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PRESIDENTIAL ADDRESS

Rural Credit in India: Issues and Concerns*

Y.S.P. Thorat†

I

INTRODUCTION

At the outset, I would like to thank the Indian Society of Agricultural Economics for giving me an opportunity to address this esteemed gathering of academics and professionals. I am humbled at the thought that my predecessors have, without exception been economists and thinkers of great eminence. And therefore I, a career banker, whose only qualification is a passion for the subject, have no option but to approach my address in a spirit of awe and humility.

Describing India, the All-India Rural Credit Survey (AIRCS) had said, "India is essentially Rural India and Rural India is virtually the cultivator, the village handicraftsman and the agricultural labourer." Rural India, where 70 per cent of all Indians live, still depends heavily on agriculture. However, it is increasingly becoming diversified market with a strong demand for credit for agriculture and non-agricultural purposes, savings, insurance and money transfers. I will endeavour to trace the sequence of events – both policy and institutional – during pre- and post-reform periods; dwell on the concerns relating to financial exclusion and touch upon the SHG-Bank Linkage model, which is a meaningful "inclusive response" to this concern.

In the development strategy adopted by independent India, the primary focus was growth with equity. Given an understanding of the seasonal credit requirements of farm operations, institutional credit was perceived fairly early in the development process as a powerful tool for enhancing production and productivity and for poverty alleviation. The debates surrounding these issues, as also the suggested policy directions were clearly spelt out in the report of the All India Credit Survey Committee 1952.

To achieve the objectives of production and productivity, the stance of policy towards rural credit was to ensure provision of sufficient and timely credit at reasonable rates of interest to as large a segment of the rural population as possible. The strategy devised for the purpose rested on three pillars: expansion of the

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†Chairman, National Bank for Agriculture and Rural Development (NABARD), Bandra-Kurla Complex, Mumbai – 400 051.

institutional structure, directed lending to disadvantaged borrowers and sectors and lower interest rates.

The chosen institutional vehicles for the task were co-operatives, commercial banks and Regional Rural Banks (RRBs). Between 1950-69, the emphasis was on the promotion of co-operatives, followed by a concerted push by commercial banks during the post nationalisation period to establish branches in the rural areas and the creation of new institutional structures - RRBs in 1970s, National Bank for Agriculture and Rural Development (NABARD) in the 1980s and Local Area Banks in the late 1990s.

During this period, policy intervention at the macro level was considered necessary to overcome factors which were perceived as discouraging the flow of rural credit namely, high cost of servicing, geographically dispersed customers, lack of trained and motivated rural bankers, etc. The Central Bank's policy response consisted of social control and nationalisation, expansion of branch network into unbanked and under-banked areas, evolution of Lead Bank Scheme and area approach, enunciation of concept of targets for priority sector and weaker section lending and special credit-cum- subsidy programmes for the poorer sections of rural and urban areas.

Reaching credit at concessional rates was one of the important elements of the strategy for deployment of rural credit. The justification for offering credit at concessional rates to certain categories of borrowers was based on the argument that farm-based investment activity in the short run does not always yield a return which enables regular servicing of loans and at the same time meet the minimum consumption requirements. Since concessional lending impacted the profitability of rural financial institutions (RFIs), a policy of cross subsidisation and refinance from the Reserve Bank of India and later NABARD was put in place simultaneously. This was broadly the policy framework, which prevailed for over two decades.

There is a general consensus that the strategies followed within this framework helped to build a broad-based institutional infrastructure for the delivery and deployment of credit and also ensured a wider access of financial services to the poor. To take a few indicators, the growth of credit during 1970-95 in real terms at 7 per cent was greater than

- The annual growth in gross domestic product (GDP),
- Real public agricultural capital formation at 3 per cent,
- Real private agricultural capital formation at 4 per cent,
- Real agricultural input spending at 6 per cent.

Resultantly, a much greater proportion of the rural households now have access to credit from these multiple formal institutions compared to less than 10 per cent in the early 1950s.

The significant increase in the credit flow from institutional sources brought forth a strong sense of expectation from the public sector banks. However, this expectation could not be sustained as the emphasis throughout was on achieving certain quantitative targets. As a consequence, inadequate attention was paid to the qualitative aspects of lending resulting in loan defaults and erosion of repayment ethics, to a greater or lesser extent, by all categories of borrowers. The end result was a disturbing growth in overdues, which not only hampered the recycling of scarce resources of banks, but also affected the profitability and viability of financial institutions. Ultimately, financial deepening occurred but the development impact of rural finance was blunted. In 1991, that is, on the eve of reforms, the rural credit delivery system was in poor shape.

The basic aim of the financial sector reforms was to improve the soundness, efficiency and productivity of all credit institutions, including rural credit institutions whose financial health was far from satisfactory. The reforms sought to enhance the areas of commercial freedom, increase their outreach to the poor and stimulate additional flows to the sector. The reform programme also included far-reaching changes in the incentive regime through liberalising interest rates for co-operatives and RRBs, relaxing controls on where, for what purpose and whom the rural financial institutions (RFIs) could lend, introducing prudential norms and restructuring and recapitalising of RRBs.

As a result of the reform process, the financial health of commercial banks has improved in terms of parameters such as capital adequacy, non-performing loans and return on assets consistent with international standards for classification of advances and prudential norms being applied in almost all the areas. However, commercial banks being more focused on profitability, tend to cherry pick and give comparatively less priority to marginal and sub-marginal farmers.

The verdict on the 100 years old co-operatives is equally clear. Despite being the dominant purveyors of production and investment credit, their share has steadily declined over time. As on date, they face serious problems of governance, solvency and operational efficiency. A large segment of the co-operative credit structure is multi-layered, under- capitalised, over-staffed and under-skilled, often with mounting non-performing assets coupled with erosion of public deposits in certain cases.

As regards RRBs, barring a few, most have “turned around” but are often characterised as ‘investment’ rather than credit institutions and are perceived to have deviated from the mandate of serving the poor and disadvantaged.

Overall, the concerns in relation to rural credit – other than those relating to structural issues - are generally expressed in terms of – Inadequacy of credit, Constraints on timely availability of credit, High interest rates, Neglect of small and marginal farmers, Low credit-deposit ratios in several states and Continued presence of informal markets.

Speaking in this regard the RBI Governor has recently remarked that these problems in regard to rural credit have been well documented and several policy-

approaches made to remedy the situation. However, there is some element of dissatisfaction that the overall situation in regard to rural credit is not improving to the desired level inspite of a series of actions. He has added, and I quote, "It is a matter of concern that cognizable success is eluding the policy-makers, at a time when increasing commercialisation warrants a big thrust in institutional credit to agriculture. There is thus a discernible widespread intellectual recognition that while immediate measures are undertaken to increase the flow of credit to agriculture, there is a need to review the policy of rural credit in a comprehensive and thorough manner."

II

ISSUES AND CONCERNS

There is no gainsaying the fact that the formal institutional structure needs revamping to improve the efficiency of the credit delivery system in rural areas.

In the case of co-operatives, the Vaidyanathan Committee has concluded that having regard to its outreach and potential, recapitalisation could be undertaken so that the credit channels for agricultural credit which are presently choked could be declogged. The Committee has, however, made it clear that recapitalisation should only be considered if it is preceded by legal and institutional reforms by State Governments aimed at making co-operatives democratic and vibrant institutions run according to sound business practices, governance standards and regulated at the upper tiers by the RBI. The recommendations of the Vaidyanathan Committee have been accepted by the Government of India and are in the process of receiving the approval of states.

The Long Term Structure is under similar examination by Vaidyanathan Committee II.

In so far as commercial banks are concerned, competition and search for higher returns is driving these banks to look for profitable avenues and activities for lending such as financing of contract farming, extending credit to the value chain, financing traders and other intermediaries, etc. Simultaneously, we are witnessing the emergence of institutional systems and products such as futures markets, weather and crop insurance designed to minimise the risk of lending. The direction is clear that commercial bank lending will be to clientele which can bear the load of commercial considerations. The coverage of excluded sections of the population by them is currently being supported under government sponsored schemes and targets for weaker sections within the priority sector. The efficacy of this, if measured by the yardstick of "collections", is poor.

Merging and revamping of RRBs that are predominantly located in the tribal/backward regions is seen as a potentially significant institutional arrangement for financing the excluded. Such an exercise is currently on and the State Government's and Sponsor Banks have to come together and cooperate in this area.

In today's lecture, I am not going to go into these areas further. I will instead focus on the whole issue of those who are "financially excluded" in the rural areas and the extant institutional response to them.

In this context, the recently published NSSO Survey (2003) - relating to rural households is relevant. The survey data point out that of the 147.90 million rural households in the country, around 89.35 million households or roughly 60 per cent are cultivator households. Of these cultivator households, 48.6 per cent translating into 43.40 million households are indebted to either formal sources or non-formal sources or to both.

By implication, nearly 51 per cent of the cultivator households translating into 45.95 million households or over 200 million, poor are not indebted at all. It is pertinent to note that in the non-indebted category, 88 per cent of the households are headed by Small/Marginal farmers with farm holdings of less than 2 hectares.

These and related data lead to certain conclusions: The first is that as a proportion of total cultivator households at 89.35 million, the coverage by formal sources – banks, micro finance institutions, self-help groups (SHGs) – is 24.31 million households or only 27 per cent. The next point is that the extent of coverage, the outreach of the banking system at 24.31 million cultivator households, shows a distinct bias towards households with larger farm holdings. The data show that in regard to very small land holdings of say around 25 cents, the formal system's outreach is hardly 23 per cent, while in regard to farm holdings between 5 and 10 acres it is around 65 per cent. The third observation is that of the indebted households, if the five states of Andhra Pradesh, Tamil Nadu, Punjab, Kerala and Karnataka - which show high levels of indebtedness to the formal and informal system - are netted out, the overall level of indebtedness falls by nearly 6 percentage points from 48.6 to 42.7. What is more significant is that the level of indebtedness to only formal sources by cultivator households in the remaining states drops to barely 20 per cent. The fourth conclusion is that the coverage by informal sources is around 19.09 million households. Informal sector coverage appears stable in some states, increasing in others and only declining in some states in a patchy sort of way. There is a need to understand the informal markets, the network of relationships that support them and the nature and extent of informal linkages with the formal system. The fifth point is that hitherto, formal concern has been primarily focused on the indebted poor. The stance of policy and effort has been to find ways and means to increase the flow of institutional credit to the indebted poor, reduce the procedural and documentation hassles which characterise lending to such poor and ensure that affordable credit is reached to them at the appropriate time in adequate measure.

The most recent stipulation requiring banks to finance 100 new borrowers per branch on a continuing basis under the Government of India scheme for doubling of credit launched in 2004 is a step towards including the excluded. It is reported that the effort has been significant and that up to March 2005, 7.88 million new farmers had been financed by commercial banks, RRBs and co-operatives taken together.

However, this needs to be validated through field studies because ground level data indicate that there is some fuzziness regarding the way new borrowers may have been defined.

The short point is that merely requiring bank branches to finance 100 new farmers per annum will not be enough. If the 45.95 million rural households who are reported as not being indebted at all have to be brought within the indebted fold, a specific strategy will have to be designed for the purpose.

In order to design such a strategy, it is important to bear in mind that 88 per cent of the 46 million households in the non-indebted category are headed by small/marginal farmers with farm holdings of less than 2 hectares. We need to ask whether such farmers do not need credit or do not get credit? And if the answer is in the negative, we need to further ask whether it will be sufficient to give them credit without taking supportive measures to ensure their economic viability? I tend to believe that if this category of the poor have to be financed, then there is an obligation to create opportunities in which they can use the credit in a meaningful way. This can be best done by creation of production and employment opportunities in the real sector through public investment.

We also need to ask whether the financing of sub-marginal farmers is a credit plus issue? If it is a credit "plus" issue, what does the "plus" comprise of? Is it merely a grant based support such as under an employment guarantee scheme or should grant cum credit support be combined with investment in human capital through education and health. Then again, we know the sub-marginal farmers migrate. What is the extent of their migration? How can they be returned to land based and non-farm activities? What measures can we take to build the capacity and capability of such farmers? And is the banking system capable of meeting this challenge through its present mode of distribution of credit through the branch-banking model? All this will entail, among others, the "mapping" of the excluded by region and vocation. We are considering mounting a survey for the purpose and I would request the academicians assembled here to assist us and give us their counsel.

III

SHG-BANK LINKAGE

Having delineated the position in regard to the excluded, let me state that reaching the excluded is within the realm of possibility through a variety of interventions including innovations in product design and methods of delivery, through better use of technology and related processes and through institutional innovations backed by political and executive will. However, for want of time, I will deal with only one said intervention namely, the SHG-Bank Linkage model of NABARD, which is an outstanding example of an innovation leveraging on community-based structures and existing banking institutions.

The SHG- Bank linkage was conceived at a time when the financial sector reforms were motivating policy planners to search for innovative products and

strategies for delivering financial services to the poor in a sustainable manner consistent with high repayment rates. The search for these alternatives started with internal introspection regarding the innovations which the poor had been traditionally making, to meet their financial services needs. It was found that the poor tend to come together *in* a variety of informal ways for pooling their savings and dispensing small and unsecured loans at varying costs to group members on the basis of need. The essential contribution of NABARD in the SHG-Bank programme was to recognise this process, which had been catalysed by NGOs, and to create an interface of these informal arrangements of the poor with the banking system. The SHG-Bank Linkage Programme started as an Action Research Project in 1989. Positive field level findings led, in 1992, to the setting up of a Pilot Project. The project was designed as a “Partnership Model” between three agencies, viz., the SHGs, banks and non-governmental organisations (NGOs).

- SHGs were to facilitate collective decision-making by the poor and provide 'doorstep banking';
- Banks as wholesalers of credit, were to provide the resources and
- NGOs were to act as agencies to organise the poor, build their capacities and facilitate the process of empowering them.

IV

ACHIEVEMENTS

The programme has come a long way from the pilot stage of financing 500 SHGs across the country. Of the total SHGs formed, more than 1.6 million have been linked with 35,294 bank branches of 560 banks in 563 districts across 30 States of the Indian Union. Cumulatively, they have so far accessed credit of Rs.6.86 billion. About 24 million poor households, translating into nearly 120 million poor, of which around a third belong to the SC/ST category, have gained access to the formal banking system through the programme.

Given these quantitative achievements, what has been the impact of the programme. Cumulative experience and field findings show that: The programme has reduced the incidence of poverty through increase in income, helped the poor to build assets and thereby reduce their vulnerability. It has enabled households that have access to it to spend more on education than non-client households. Families participating in the programme have reported better school attendance and lower drop out rates. It has empowered women by enhancing their contribution to household income, increasing the value of their assets and generally by giving them better control over decisions that affect their lives. In certain areas, it has reduced child mortality, improved maternal health and the ability of the poor to combat disease through better nutrition, housing and health - especially among women and children.

Again, in certain areas, it has contributed to a reduced dependency on informal money lenders and other non-institutional sources. Finally, it has offered space for different stakeholders to innovate, learn and replicate. As a result, some NGOs have added micro-insurance products to their portfolios, a couple of federations have experimented with undertaking livelihood activities and grain banks have been successfully built into the SHG model in the eastern region. SHGs in some areas have employed local accountants for keeping their books; and IT applications are now being explored by almost all for better MIS, accounting and internal controls.

Given these findings, what have been the lessons learnt?

1. The first learning is that the "poor are bankable". When this is viewed in context of the attitudinal constraints that characterised bankers on the eve of the linkage programme, one can appreciate what an immense learning point this has been.

2. The second key learning is that the poor, organised into SHGs, are ready and willing to partner mainstream financial institutions and banks on their part find their SHG portfolios "safe" and "performing".

3. The third learning is that despite being contra intuitive, the poor can and do save in a variety of ways and the creative harnessing of such savings is a key success factor.

4. The fourth learning is that successful programmes are those that afford opportunity to stakeholders to contribute to it on their own terms. When this happens, the chances of success multiply manifold.

5. The fifth learning is that when a programme is built on the existing structures, it leverages all strengths. Thus, because the SHG-Bank programme is built upon the existing banking infrastructure, it has obviated the need for the creation of a new institutional set-up or introduction of a separate legal and regulatory framework. Since financial resources are sourced from regular banking channels and members' savings, the programme by-passes issues relating to regulation and supervision. Lastly, since the Group acts as a collateral substitute, the model neatly addresses the irksome problem of provision of collateral by the poor.

6. The last learning is that central banks, apex development banks and governments have an important role in creating the enabling environment and putting appropriate policies and interventions in position which enable rapid upscaling of efforts consistent with prudential practices. But for this opportunity, no innovation can take place.

V

CHALLENGES

Notwithstanding these valuable learning points it is clear that if the programme is to measure up to the task of reaching the excluded 46 million non-indebted cultivator households, it will have to meet the challenges confronting it. For this it must introspect and develop within itself the flexibility which will permit, indeed encourage, innovation in design and practice. What are the challenges which the movement faces today?

The first challenge is the skewed distribution of SHGs across States. About 60 per cent of the total SHG credit linkages in the country are concentrated in the Southern States. However, in States which have a larger share of the poor, the coverage is comparatively low.

The second challenge is that having formed SHGs and having linked them to banks, how can they be induced to graduate into matured levels of enterprise, how can they be induced to factor in livelihood diversification, how can they increase their access to the supply chain, linkages to the capital market and to appropriate/production and processing technologies.

The SHG Bank-Linkage programme also needs to introspect whether it is sufficient for SHGs to only meet the financial needs of their members, or whether there is a further obligation on their part to meet the non-financial requirements necessary for setting up businesses and enterprises. In my view, we must meet both.

The third challenge is how to ensure the quality of SHGs in an environment of exponential growth. Due to the rapid growth of the SHG Bank Linkage Programme, the quality of SHGs has come under stress. This is reflected particularly in indicators such as the poor maintenance of books and accounts etc. In my assessment, significant financial investment and technical support is required for meeting this challenge.

The fourth challenge is that the programme success has motivated the Government to borrow its design features and incorporate them in their poverty alleviation programme. This is welcome but the fact is that the Government's Programme (SGSY) has an inbuilt subsidy element which tends to attract members and cause them to leave their original SHG-Bank linked groups and migrate to the SGSY groups generally for the wrong reasons.

Micro level studies have also raised concerns regarding the process through which groups are formed under the SGSY. The finding is that in many cases members are induced to come together not for self help, but for subsidy. I would urge a debate on this as there is a need to resolve the tension between SGSY and linkage programme groups. One answer could be to place the subsidy element in the SGSY programme with NABARD. The subsidy could then be utilised for providing indirect support for purposes such as sensitisation, capacity building, exposure visits to successful models, etc.

A derivative of the above is perhaps the need to extend the above debate to understanding and defining the role of the State Governments vis-à-vis the linkage programme. It is clear that on the one hand, the programme would not have achieved its outreach and scale, but for the proactive involvement of the State Governments. On the other hand, many State Governments have been overzealous to achieve scale and access without a critical assessment of the manpower and skill sets available with them for forming, and nurturing groups and handholding and maintaining them over time. This needs to be studied and addressed.

The emergence of SHG Federations has thrown up another challenge. On the one hand, such federations represent the aggregation of collective bargaining power, economies of scale, and are a fora for addressing social and economic issues; on the other hand there is evidence to show that every additional tier, in addition to increasing costs, tends to weaken the primaries. There is a need to study the best practices in the area and evolve a policy by learning from them.

Before closing, let me use this opportunity to sound two notes of caution. One, that while we are upbeat about the success achieved and the potential that the SHG – Linkage programme offers to reach the poor, we need to be realistic not to view this instrument as a one-stop solution either for rural credit or for all developmental problems. The programme has certain inherent limitations and these should be addressed. The second is that the issues of rural credit cannot be addressed without strengthening the credit delivery system. It is for this reason that the efforts under way to strengthen the institutional mechanisms to facilitate lending to this sector will have to be continued with vigour and supported with great sincerity by the State Governments. I have no doubt that if State Governments lend their executive and political support, the co-operatives and RRBs can be revitalised and converted into effective instruments for serving the public good. That this can be done was articulated by the Hon'ble Prime Minister at the last meeting of the National Development Council.

Speaking to us, he said, "Today, India is at a historic point in its development trajectory. As I said in my opening remarks yesterday, we are now at a point in time where we can deliver growth at a rate of 7 – 8 per cent. At this point in time, owing to the developments over the last two decades, there are no external constraints to the growth of our country. It is very much in the realm of possibility for this country to become a prosperous nation, rid of the perennial scourges of poverty, ignorance and disease. The world is today looking at India with great interest as the saga of our development and rise to prominence on the international stage unfolds. Rare are such moments in history when a nation suddenly captures the imagination of the world.

In such circumstances, if there are any constraints, these are purely internal. Our success in living up to our potential depends solely only on us. No external force can be blamed if we do not rise up to everyone's expectations. Therefore, it is incumbent on all of us to ensure that we realise this potential. It is this vision of a resurgent India that must guide our actions while discharging our duties."

On this note of hope for a better tomorrow, I take leave of you. Thanking you once again for having given me this honour and opportunity today.