, No. 27, July 04, 2004
[15] The low-cost character of RRBs had eroded to an extent by the late 1980s, due to the granting of parity in pay scales with those of the sponsor banks by the National Industrial Tribunal because of which wage bills went up. Velayudham and Sankaranarayanan (1990) note that the origin of the problem lay in the structure of the remunerations for RRB staff which was to correspond to the salary structure of comparable district level functionaries of the concerned state government, whereas banking was a central subject. The entire problem could have been avoided if the central government had created a rural service cadre exclusively for the RRBs.

and March 2003 *the number of small borrowers' loan accounts* with the rural branches of the RRBs declined by 6.7 percent or at an annual average rate of 0.96 percent. This has happened despite the Reserve Bank raising the credit ceiling for small loans disbursed by banks from Rs. 25,000 to Rs. 2 lakhs. The significant growth of *loan outstanding to small borrowers* seen in Col.(3) Table 4 could come about only due to this leeway provided by the Reserve Bank. Banks on their part are narrowing their client base and targeting the high-worth customers so that the account sizes are getting bigger and bigger. Such a pattern is confirmed by Sinha et al (2003) who note a decline in the number of total loan accounts for the sample banks, whereas the overall business levels were fast rising.

Table 4: Annual Average Growth of Credit to Small Borrowers by RRBs: March 1996- March 2003

(in percentage)

	No. of Accounts	Amount Outstanding
Rural	-0.96	28.24
Semi-urban	3.17	43.29

Source: RBI, Basic Statistical Returns of Scheduled Commercial Banks in India, various years.

Overlapping with the growing inequalities in credit distribution based on income/ endowments, was the deteriorating regional distribution so that the weaker sections in certain parts of the country – the typically backward regions – had to bear the double burden of discrimination. Not only did the credit-deposit ratio plummet across the country, in the Eastern, North-Eastern and Central regions it touched rock-bottom levels. (see Table 5) Within a decade of initiation of neo-liberal economic reforms, the credit-deposit ratio of the RRBs dipped to one-half to one-third of the levels existing before the reforms. It is noteworthy that the decline in credit-deposit ratio was not due to any declared/ explicit policy move to control credit growth. Through most of the 1990s the RRBs were flouting the Reserve Bank's own minimum stipulated standard of 60 percent for credit to deposit ratio expected of scheduled commercial banks.

Table 5: Region-wise Credit-Deposit ratio of the RRBs

(in percentage)

	Northern	North-Eastern	Eastern	Central	Western	Southern	All India
Jun-82	126.5	113.8	115.9	82.2	120.5	183.8	122.1
Jun-85	97.6	87.7	119.3	88.3	109.6	172.0	112.9
Jun-90	66.5	103.8	76.6	61.5	105.0	146.9	83.3
Jun-95	39.0	57.4	49.3	44.1	58.1	90.4	54.4
Jun-00	37.9	30.4	31.5	31.6	49.5	75.3	41.0
Jun-02	39.6	30.6	33.0	33.0	50.1	77.9	42.8
Mar-03	42.6	33.7	35.3	36.6	52.5	78.8	45.7

Source: RBI, Basic Statistical Returns of Scheduled Commercial Banks in India, Vol. 32, March 2003; and RBI, Banking Statistics 1972-2002, Occasional Publication.

As a matter of policy, the RRBs were set up mainly in the unbanked and underbanked regions of the country. An important aspect of the location policy was that the RRBs would cover a compact area of not more than two or three districts where the weaker sections of the population are predominant. During the seventies and the eighties, the maximum number of RRBs were thus opened in the Central, Eastern and the North-eastern regions in the country that had the largest number of backward districts. Recovery performance of several of these RRBs was unsatisfactory in many of these states, when compared to Punjab, Kerala or Tamil Nadu, the better-off states. This was largely so, irrespective of the identity of the sponsor bank. Yet in the liberalized banking era, these banks had to become competitive, improve their profitability and conform to prudential regulations of asset classification and provisioning norms, on an equal footing. At a time when most of the RRBs were escaping credit activities, the propensity to do so will only be higher for banks that were chronically incurring losses. Thus, Sinha et al (2003) observe that, of the five sample RRBs from different parts of the country, the RRB from Central India was the one with the highest share of investment in its portfolio. Credit advances were biased towards non-priority sector lending, and the bank exhibited the least interest towards SHG based lending among the sample banks. The bank had a credit-deposit ratio of only 27 percent! However, despite the banks desisting from loan operations, it had not been able to turnaround from a loss-making to a profit making bank. It had the lowest return on assets.

Clearly, such an overwhelming pattern of rural disintermediation, particularly acute in the poorer regions of the country, had to have a direct bearing on real economic growth, which in the nineties was characterized by major regional imbalances. Dreze and Deaton (2002) note that whereas the western and southern states (Andhra Pradesh excluded) had done comparatively well, the low growth states formed a large contiguous region in the north and east. This was a matter of concern, since the northern and eastern regions were poorer to start with. Indeed, National Sample Survey data suggest a strong pattern of inter-regional 'divergence' in average per capita expenditure (APCE): states that started off with higher APCE levels also had higher growth rates of APCE between 1993-94 and 1999-2000. In some of the poorer states, notably Assam and Orissa, there was virtually zero growth of average per capita expenditure (and very little reduction, if any, in rural poverty) between 1993-94 and 1999-2000. [16]

More Recent Measures

It is only in the past few years that the unwanted effects of reform measures on rural banking have begun to be recognized in certain official quarters. That the improved performance of the RRBs – 163 out of 196 RRBs were earning profits in 2003-4- was largely a result of the banks abrogating their credit intermediation role rather than a sign of their genuine health and vibrancy is pitifully obvious. Moreover, the agrarian distress

[16] Deaton, Angus and Jean Dreze (2002) `Poverty and Inequality in India A Re-Examination' in Economic and Political Weekly, September 7.

and stagnation of the rural economy has become too stark and imminent and, of course, the political ramifications of the crisis can no longer be ignored.

Among the various official Committees that were set up to review the situation and make policy recommendations on the future course of development of the RRBs, the Parliamentary Estimates Committee (2002-3) had come up with a number of useful suggestions to tackle the shrinking credit delivery to the priority sector and the rural areas: [17]

``Among RRBs which are making absolute profit, the credit-deposit ratio should not be lower than 75%, and for those which are making profits but still have accumulated losses, an increasing trend of the ratio should be ensured and their investment portfolio should get reduced accordingly." (pp. 63)

``The priority sector lending by RRBs has been declining and as per the latest figures, priority sector lending to agriculture and other allied activities comes to about 57% of the total lending……… There could be no rationale for fixing the same norms for lending to priority/agricultural sector by the RRBs as in the case of commercial banks. The RBI should apply proper checks to ensure that the present level of 57% of lending by the RRBs to the priority sector is not allowed to decline further. And it should look into the…. desirability of enhancing the percentage of lending to the priority sector." (pp. 67)

``The Committee is constrained to note that the percentage of loans to small and marginal farmers out of total loans disbursed by the RRBs has been declining steadily.[18] The RRBs do not maintain separate details of number of accounts of small and marginal farmers. In the absence of such information it is difficult to understand as to how RRBs ensure credit disbursement to small/marginal farmers and other weaker sections of society as per the guidelines issued by the Government/ the RBI. The Committee recommends that the RRBs should take steps for compiling and maintaining data regarding credit facility extended to small and marginal farmers and other weaker sections of the society to monitor that credit facilities being provided by RRBs reach the targeted beneficiaries." (pp. 68)

``A number of RRBs were charging compound interest on agricultural loans. Even on the subsidy part, certain RRBs were charging compound interest, which was in utter violation of the guidelines issued by the RBI. The Committee is of the view that this trespass should be dealt with severely….. More distressing is the fact that even though in the case of a number of banks this irregularity was pointed out in the Inspection Reports by NABARD, neither had the RRBs taken any corrective measures in this regard nor was any serious note of it taken by the sponsor banks…….. It appears the RBI, NABARD and the sponsor banks seem content with issuing of circulars and conducting mandatory inspections without ensuring compliance of the guidelines issued by them and rectification of irregularities noticed during inspections." (pp. 69, 105)

On the issue of NPAs of the RRBs, the Committee expressed its dissatisfaction at the current levels. ``While the official statistics highlights the decline in NPAs from 34 percent in March 1996 to 18.34 percent in March 2001, the level of NPAs in absolute terms had declined only marginally from Rs 3232 crores to Rs 2990 crores.[19] The RRBs should seriously address the question

[17] Same as fn. 9.

[18] During 1998-99, the percentage of total loans disbursed to small and marginal farmers was 41.50%, it came down to 38.90% and 36.40% during 1999-2000 and 2000-2001, respectively.

[19] By March 2004, the NPAs of RRBs had fallen to 12.6 percent in relative terms, but in absolute terms the amount had risen to Rs 3299 crores.

of reduction of NPAs through well defined policies and strategies, some of which are detailed by the Committee." (pp.74)

Very few of the above recommendations were, in fact, accepted by the RBI/ GOI. From the year 2003-4, the RBI revised upwards the lending target for priority sector to 60 percent of the total advances for the RRBs. Ambitious overall credit targets were laid down for the RRBs by the Union Government. The farm credit target for the RRBs at Rs 11,900 crore for the fiscal year 2005-06 is 40 percent higher than Rs 8,500 crore target set during the fiscal year 2004-5. But little else happened. In reviewing the action taken by the RBI/GOI on the proposals of the Estimates Committee (2002-3), the Committee in 2004-5 finds that `no specific action has been taken' on most of the major recommendations.[20]

The Question of Ownership

The approach of the Estimates Committee in looking at the Regional Rural Banks was unique in that most other official Committees in the recent years even while noting the deteriorating patterns in credit activities by the RRBs have completely bypassed the subject while making policy recommendations. Instead attention is held by issues of *ownership* and *capital requirements for the RRBs as necessary steps towards restructuring*. At present there is no capital to risk weighted asset ratio (CRAR) prescription for RRBs. The Internal Working Group on RRBs (RBI, 2005) has recommended that the RRBs be asked to maintain a CRAR of 5 percent to begin with, and over time they may align themselves to the Basle I standards.[21] To wipe out the accumulated losses, provide for the NPAs, and maintain 5 per cent CRAR for the RRBs in the existing scenario, the Working Group's calculations show that capital to the extent of Rs.3,050 crore would have to be infused. It is obvious that the RRBs are being restructured along the same lines as the commercial banks. Is the step necessary? We hold that it is not. Even if one were to believe in a case for CRAR for commercial banks on the lines that the new freedom given to banks to determine their portfolio, including investments in stock markets might result in high levels of risk in the system, which the regulators believe can be contained through capital requirements, the same logic cannot be applied to the RRBs simply because such portfolio choices can never be allowed for these institutions. On the other hand, given that the income recognition and asset classification norms have already caused these institutions to shy away from credit activities to an unacceptable extent, further prudential norms involving high risk-weight on most loaning business can only exacerbate these tendencies further. It is widely established in the developing country contexts that the response of banks to hitting regulatory constraints on their capital ratio is mostly through cutting back loans or by switching from higher to lower risk weight assets, rather than by raising capital. At a time when most rural areas are starved of credit, it is difficult to comprehend the urgency to impose capital requirements on the RRBs.

[20] The Estimates Committee (2004-5), The 2nd Report, Review of Action taken by Government on the recommendations contained in the Sixteenth Report of Estimates Committee (Thirteenth Lok Sabha) on the Ministry of Finance and Company Affairs (Department of Economic Affairs – Banking Division) - `Regional Rural Banks', Dec. 2004.

[21] Reserve Bank of India (May 2005) "Report of the Internal Working Group on RRBs".

The subject of consolidation of the RRBs as a way of raising their viability and profitability has recurred several times since the beginning of the reform process but without any policy outcome. Various working group and committees have prescribed different measures as also models for restructuring the RRBs. We pick up the most recent threads in the debate. The Chalapathy Rao Committee (2002) had proposed that the government reduce the number of RRBs to around 40 from the present 196.[22] Options for mergers could be mergers of RRBs following `one-sponsor bank approach' or they could be amalgamated with their sponsor banks, and thereafter the RRBs could operate as `commercial entities'. The Vyas Committee II (June 2004), on the other hand, has forwarded a more logical solution.[23] After weighing the various options for amalgamation, it decided that it could not consider "the option of merger with the sponsor bank, as it would go against the rationale of the third channel for rural credit with a clear rural focus and regional orientation." Instead, it recommended merger of RRBs so as to create a zonal bank for RRBs in the North-East and rural banks at state level for the rest of the country. These banks would work on a stand alone basis and the sponsor banks plus NABARD would contribute to the equity. In the latest document on the subject, the Internal Working Group on RRBs (RBI, 2005) has also proposed consolidation of the RRBs as the merged entities will have a larger area of operation and the merger process will help in strengthening some of the weak RRBs. Eliminating the option of merger of RRBs with sponsor banks, the Group has put forth two options: merger between RRBs of the same sponsor bank in the same state and merger of RRBs sponsored by different banks in the same state.

Independent of the official deliberations, the All Indian Regional Rural Banks Employees Association (AIRRBEA) has proposed that the RRBs be amalgamated to form zonal or state-level RRBs. They have cited two strong reasons to make the case. "The RRBs must be restructured into zonal or state level RRBs under any public sector apex banking institution or NABARD, <u>so as to ensure the unity of command and cross subsidisation</u>….<u>As in any banking institution, if the central balance sheet is prepared at the apex level, the losses of the few RRBs (in the Eastern, North-Eastern and Central regions) … can easily be taken care of with the huge aggregate profit of a majority of the RRBs</u>." Further, a national body like that of NABARD should monitor the activities of such RRBs. Opposing the demands of All-India RRB Officers Federation for

[22] Government of India, (June 2002) "Report of the Working Group to Suggest -Amendments in the Regional Rural Banks Act, 1976" (Chalapathy Rao Committee) This Committee was set up to suggest measures for reviving regional rural banks (RRBs) under the chairmanship of NABARD managing director Chalapathy Rao. It seems that among the stakeholders and supervisory authorities, NABARD holds some of the most extreme views. Rakesh Malhotra, Assistant General Manager, NABARD has gone on record saying that "the viability of the RRB should be made the sole criteria for the survival of the bank. Closure of only 1 RRB on grounds of financial health will rejuvenate remaining 195 RRBs in the country. …..NABARD should have authority to sack the Chairman of an errant bank, or merge the loss making bank, or impose a moratorium on a falling bank, or in extreme case wind the operations of the bank. The Section 26 of RRB Act, 1976 relating to bar to liquidation of RRB should be abrogated." India's RRBs – The Forgotten Case in Financial Sector Reforms. Dr. Rakesh Malhotra. NABARD. April 2002.

[23] Reserve Bank of India (June 2004) "Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System" (Vyas Committee II)

amalgamation of RRBs with the sponsor banks as the only route to sustainability, AIRRBEA has demanded de-linking of the RRBs from the sponsor banks so as to ensure functional autonomy for the rural banks, and to relieve the burden of `sole' commercial orientation so that the rural credit activities can be pursued more freely.[24] (emphasis ours)

The AIRRBEA statement clearly takes the issue of ownership beyond the current preoccupation with profitability, and asserts that not only can viability issues be handled better by restructuring the RRBs along the lines suggested by them, but more importantly it can enable improved performance vis-à-vis credit activities, which is the urgent need today. The control of sponsor banks on the RRBs needs to be seriously revaluated. At a time when the sponsor banks are themselves constrained to make cuts in the manpower and credit to agriculture or the SSI sector, they are unable to extend the help to the RRBs on which their sponsorship was premised. In our view, it is necessary that along with the Vyas Committee recommendations, which has astutely defined the post-merger banking structure in terms of state-level banks, the policymakers also take into consideration the legitimate demand for functional autonomy and to rid the RRBs of the `sole' commercial orientation such that the present decline of rural banking might be reversed.

Conclusion

We have briefly reviewed the three phases of Regional Rural Banking in India – the inception and expansion phase (1976-1990) which saw rapid growth of the RRBs activities; the reform phase (1991-2002/3) which raised the profitability of these banks at the cost of massive rural disintermediation, particularly of the targeted borrower categories; and the most recent phase of stock taking and perhaps some repositioning to strike a balance in the conundrum of `viability versus outreach'. We have argued that the first phase while more focused on outreach was not devoid of a blueprint for viability, though the notion of viability for the RRBs was much more nuanced than what it denoted under the neo-liberal reform era. It is true that the commercial principles of banking were put under stress, especially in the later part of the 1980s, which needed corrective steps, and indeed many of the policy recommendations of that time were geared to improve recovery and reduce losses incurred by these banks. However, it was generally held that these improvements could be done (and had to be done) within the parameters set for the RRBs, which in turn were determined by the overall vision of rural banking.

The reform phase supplanted this understanding with a singular focus on commercial profitability for the RRBs. In a sense, the reforms of the RRBs were no different from the reforms of the commercial banks. The same set of policies was implemented, and the same set of standards set to calibrate their performance. Not surprisingly then, the RRBs started aping the commercial banks in their activities – banks relocated to more promising areas; investments in government securities and PSU bonds and debentures increased while banks were hesitant to increase their loan portfolios; credit was extended mainly under non-priority sector heads so that the proportion of priority sector loans

[24] See `Strengthen RRBs to meet the target', in People's Democracy, Vol. XXVIII, No. 27, July 04, 2004

declined despite the dilution of the priority sector definition in several ways; interest rates on lending were deregulated which resulted in high interest rates charged by the RRBs; credit to deposit ratio became less than half of the pre-reform levels indicating increased net transfer of resources from the rural poor to the urban rich; regional imbalances aggravated; and the small borrowers, the principal clients of the RRBs were overwhelmingly sidelined. By the beginning of the present decade, the carefully built structure of rural development banking in India had all but collapsed.

In the past couple of years, which we delineate as the third phase of Regional Rural Banking, there have been one or two hesitant moves towards correcting the gross excesses of reforms, such as the upward revision of the priority sector lending target to 60 percent of the total advances. Clearly, there is need for a much bolder approach. The minimum that needs to be done, immediately, is to implement the recommendations of the government's own Estimates Committee (2002-3) fully so that both the volume of credit and the terms of credit to the rural areas, and to the targeted population, can begin to improve. More generally, the incentive environment currently in place, which forces banks to respect commercial viability `only' without any obligation towards RRBs primary banking activities has to be urgently replaced. This doesn't mean a return to the pre-reform era of banking, but rather moving towards a sensible blend of the central and the progressive elements of the `RRB innovation' while pursuing a `nuanced' criteria of viability, which must necessarily be different from the present benchmarks of banking performance.

The formation of zonal and state RRBs by merging the various RRBs would be a welcome move. At present, the mergers of RRBs are taking place entirely with a view to improve profitability. Several sponsor banks have announced their plans to merge the different RRBs sponsored by them in a state (for example, the United Bank of India merging its RRBs in West Bengal and Assam), while the more profitable RRBs are being merged with the parent bank (the merger of Chikmagalur Kodagu Grameena Bank – a RRB, with its parent Corporation Bank). Before the process gathers momentum, and many more RRBs are amalgamated so that further branch rationalization is possible and dislocation of the RRB staff is made easy, it is important that the authorities intervene to create the proposed state level RRBs, liberate the RRBs from the overlordship of the sponsor commercial banks, ensure that the majority ownership of the RRBs remain under state control, set up independent governance structure(s) for the RRBs and restore functional autonomy to these banks. The purpose of the ownership reform of the RRBs must be the same as for the other aspects of RRB policy: to foster a bank-led equitable rural growth.