Y V Reddy: Rural banking – review and prospects

Text of the first Smarajit Ray Memorial Lecture delivered by Dr Y V Reddy, Governor of the Reserve Bank of India, organised by the Andhra Pradesh Mahila Abhivruddhi Society, Hyderabad, 16 December 2006.

*   *   *

Dr. Kotaiah, Mrs. Nandita Ray, Mr. C. S. Reddy, Prof. Mahendra Dev and Distinguished guests,

I am grateful to the organisers for giving me an opportunity to deliver the first Smarajit Ray memorial lecture. Mr. Ray, about a couple of years younger to me in age and a valued colleague in the civil service, had been one of my close friends for almost four decades. He was a self-effacing person with courage of conviction in servicing the cause of the poor with great integrity and objectivity. I also happen to know his wife, Mrs. Nandita Ray, particularly in terms of her association with the Centre for Economic and Social Studies. Together, they worked for a better society and the betterment of the downtrodden. Given his simplicity and humility, it was difficult for many to believe that Mr. Ray had been a student of the elite Presidency College, Kolkata; Delhi School of Economics and London School of Economics. It is said that he inherited his courage of conviction from his father Mr. Ranajit, who was also of the Indian Civil Services.

Since this is the first in the series of lectures, I will recall in brief Mr. Ray's major achievements.

First, and perhaps the foremost is his pioneering role in the development of women's help groups in Andhra Pradesh, which led the SHG movement to become the most impressive mass movement in this area.

Second relates to his innovations in the organisation of the drought prone area programme, specially in terms of people's participation.

Third is his contribution to the programme of "back to school" which specifically targetted the children who were school dropouts and majority of whom were scheduled castes in the rural areas.

Fourth, he prepared a useful document on integrated irrigation management and also helped in resettlement and rehabilitation of the project oustees.

Fifth, he helped to set up the Environment Research and Training Institute, which focused on consultancy, and training in a wide range of environment-related issues – perhaps, the first of its nature at the State level.

I have been a silent admirer of his contributions and achievements in these diverse fields. However, I had a closer interaction with him in my personal and professional capacity very recently. He visited Mumbai in March 2005 to attend the Sachin Choudhury memorial lecture and at that time, I spent almost a full day with him, both in my office and at home. I was deeply impressed by his commitment to issues relating to micro finance. This prompted me to follow it up with a meeting with all people concerned with the micro finance movement involving NGOs in Andhra Pradesh at the Reserve Bank of India, Hyderabad in June, 2005. Mr. Ray helped in organising this meeting, which gave me a deep insight into the issues involved. In a sense, therefore, Mr. Smarajit Ray was a catalyst for my getting deeply involved in the matters relating to micro finance and thus, both RBI as an institution and I, at a personal level, are, therefore, indebted to him. This first memorial lecture is, thus, our way of acknowledging the inspiration that we derived from his personal conduct and his professional work.

Considering the deep interest that he had shown during his life time and the relevance of that work to the RBI, I have chosen to speak on the subject of Rural Banking. After a brief review of the past and recent efforts, the current perceptions on outcomes are noted. I will then mention the national policy directions, followed by, what I would call, New Realities. I will conclude the lecture with a few issues that need to be addressed in the days ahead.

Review of efforts

It is useful to recall that rural banking was traditionally a monopoly of the money lenders, till the colonial government enacted Co-operative Societies Act in 1904 with a view to making the co-operatives as premier institutions for disbursement of credit. The Process of a three-tier structure commenced in 1915. Government was also providing agricultural loans usually called Takkavi loans, which have since been discontinued. The RBI Act vested a unique responsibility of rural credit to the central bank. All India Rural Credit Survey (1951) of the RBI opined that the co-operatives were "utter failure" in providing rural credit, but added they had a vital role in agriculture credit. The Imperial Bank was nationalised as SBI, which was visualised as a vehicle for rural banking. A rural credit survey of 1966 also concluded the ineffectiveness of co-operatives but stressed the importance of their succeeding. Many State governments legislated the registration and regulation of money lenders but with little emphasis on implementation. Nationalisation of banks in 1969 gave a boost to expansion of banks and banking in rural areas. The Reserve Bank hived off a part of its role in agricultural credit to a separate national level institution, viz, Agriculture Refinance and Development Corporation (ARDC) in 1975. Soon thereafter, a legislation was enacted to create Regional Rural Banks, with participation from Central and State governments and the nationalised banks, which have their network spread almost all over the country. Subsequently, the ARDC was converted into NABARD, which continued to get the lines of credit from the World Bank. The World Bank’s lines of credit were, however, discontinued on the ground that functioning of co-operatives had been less than acceptable. Simultaneously, the directed credit in the form of priority sector lending continued and the administered interest rate regime lasted.

During the reform period, capital was infused into the RRBs and the NABARD. While the priority sector lending continued, the administered interest rate regime was dismantled. To make up for the shortfall in the priority sector lending by the banks, the Rural Infrastructure Development Fund (RIDF) was initiated to ensure the envisaged flow of bank resources to agriculture through the intermediation of the NABARD and the State governments. A system of Special Agricultural Credit Plan was also introduced. Innovations in the area of rural credit included Kisan Credit Cards and encouraging bank-SHG linkages. It may also be of interest to note that many District and State Co-operative Banks are yet to meet the applicable minimum capital requirements.

More recently, since 2004, vigorous efforts have been made to more than double the credit flow to agriculture. Emphasis has been laid on sound credit culture, effective credit delivery and appropriate credit pricing. New instruments for financial inclusion such as General Credit Cards and no-frills accounts were initiated. Micro finance programme was intensified and new guidelines for business-facilitator model were issued. Use of technology for rural banking is being encouraged. Special Area Plans for banking in several states such as Uttaranchal, North Eastern States, Chattisgarh, Bihar and Andaman-Nicobar have been formulated to suit the local conditions. In terms of institutional development, consolidation of the RRBs, revamping of the urban co-operative banks as per the vision document, revival of rural co-operative credit structure as per the Vaidyanathan Committee recommendations, a plan for restructuring of long-term lending institutions for agriculture, and a revisit to the prescriptions relating to the priority sector lending are underway. While a Working Group to review the legislations of various States in regard to money lending has been formed, another Working Group is looking into the relief measures for the distressed farmers. Above all, as per the Government of India announcement in 2005, it has been decided to subsidise the commercial banks and NABARD to enable provision of short-term credit at 7% interest rate to the major segment of the farmers.

In brief, there have been vigorous and determined efforts towards expansion of rural credit, especially through rural banking.

Current perception of outcomes

The litmus test of any effort is the outcome, and perhaps even more important, the perceptions of the outcomes. These can be summed up as follows.

First, the non-institutional credit still continues as far as rural areas and agriculture sector are concerned.

Second, the credit-deposit ratio shows that despite the intermediation of banks, the ratio continues to be low in the rural area.

Third, the all-in costs of credit from banks, after factoring in timeliness, transaction-costs, access, etc, appears high for agriculture relative to private corporate sector even after accounting for the risks as reflected by the level of actual non-performing assets.

Fourth, the performance of some of the public sector banks in rural and agricultural lending is also inadequate while that of most of the private and foreign banks is even lower, despite considerable expansion of the scope of priority sector lending.

Fifth, credit-system in rural areas finds it difficult to cope with the rising demands of commercialised agriculture and in any case, there are few credible risk-mitigation measures for the borrowers resulting in greater distress to the farmers in areas with significant presence of commercial crops.

Sixth, while there has been notable progress in micro finance, it is, mostly confined to the states with fairly well-developed banking system. Further, the cost of credit at around 20 to 30% also appears high.

Seventh, the co-operative credit system is, in most parts, dormant and it is commented that the three-tier structure helps finance the bureaucracy rather than benefiting the farmers. Similarly, in many parts of the country, RRBs are less active though in some others they are expanding.

Eighth, while there has been significant growth in rural credit in the recent years, its medium-term sustainability is contingent upon growth in agriculture and improvements in the institutional settings.

In brief, the perceptions on the outcomes of vigorous and varied efforts to expand the reach of rural banking, seem to be less than expected.

Perhaps it is time we ask ourselves some questions.

First have our strategies, in terms of institutions and strategic directions, been flawed all along? Have we run out of ideas in this regard? Is our thinking on rural credit has fallen behind the emerging realities in the economy? Is there a need for distinguishing between the cause and the effect as also between the symptom and the disease? Is it lack of credit availability or want of commercial viability of agriculture that is constraining the credit-flow, or is it a complex combination of both? While we may not be able to answer many of these questions satisfactorily, I submit that we need to keep asking these right questions.

New policy directions

Answers to some of the complex questions relating rural credit may be found in the most recent policy directions. The National Development Council approved a week ago "An Approach to the 11th Five Year plan" which contains extensive references to the future policy directions. Some extracts from the document may be in order.

On objectives and challenges

"One of the major challenges of the 11th Plan will be to reverse the deceleration in agricultural growth from 3.2% observed between 1980 and 1996-97 to a trend average of around 2.0% subsequently".

"To reverse this tend, corrective policies must not only focus on the small and marginal farmers who continue to deserve special attention, but also on middle and large farmers who suffer from productivity stagnation arising from a variety of constraints".

"A second green revolution is urgently needed to raise the growth rate of agricultural GDP to around 4%".

On financing development

"The 11th Plan must ensure that our policies are sufficiently flexible to support the development of micro finance. Interest rates in the micro finance sector have to be significantly higher than in the banking sector reflecting the much higher cost of doing business. It is important to remember that most micro-finance institutions charge rates which are much lower than rates charged by money lenders".

On agriculture sector policy

"The failure of the organised credit system in extending credit has led to excessive dependence on informal sources usually at exorbitant interest rates. This is at the root of farmer distress reflected in excessive indebtedness".

"There is evidence that farm debt is increasing much faster than farm incomes and the larger issue of the overhanging debt stock, as distinct from credit flow, has not even been on the agenda except of a few State governments. Admittedly, there are limits to the extent that banks can be expected to play a purely social role in today's more competitive environment. However, too conservative an approach on settling debt that has turned bad, due to contingencies of poor weather or prices, is not even prudential banking if this serves only to show bank balance sheets to be better than they are, and prevents profitable new lending. There are several suggestions, ranging from a Stabilisation Fund to be run by the Centre for automatic write-off under some specified conditions, to the setting up by States of standing professional Debt Commissions to examine individual debt (including to non-institutional sources) on a case-by-case basis for one time settlement. The 11th Plan will examine in details the impediments which now stand in the way of social and developmental banking and suggest innovations that can improve access and speed up one-time settlements while maintaining credit discipline and financial prudence".

"As farmers adopt new and untried technology, and increase input intensities, they also face larger risks."

"These and related issues of risk management are again largely non-plan areas but need to be addressed during the 11th Plan. This should ideally be done by concentrating on innovations in design which could help expand insurance in a manner that is financially viable without excessive subsidy."

It is also useful to extract some of the statements of Prime Minister Dr. Manmohan Singh, on the subject in the meeting of National Development Council on 9th December 2006.

"The 11th Plan must give top priority to redressing the weaknesses in the agricultural sector. Growth in the agricultural sector has been less than 2% per annum since the middle of the 1990s. With about half of the rural population still dependent on it for most of their income we cannot expect inclusive growth if we do not revitalise agriculture. It is important to recognise that the problem is not distributional, with the better off farmers doing well while the small farmers and the landless face hardships. Though the weaker groups clearly face more difficulties and need special attention, agriculture as a whole is in crisis. We should, therefore, focus on achieving higher productivity and incomes for all farmers in both crop and non-crop agriculture."

"The Approach Paper calls for corrective action in several dimensions of agriculture. Water is a critical input for agriculture and we need to re-examine all aspects of the water economy. We are not spending enough on irrigation and what we are is not being utilised efficiently."

"In addition to investment in irrigation, we must take steps to conserve water and promote artificial recharge in rain fed areas."

"Other issues on the agriculture agenda identified in the Approach Paper relate to the need for focused research in specific crops, farming systems and dry land farming practices, improved extension work to close the knowledge deficit affecting farm productivity; better seeds and inputs; enhanced facilities for credit, including revamping the co-operative credit system; initiatives to support agricultural diversification with effective marketing solutions; and completing the unfinished agenda of land reforms etc".

The four deficits

Before concluding this section, I would like to invite your attention to land-mark observations made by the Prime Minister in his address at 2nd Agriculture Summit on October 18, 2006, wherein he develops the four deficits theme.

"When we review our agricultural situation, it is clear that there are four deficits we need to bridge. These four deficits are (i) the public investment and credit deficit; (ii) the infrastructure deficit; (iii) the market economy deficit; and (iv) the knowledge deficit. Taken together they are responsible for the development deficit in the agrarian and rural economy."

"However, we need more thinking on the credit front. While the financial system should do more for the credit needs of farmers, we need to raise some questions. What do farmers need – a lower rate of interest or reliable access to credit at reasonable rates? Is our existing institutional framework adequate for meeting the requirements of our farmers who are a diverse lot? Do we need to create new institutional structures such as SHGs, micro finance institutions, etc, to provide improved and reliable access to credit? Or do we need to bring in money lenders under some form of regulation? It is necessary that we find answers to these questions in the near future."

New realities

It is useful to recognise that there are unprecedented structural changes in the fast-growing domestic economy and rapidly-integrating global economy. These throw up what may be called new realities but these have to be met (a) without losing sight of large population currently dependent on agriculture; and (b) the medium-term trend towards lower share of GDP generation in agriculture. Thus, while some short-term actions may be warranted to be sensitive to aspirations and expectations in rural areas, medium to longer-term strategies have to take into account what may be termed as new realities, though some of them are old realities with greater relevance now and in future. There is some recognition of these in the Approach Paper to 11th Five Year Plan, to which there was detailed reference earlier in the speech. Kindly let me elaborate on the theme here:

First, there is a continuum of agricultural and non-agricultural activities, in terms of inputs, outputs, supply chains, etc, in an emerging, highly-commercialised and globalising agriculture.

Second, there is a spectrum of financial services such as deposit taking, lending, insurance, pension, mutual finds, etc, and there exist several financial intermediaries which need to complement and compete with each other even in rural areas. Banks and banking are a part of this emerging larger whole of the financial institutions and their activities.

Third, there is a clear trend towards rural–urban continuum in economic linkages and the process of integration needs to be facilitated in the interests of growth and equity. Hence, segmentation of these through public policies or procedures should, at best, be an exception than the rule.

Fourth, distinction between productive and non-productive or consumption end, becomes blurred and in any case, consumption smoothening is essential. The cash flow and risk management become more relevant relative to ensuring and monitoring end use of funds.

Fifth, today's technology provides immense opportunities to the financial intermediaries to reach a large section of population, assess and price risks better, and minimise transaction costs. Naturally, this would need considerable business re-engineering.

Finally, there are dramatic changes in demand for food and other articles and supply of related inputs that need to constitute some of the basic elements of a new approach. These aspects of a new approach have been comprehensively and succinctly brought out in a paper by my colleague Dr. Rakesh Mohan, titled " Agricultural Credit in India: Status, Issues and Future Agenda. (RBI Bulletin, November 2004). I do not want to repeat them here.

Issues

The new policy directions by NDC and the Prime Minister clearly indicate the criticality of improving the credit system but rightly position it as one of the four deficits that need to be addressed to manage the crisis of stagnation in the Indian agriculture. Agriculture development has to be led by ensuring commercial viability, which has to be enabled by an appropriate credit system. In other words, credit can be a substitute for longer-term commercial viability only if a price is paid in the financial sector and fiscal sector. At the same time, costly or inadequate credit system may constrain growth and commercial viability. The main issues in this regard, therefore, are related to, what may be called, policies complementary to credit or financial services for upliftment of rural economy. Illustratively these are:

First, fiscal policy could play an enabling role in two ways in terms of (a) targetting the poor for subsidy; and (b) enhancing public investment while encouraging private investment that would benefit the rural economy. Perhaps to make agriculture commercially viable, costs and benefits of continuing with the existing allocation of resources for subsidising water, power and fertilizer need to be assessed vis-à-vis bestowing focused attention to providing funds for risk mitigation, investments for enhancing supply, ensuring quality and rationalising availability.

Second, trade policy, both domestic and external, should facilitate commercialising of agriculture and thus, enhance the scope for investments. Restrictions to trade within the country at a time when economy is opening up, may, at times, be less than optimal. As mentioned, the savings in rural areas and agriculture are now transmitted by the banking system to urban areas and non-agriculture, often, for want of commercially viable avenues in rural areas. Besides, banks have to improve their own risk-assessment, pricing and credit-disbursement procedures on an urgent basis.

Third, major bottleneck is inadequate arrangements for risk mitigation, be it in regard to quality or timeliness of inputs especially seed, fertilizer, water, power or price of outputs. The risk mitigation for natural calamities or vagaries of weather is often discretionary, based on assessment and response of public-policy. Risk mitigation mechanisms will make credit disbursal also less risky.

Fourth, there are attitudinal aspects that need to be considered. It is often said that fiscal support to manufacturing industry is called incentive, while similar support to agriculture is called subsidy. It may be worthwhile considering institutional arrangements and incentive framework that would facilitate attitudinal changes.

Fifth, financial sector as a whole, and banking system in particular, may have to consider paradigm shift in strategies and processes consistent with new thinking, as urged by the Prime Minister and the NDC. Reserve Bank and the whole of banking system stand in readiness to serve this worthy cause of ensuring development of rural-agrarian economy by integrating it with the vibrant services and manufacturing sectors.

Let me conclude by thanking the organisers for giving me the opportunity to share may thoughts on this subject, which affects a major part of our country's population. I would also like to place on record my deep appreciation of the initiatives taken by the organisers in instituting the Memorial Lecture Series and want to assure them of my whole-hearted support to this worthy initiative. Thank you.