AgEcon SEARCH

RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

*The World's Largest Open Access Agricultural & Applied Economics Digital Library*

**This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.**

**Help ensure our sustainability.**

Give to AgEcon Search

AgEcon Search
http://ageconsearch.umn.edu
aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

Vol. XLIX
No. 3

CONFERENCE NUMBER

JULY - SEPTEMBER 1994

ISSN 0019-5014

# INDIAN JOURNAL OF AGRICULTURAL ECONOMICS

INDIAN SOCIETY OF AGRICULTURAL ECONOMICS, BOMBAY

*Ind. Jn. of Agri. Econ.*
*Vol. 49, No. 3, July-Sept. 1994*

# Formal Agricultural Credit System in India: Shape of Things to Come*

**M.V. Gadgil†**

## INTRODUCTION

During the two decades 1971-91, the formal agricultural credit system, comprising the National Bank for Agriculture and Rural Development (NABARD), rural and semi-urban branches of commercial banks, co-operatives (both in the short-term and long-term credit structures) and Regional Rural Banks (RRBs) has expanded sizeably in quantitative terms. It is no exaggeration to say that the diffusion of the Green Revolution in the ecologically favourable regions in India was greatly facilitated by the formal credit system providing large amounts of investment and production credit to farmers. The White Revolution and the development of horticulture, plantation, poultry, fishery and oilseeds have similarly been facilitated by credit. The dependence of farmers on informal credit has been reduced substantially by the growth of institutional credit, as has been revealed by the Reserve Bank of India's (RBI) All-India Debt and Investment Surveys, 1971-72 and 1981-82. The rural and semi-urban branches of commercial banks have mobilised large deposits. While these are no mean achievements, several weaknesses of the system have also come to surface. These include the precarious viability of credit institutions, defaults in loan repayment by farmers, concentration of credit in irrigated areas or those with high and assured rainfall and inadequate attention to the real impact of credit due to the monitoring system focusing on financial achievements. The future of the system also appears uncertain in the absence of an unambiguous Government policy on financial sector reforms (FSR), which are intended to strengthen the financial system. This paper therefore discusses the likely impact of FSR on the formal agricultural credit system in the future.

## FINANCIAL SECTOR REFORMS

Financial sector reforms, an integral part of the economic restructuring programme, are set forth in the *Report of the Committee on the Financial System* or Narasimham Committee, appointed by the Government of India. Among the Committee's recommendations, those which are germane for this paper are:

(i) Phasing out of directed lending for priority sectors, and redefining the sectors in the interim to include small and marginal farmers, tiny industry, small business and transport operators, rural artisans and other weaker sections and fixing the credit target for this group at 10 per cent of aggregate credit;
(ii) Deregulation of interest rates;
(iii) Delinking of rural branches of commercial banks and reconstituting them into new rural banks; and
(iv) Merger of willing RRBs into the newly proposed rural banks and allowing them to do all types of banking business after maintaining at a minimum the present level of their lending to the target groups.

* Keynote paper.
† Former Managing Director, National Bank for Agriculture and Rural Development.

The official reaction to these recommendations can be seen in RBI's *Report on Trend and Progress of Banking in India, 1991-92* (Reserve Bank of India, 1993, pp. 2-8). As for abolition of directed lending, the Report says: "A detailed assessment indicated that the redefined priority sector would account for significantly larger than 10 per cent of the total credit and as such acceptance of the Committee's recommendation would put a severe squeeze on the .... redefined priority sector. For instance, if advances for farm mechanisation, advances over Rs. 10 lakh to small industries, advances over Rs. 5 lakh to small road and water transport operators and advances to professional and self-employed persons are excluded from priority sector, the ratio of the redefined priority sector advances to net bank credit as at the end of March 1990 would work out to a little less than 30 per cent. In case advances over Rs. 2 lakh to agriculture, small-scale industries and transport operators and all advances to professional and self-employed persons are excluded from the priority sector, the ratio of residual advances to net bank credit would work out to 25 per cent. Again, there is little merit in a drastic reduction in the target for the priority sector and then meeting the requirements of these sectors through refinance from Reserve Bank as this would result in increasing the amount of created money thereby fuelling inflationary pressures .... While there is a case for reviewing the present coverage and targets for priority sector lending, the experience of a number of countries is that some direction of credit is necessary in the development process." The RBI does not address the basic issues of viability of enterprise and self-liquidating character of loan which are often sacrificed by banks in their anxiety to achieve financial targets in respect of directed credit programmes like IRDP.

On deregulation of interest rates, the Report says: ".... the basic thrust of the Narasimham Committee that real interest rates should be positive and that concessive interest rates should not be the vehicle for subvention has been well accepted and a series of reform measures have been put in place.... There is, however, a need for further rationalisation of interest rates and in particular it is desirable to evolve a Reserve Bank Reference Rate of Interest which could then be the basis for determining the entire gamut of interest rates.... While these measures need to be persevered with, there is need for a cautious step-by-step approach rather than a rapid deregulation of all interest rates in the system. The experience in a number of countries has been that too rapid a deregulation .... can be destabilising - something which the Indian banking system can ill-afford at this stage."

On restructuring of agricultural credit institutions, the Report mentions that the Government of India (GOI) has proposed a merger of all the 196 RRBs into a National Rural Bank (NRB). A Steering Group comprising representatives of GOI, RBI, NABARD and major sponsor banks has estimated that the NRB would need a paid-up capital of Rs. 500 crores (of which 51 per cent should be contributed by GOI) and an additional Rs. 1,070 crores of GOI subvention to cover losses accumulated to March 1993 (Rs. 850 crores) and arrears of salary payable to the RRB staff on account of award of the National Industrial Tribunal (Rs. 220 crores). "No decisions have been taken on the final setup of the proposed NRB .... it would be necessary to focus attention on the burden on the Government for funding ...., the drawing of a balance between viability of operations and reasonable cost of credit, the question of recovery (of loans) ...." Meanwhile, RRBs have been allowed with effect from September 1992 to do non-target group-financing not exceeding 40 per cent of their fresh loans (NABARD, 1993, p. 163), which figure has been raised to 60 per cent from December 1993. The issue of future viability of the monolithic NRB has not been discussed

in the Report. There is also no mention in the Report of the official thinking on the Narasimham Committee recommendation to hive off rural branches of public sector banks and reconstituting them into rural banking subsidiaries. Meanwhile, NABARD has selected 49 weak RRBs for rehabilitation. Thus the silence on the creation of rural banking subsidiaries and the effort at rehabilitation of some RRBs suggest that the Government is not inclined to restructure the rural credit institutions as proposed by the Narasimham Committee or in any other manner.

To sum up, official thinking on the Narasimham Committee Report favours only a gradual deregulation of interest rates. It does not favour the abolition of directed lending, delinking of the rural branches of public sector commercial banks and merging them into rural banking subsidiaries, the merger of RRBs into the proposed rural banking subsidiaries or even the creation of NRB. Since this author was not able to trace any documentary evidence suggesting changes in official thinking, it is assumed that what has been set down above continues to be the official policy.

## MOVEMENT OF INTEREST RATES ON AGRICULTURAL LOANS, 1980-1994

Since official thinking appears to have favoured the Narasimham Committee recommendation on a phased deregulation of all interest rates, it is necessary to examine whether the recent movement of the rates has been in that direction. With a total deregulation, the rates on farm loans are likely to be real and positive and the interest spread for the banks large enough to meet the transaction costs and risk, besides leaving some surplus to make agricultural credit a commercially attractive proposition. There will be no need under such a situation to cross-subsidise agricultural credit. Accordingly, Tables I and III respectively trace the changes in the interest rates on crop loans (short-term) and farm investment loans (medium- and long-term) over the period July 1980 to March 1994. From this period, changes between 1990 and 1994 are of particular significance since the former year coincides with the onset of the economic restructuring programme.

As for the ultimate lending rates on *crop loans*, the highlights of Table I are:

(i) During the fourteen years, there have been ten changes in the rates. The lowest rate, which stood at 12.5 per cent in March 1981, was reduced to 10 per cent in March 1989, raised to 11.5 per cent in October 1991 and to 12 per cent in April 1993.

(ii) The changes in the highest rate have been within the range of 13 to 20 per cent. The variation in such rate between September 1990 and March 1994 reflects the anti-inflationary policy of RBI.

(iii) The rate has increased with an increase in the size of loan all along. However, the number of size slabs, which stood at only two from 1980 to August 1987 increased to three in September 1987 and to six in September 1990, came down to five in October 1991, to four in April 1992 and stands at three since April 1993. The amount of loan falling in the size slabs has progressively increased. The smallest slab, which covered loans upto Rs. 2,500 in 1980, now (since April 1993) extends to loans upto Rs. 25,000. The size of the largest slab has also increased over the same period from Rs. 2,501 to Rs. 2 lakhs.

(iv) Data on size classification of crop loans are available only in respect of co-operatives. Even the latest available such data relate to 1986-87 and 1987-88 and the size-groups are not consistent with the slabs formed in April 1993 for variation in the rates of interest (Table II). Only one inference can be drawn from the data, viz., that the majority of the borrowers (88 per cent) with loans upto Rs. 5,000 in those years with corresponding limit now raised

TABLE I. MOVEMENT IN THE INTEREST RATES ON CROP LOANS, 1980-1994

(per cent per annum)

| Size of loan (Rs.) | Rates to farmers | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Before July 1980 | From 1.7.80 | From 2.3.81 | From 1.4.83 | From 1.9.87 | From 1.3.89 | From 22.9.90 | From 9.10.91 | From 22.4.92 | From 8.4.93 | From 1.3.94 |
| (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) | (12) |
| Upto 2,500 | 11.00 | 11.85 | 12.50 | 11.50 | 11.50 | 10.00 | 10.00 | 11.50 | 11.50 | 12.00 | 12.00 |
| 2,501-5,000 | 13.00 | 14.00 | 12.50 | 11.50 | 11.50 | 10.00 | 10.00 | 11.50 | 11.50 | 12.00 | 12.00 |
| 5,001-7,500 | 13.00 | 14.00 | 15.00 | 14.00 | 12.50 | 10.00 | 10.00 | 11.50 | 11.50 | 12.00 | 12.00 |
| 7,501-10,000 | 13.00 | 14.00 | 15.00 | 14.00 | 12.50 | 11.50 | 11.50 | 13.00 | 13.50 | 12.00 | 12.00 |
| 10,001-15,000 | 13.00 | 14.00 | 15.00 | 14.00 | 12.50 to 14.00 | 11.50 | 11.50 | 13.00 | 13.50 | 12.00 | 12.00 |
| 15,001-25,000 | 13.00 | 14.00 | 15.00 | 14.00 | 12.50 to 14.00 | 12.00 | 12.00 | 13.50 | 13.50 | 12.00 | 12.00 |
| 25,001-50,000 | 13.00 | 14.00 | 15.00 | 14.00 | 14.00 to 15.50 | 14.00 to 15.50 | 14.00 | 15.50 | 16.50 | 16.50 | 15.00 |
| 50,001-2 lakhs | 13.00 | 14.00 | 15.00 | 14.00 | 14.00 to 15.50 | 14.00 to 15.50 | 15.00 | 16.50 | 16.50 | 16.50 | 15.00 |
| Above 2 lakhs | 13.00 | 14.00 | 15.00 | 14.00 | 14.00 to 15.50 | 14.00 to 15.50 | 16.00 (Minimum) | 20.00 (Minimum) | 19.00 (Minimum) | 17.00 (Minimum) | 15.00 (Minimum) |

RATES ON REFINANCE

| Type of Institution | From July 1980 to June 1981 | From July 1981 to February 1989 | From 1.3.1989 to 28.2.1994 | From 1.3.1994 |
|---|---|---|---|---|
| Co-operatives | 6.00 | 7.00 | 3.00 to 5.00, depending upon refinance as per cent of loans outstanding with PACS | Same |
| RRBs | 7.00 | 7.00 | 5.00 | 6.50 |

*Source:* NABARD Circulars.

TABLE II. CLASSIFICATION OF CROP LOANS ISSUED BY PRIMARY AGRICULTURAL CREDIT SOCIETIES BY LOAN SIZE - ALL INDIA

| Year | Upto Rs. 500 | | Rs. 501 - 1,000 | | Rs. 1,001 - 3,000 | | Rs. 3,001 - 5,000 | | Rs. 5,001 - 10,000 | | Over Rs. 10,000 | | Total | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | No. of borrowers | Amount | No. of borrowers | Amount | No. of borrowers | Amount | No. of borrowers | Amount | No. of borrowers | Amount | No. of borrowers | Amount | No. of borrowers | Amount |
| (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) | (12) | (13) | (14) | (15) |
| 1986-87 | 5,954 | 208.90 | 5,214 | 432.26 | 4,352 | 888.67 | 2,164 | 826.74 | 1,085 | 701.34 | 395 | 535.42 | 19,164 | 3,593.33 |
| | (31.1) | (5.8) | (27.2) | (12.0) | (22.7) | (24.7) | (11.3) | (23.0) | (5.7) | (19.5) | (2.0) | (14.9) | (100) | (100) |
| 1987-88 | 5,931 | 334.67 | 4,936 | 416.94 | 4,142 | 983.40 | 2,411 | 960.85 | 1,786 | 1,003.65 | 544 | 626.56 | 19,750 | 4,326.07 |
| | (30.0) | (7.7) | (25.0) | (9.6) | (21.0) | (22.7) | (12.2) | (22.2) | (9.0) | (23.2) | (2.8) | (14.6) | (100) | (100) |
| | 11,885 | 543.57 | 10,150 | 849.20 | 8,494 | 1,872.07 | 4,575 | 1,787.59 | 2,871 | 1,704.99 | 939 | 1,161.98 | 38,914 | 7,919.40 |
| Two-years average amount per borrower (Rs.) | | 457 | | 833 | | 2,202 | | 3,886 | | 5,879 | | 12,494 | | 2,036 |

*Source:* NABARD (1994), *Statistical Statements Relating to the Co-operative Movement in India, 1987-88*, Bombay, pp. 313-316.

*Notes:* 1. Number of borrowers in '000s.

2. Amount in Rs. crores except the two-year average.

3. Figures in parentheses are percentages to the total.

upto Rs. 25,000 will be required to pay a 2-point higher interest rate.

(v) The ups (during 1980-81) and downs (from 1983 to 1989) in the interest rates do not appear to have any economic rationale. In other words, extra-economic reasons seem to have governed the movement in the interest rate upto October 1991.

(vi) The rates of interest on refinance for crop loans fell sharply in March 1989 (to compensate the co-operatives and RRBs for the reduced rates to ultimate borrowers) and even in March 1994 stand at the same level. Only the rate applicable to RRBs is up by 1.5 points.[1] This suggests that the new rates on crop loans to farmers are not high enough to enable the co-operatives and RRBs to meet the financial, transaction and risk costs, necessitating continued subsidisation by NABARD/RBI. By the same token, commercial banks may also be required to continue cross-subsidisation of agricultural credit. A lot more will have to be done in the future to make such credit self-sustainable.

Turning to the movement of rates on *investment loans* (Table III), the salient changes over the 14 years are:

(i) In contrast to crop loans, the rates to ultimate borrowers have remained constant between March 1981and September 1990, the difference between the lowest and highest rates being 2.50 points. During this period, the rate for preferred investments varied not with loan size or the size of land holding of the borrower but the nature of investment. Minor irrigation and land development, land-augmenting and labour-augmenting investments attracted the lowest rate of 10 per cent, irrespective of loan size or the size of land holding of the borrower. For all other investments, however, the rate was lower for small farmers than for non-small farmers, the distinction between them being based on the size of land holding.

(ii) It is only since September 22, 1990 that the rate varies with the size of loan. For loans upto Rs. 2 lakhs, the hitherto prevalent distinction between preferred and other investments was abolished by prescribing uniform rates; it is only for loans above Rs. 2 lakhs that preferred investments attract a 1-2 point lower rate than other investments.

(iii) Between September 22, 1990 and March 1994, the lowest rate increased from 10 per cent to 12 per cent, there being a corresponding increase of 1 point in the highest rate to 15 per cent. The rates applicable to loans above Rs. 2 lakhs are mostly for institutional borrowers and not for individual farmers. Tractor loans to individual farmers (falling in the range of Rs. 25,001 - Rs. 2 lakhs) now attract a 14 per cent rate, down by 1 point from the April 1993 rate.

(iv) The rates on NABARD refinance for investment loans upto Rs. 25,000 have remained constant at 6.5 per cent for co-operatives and RRBs; for commercial banks it is higher by 1 point since March 1994. Compared with the eighties, the rate on refinance on loans exceeding Rs. 25,000 is up by 1.5 to 4.0 points in March 1994 for co-operatives and RRBs but by 2 to 4.5 points for commercial banks. The discrimination by NABARD against the commercial banks appears strange since their share in the total schematic refinance disbursed by NABARD during 1992-93 to all types of banks was the highest at 43 per cent and has been so since the inception of NABARD in 1982. On their part, commercial banks are also showing reluctance to avail of refinance since its cost is higher than that of deposits.

TABLE III. MOVEMENT OF INTEREST RATES ON SCHEMATIC AGRICULTURAL INVESTMENT LOANS (MEDIUM- AND LONG-TERM), 1980-1994

*(per cent per annum)*

| Sr. No. | Purpose/Class of farmer/Loan size | 1.7.1980 to 1.3.1981 | | 2.3.1981 to 21.9.1990 | | 22.9.1990 to 28.2.1994 | | From 1.3.1994 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Rate on refinance | Rate to ultimate borrowers | Rate on refinance | Rate to ultimate borrowers | Rate on refinance | Rate to ultimate borrowers | Rate on refinance | | Rate to ultimate borrowers | |
| | | | | | | | | Co-op. Banks and RRBs | Commercial Banks | With refinance | Without refinance |
| (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) | (12) |
| 1. | Minor irrigation and land development | 6.50 | 10.25 | 6.50 | 10.00 | 6.50 | - | - | - | - | - |
| 2. | Other purposes | | | | | | | | | | |
| | (a) Small farmers | 6.50 | 10.25 | 6.50 | 10.00 | 6.50 | - | - | - | - | - |
| | (b) Other farmers | 8.00 | 11.35 | 8.00 | 12.50 | 8.00 | - | - | - | - | - |
| 3. | Upto Rs. 25,000 (All purposes) | - | - | - | - | 6.50 (on loans upto Rs. 50,000) | 10.00 to 13.50 | 6.50 | 7.50 | 12.00 | 12.00 |
| 4. | Rs. 25,001 to Rs. 2 lakhs (All purposes) | - | - | - | - | 9.50 to 10.00 (on loans above Rs. 50,000) | 13.00 to 15.00 | 9.50 | 10.00 | 14.00 | 14.00 |
| 5. | Above Rs. 2 lakhs | | | | | | | | | | |
| | (a) Thrust areas* | - | - | - | - | 9.50 to 10.50 | 13.00 to 15.00 | 9.50<br>10.50 | 10.00<br>11.00 | 14.00<br>15.00 | 14.00 (Minimum) |
| | (b) Other purposes | - | - | - | - | 12.00 | 13.00 to 15.00 | | | | 15.00 (Minimum) |

*Source:* NABARD Annual Report and Circulars.

* Include wasteland development, dryland farming, 100 per cent export-oriented agricultural projects other than tea, coffee and rubber, and minor irrigation schemes by co-operatives and public corporations.

Diminished recourse to refinance may cut down the rate of growth of investment loans by commercial banks, adversely affecting capital formation in agriculture, which is already slackening.

(v) A distribution of farm investment loans by size is not available even in respect of co-operatives. But the average size of the loan being less than Rs. 25,000, it is possible to conclude that the majority of farmers will now be required to pay higher rates.

The following is a summary of the transaction costs and risks as estimated by the Khusro Committee (Reserve Bank of India, 1989) for different credit institutions for the years 1983-84 through 1985-86:

*(Rs. per Rs. 100 outstanding loan)*

| Item | PACS | LDB | RRBs | Commercial banks |
|---|---|---|---|---|
| Transaction costs | 5.40 | 4.04 to 4.74 | 6.90 | 6.00 to 7.50 |
| Risk costs | 1.00 | 1.00 | 1.25 | 1.00 |

The transaction costs in 1994 would be higher than the above estimates due to a rise in staff salaries (80 per cent of the transaction costs, according to the Khusro Committee, are manpower related) and escalation in the costs of office rent, transport, stationery, postage, telephone charges, etc. If it is assumed that the present transaction costs are higher by one percentage point than the above estimates but that the risk cost is constant and that a margin of 0.5 per cent is required to leave a surplus with the lending institutions, the minimum level of interest spread required works out as follows:

| | |
|---|---|
| PACS | 6.90 per cent |
| LDBs | 5.54 to 6.24 per cent |
| RRBs | 8.65 per cent |
| Commercial banks | 7.50 to 9.00 per cent |

Using the data on the structure of commercial bank deposits as on March 26, 1993 (Reserve Bank of India, 1994, p. 188) and applying the August 1994 rates on deposits paid by them (nil on current deposits, 5 per cent on saving bank deposits and 7 to 10 per cent on fixed deposits and assuming the middle rate of 8.5 per cent for all fixed deposits), the weighted average cost of deposits works out to 6.45 per cent. The corresponding figure for March 1989 is 5.90 per cent. Disregarding statutory liquidity ratio and cash reserve ratio, the minimum lending rate for agriculture now required by commercial banks to make such lending *per se* viable is between 14 per cent and 15.50 per cent. To be able to realise these rates, commercial banks will have to prefer agricultural loans exceeding Rs. 25,000 (and better still loans in excess of Rs. 2 lakhs each without recourse to NABARD refinance so that they can realise the maximum permissible lending rate of 17 per cent), which is not feasible against the objective of attaining the target set for agricultural credit. The position of RRBs would be comparable to that of commercial banks because the gains from NABARD refinance both for crop loans and farm investment loans, which carry higher rates since March 1994, would be offset partly by the higher rates they pay on deposits than the commercial banks and partly by the compulsion to earmark 40 per cent of fresh loans for

the rural poor. Such loans are small and involve proportionately higher transaction cost for banks. As for the short-term co-operative credit structure, the viability of crop loans would depend upon the relative proportions of (cheaper) refinance and the structure's own deposits, which also carry higher rates compared with commercial banks. The PACS now get finance for crop loans from the District Central Co-operative Banks (DCCB) at 9 per cent. Unless the lending rate to the farmer was 15.90 per cent, the PACS would not find the crop loan activity viable. A DCCB in Maharashtra, not eligible for refinance because it is unable to disburse at least 40 per cent of its internal lendable resources as crop loans due to growth of deposits outpacing the growth in the demand for crop loans, has an average deposit cost of 9.90 per cent. It uses such funds for lending to PACS at 9 per cent, incurring a loss of 0.9 per cent in the process. The LDBs have no resource other than refinance to fall back upon and they now enjoy wider margins than before. In short, all the credit institutions now enjoy wider margins but these do not appear adequate to make agricultural credit a viable activity for them.

The quality of credit is as important as its quantity for producing an optimal impact on productivity. Despite the wider margins now available, an improvement in the quality of credit, necessitating higher transaction costs for banks, does not appear feasible within the available spread.

Will NABARD get higher interest income from the new rates on refinance? As for crop loan refinance, the answer is clearly in the negative because all the interest income from this source is passed on by NABARD since 1989 to RBI (which provides the needed funds to NABARD). In other words, NABARD's interest margin against crop loan refinance is zero and has been so since March 1989. As regards refinance for investment loans, the new (higher) rates will definitely augment NABARD's income from this source, but by what amount cannot be projected at this stage in the absence of information on size classification of such loans. Whether the magnitude of such increased income will be sufficient to offset the adverse impact of stoppage of RBI contribution to National Rural Credit Long Term Operations (LTO) Fund since 1992-93 (zero cost resource) and the cessation of World Bank assistance for agricultural credit in India (General Line of Credit to NABARD for schematic refinance) since end-June 1989 (6 to 7 per cent GOI loans to NABARD against World Bank credits) cannot also be judged at this time. Due to continuous credits to the LTO Fund from RBI and NABARD from out of their surpluses, the proportionate share of this cost-free resource in NABARD's outstanding schematic refinance had grown steadily from 55 per cent in 1983 to 91 per cent in 1992 but had declined to 88 per cent in 1993. Correspondingly, the share of market borrowings (bond floatation at market rate of interest, which stood at 13 per cent in 1992-93) has steadily declined from 18 per cent in 1983 to 10 per cent in 1992 and increased marginally to 10.3 per cent in 1993. While schematic refinance from NABARD between 1983 and 1993 grew annually at a compound rate of 13 per cent, the corresponding growth rate for the LTO Fund was 19 per cent. This explains why NABARD has managed to earn profits throughout its life. But as the relative weight of LTO Fund decreases and that of market borrowings increases in the future, NABARD's ability to earn a profit will be eroded. If assistance from World Bank is renewed, this period of profitability may get extended.

What about the demand side reaction to the new interest rate policy? This author has argued elsewhere (Gadgil, 1992) that an interest rate of 18 per cent on crop loans would

reduce net income from crops by 1 to 5 per cent and a rate of 24 per cent by 3 to 10 per cent. As for investment loans, 73 per cent of the farm investments can afford a rate of 18 per cent, the corresponding figure being 60 per cent for an interest rate of 24 per cent. In other words, farmers can afford to bear higher interest rates if the quality of credit delivered by the credit institutions also improves in terms of adequacy of amount, timeliness, simplicity of procedures, recovery of loan in accordance with the borrower's ability to repay, a continuous monitoring of the real impact of investments and a closer liaison between the banker and the borrower. The fact that members of self-help groups borrow ungrudgingly at 24 to 36 per cent also goes in support of the need to raise the present rates on formal agricultural credit to levels at which the activity becomes viable for the lender. The available evidence suggests that the rates on formal credit are likely to be in the proximity of 18 per cent with total deregulation of interest rates.

To sum up the discussion on lending rates:

(i) It is only since 1990 that the movement in rates seems to have some economic rationale, though an element of populism is still discernible in the rate structure.

(ii) The annual rate of inflation in the wholesale prices of all commodities between 1981-82 and 1993-94 was 7.9 per cent, the corresponding figure for the movement in the consumer price index for agricultural labourers (1980-81 to 1992-93) being 8.4 per cent. Thus the rates on farm loans have been positive all through.

(iii) Despite an increase in the rates, the margins do not appear adequate to make agricultural credit a viable activity for the credit institutions, let alone permit an improvement in the quality of lending.

(iv) RBI/NABARD continues to heavily subsidise crop loans dispensed by the co-operatives and RRBs. The rate on such refinance which once used to be 2 per cent below the bank rate is now 7 to 9 per cent below the 1992-93 bank rate of 12 per cent.

(v) Diminished recourse to refinance by commercial banks, the major source of farm investment loans, following a step-up in the rate of interest on refinance, may adversely affect private fixed capital formation in agriculture.

(vi) Farmers can afford to bear higher interest rates if the quality of credit improves.

## RESTRUCTURING OF REGIONAL RURAL BANKS AND RURAL BRANCHES OF COMMERCIAL BANKS

The RRBs were originally intended to cater exclusively to the credit needs of the rural poor as low-cost alternatives to rural branches of commercial banks. Over the years, the latter assumption has been belied because the RRB staff has been awarded increases in salary from time to time, culminating recently in parity in pay-scale and allowances with their opposite numbers in commercial banks. In the process of catering to the rural poor at concessional interest rates coupled with high transaction costs associated with small loans, most RRBs have lost their viability. The objective of an institution devoted exclusively to the rural poor has also been compromised by allowing RRBs to give 60 per cent of their fresh loans to the non-poor. The Government thus appears to be convinced that no bank catering exclusively to the rural poor has the prospect of being self-sustainable. Today's RRB is thus neither fish, flesh nor fowl.

There are 196 RRBs in the country covering 397 districts with a network of 14,540

branches (September 1992). Their deposits were Rs. 6,369 crores (March 1993) while their credit stood at Rs. 4,451 crores. Of the 196 RRBs, only 44 were marginally profit-making, while the remaining 152 were incurring losses. It was in this context that the Narasimham Committee recommended allowing them to do all types of lending and their eventual merger with the proposed rural banking subsidiaries (RBS) of commercial banks. The Government's idea at one point of time, however, seems to have been to merge all the 196 RRBs into a single institution to be called the National Rural Bank (NRB). With NABARD having recently undertaken the task of rehabilitating 49 weak RRBs, the idea of setting up the NRB seems to have been given up or kept in abeyance. Even if the NRB is set up and it starts with adequate capital and its past accumulated losses are wiped out, as suggested by the Steering Group, how it is going to attain viability in the future without additional subventions from time to time remains a moot point. The merger of 196 RRBs into the NRB, by itself, does not seem to be a solution for securing institutional viability. With only 60 per cent of fresh loans allocated to the non-poor, the potential for cross-subsidising the higher transaction costs associated with small loans carrying lower rates of interest for the poor appears extremely limited. The transaction costs of RRBs would now be substantially higher than the Khusro Committee estimates furnished in the preceding section due to the pay-scale parity for their staff. Since the interest spread has probably not increased in the same proportion, the net margin (interest spread less transaction costs) would continue to be negative and probably exceeds the December 1986 estimate of Khusro Committee at minus 3.70 per cent. The proposed NRB is thus likely to be a non-viable institution right from its birth.

As for rural branches of commercial banks, the net margin against agricultural loans was estimated by the Khusro Committee at minus 0.05 per cent, the corresponding figure for the rural branch as a whole being minus 0.46 per cent. Both the figures would now be higher due to escalation in transaction costs not being offset fully by the rise in lending rates. It appears therefore that if directed lending continues, the proposed rural banking subsidiaries of commercial banks are also not likely to be viable institutions; they are likely to be even more non-viable if RRBs are merged into them. However, if interest rates are totally deregulated and directed lending is abolished, both the institutions may attain viability.

The rural branches of commercial banks have been staffed with conscripts, i.e., city-bred persons reluctant to work and live in villages even for the minimum period of compulsory rural service. Their attitude to work is to somehow complete the period of rural posting. Most of them become due for repatriation to urban areas just when they have acquired some knowhow of agricultural lending. Another development in the offing, which is likely to further restrict lending by rural branches is that ".... starting from October 1994 or so, he (branch manager) would be asked to bear a part of the burden of non-performing assets. His pay would be cut if the loans are not recovered" (Venkitaramanan, 1994). Whether RBSs are established or whether the existing set-up of rural branches of commercial banks continues in the future, there is unlikely to be a change in the outlook of the staff and hence an improvement in the quality of lending, unless the recruitment policy is changed to replace reluctant conscripts with persons who have an abiding interest in rural banking and are prepared to make a career in it. This is possible only if rural branches of commercial banks are separated and reconstituted into new institutions and if they follow a different recruitment policy. The Narasimham Committee recommendation to hive off rural branches of commercial banks appears rational against this background.

The Narasimham Committee did not deal with credit co-operatives at all. But their dominance in agricultural credit has steadily declined since 1971. However, the PACS continued to be the most important source of crop loan even in 1990-91 with a share of 57 per cent in the total outstanding amount, followed by commercial banks (37 per cent) and RRBs (6 per cent). In investment credit, the LDBs had a share of only 26 per cent as compared with the 64 per cent share of commercial banks and 10 per cent of RRBs. When both production and investment credit are added up, the relative shares are: Commercial Banks - 51 per cent, co-operatives - 41 per cent and RRBs - 8 per cent. The reasons for the declining role of co-operatives are many. In this author's view, the most important ones are: (i) injection of large amounts of external funds such as State Government capital and refinance from RBI/NABARD, which has weakened the spirit of self-help, (ii) total neglect of the principle of thrift (mobilisation of members' savings) induced by a facile flow of outside funds, (iii) increasing politicisation of the co-operative movement, (iv) defaults in repayment induced by political gimmicks like loan write-offs on the eve of elections, and (v) the policy of providing concessional credit for agriculture facilitated by access to cheap resources of RBI/NABARD. If the model of the PACS in Kerala, which provides all the credit from the members' savings without any borrowing from the DCCB and which has a loan recovery rate of over 90 per cent, had been adopted throughout the country, the co-operative credit movement would have grown from strength to strength though steadily. Without a sea change in the existing policies, the credit co-operatives are not likely to improve their performance. It is unfortunate that the co-operative institutions numbering over a lakh spread throughout the country, with intimate knowledge of local conditions and of their members and a distinct rural bias, are allowed to languish and deteriorate, because of the mistaken perceptions of scholars and politicians. A complete deregulation of interest rates and denial of cheap refinance from NABARD may prove to be the initial shock therapy required for reviving the credit co-operatives.

The adoption of multi-agency approach to rural credit, directed lending, concessional interest rates for agriculture, creation of RRBs, loan write-offs and other gimmicks such as loan melas tried out over the last 20 odd years hold out one lesson: formal credit, and cheap credit at that, is not a panacea for rural poverty. Any adjustment in the structure of rural credit institutions must satisfy some basic criteria - viability of credit institutions, healthy competition amongst them, allocation of credit on the basis of project feasibility, a minimum quality of lending and timely recovery of loans.

## FUTURE ROLE OF NABARD

As already stated, the demand from banks for NABARD refinance depends upon the rate of interest on refinance relatively to the interest cost of their own deposits. The demand for crop loan refinance from the co-operative banks and RRBs is sustained by the very low rates on refinance which have remained unchanged since 1989. On the other hand, the increased rates on refinance for investment credit effective March 1994 are proving a disincentive for commercial banks, the most important source of such credit for farmers. Given the likelihood of a total deregulation of all interest rates in the future, it is necessary to discuss the future role of NABARD in the field of agricultural credit.

NABARD's role in agricultural credit has been two-fold: (i) refinancing the loans dispensed to farmers by co-operatives, RRBs and commercial banks and (ii) performing promotional and developmental functions. The latter include mobilising the required credit

support for priority programmes like Oilseeds Production Programme, National Pulses Development Programme, Integrated Programme for Rice Development, etc.; obtaining financial support from multi-national (World Bank) and bilateral donors (e.g., Germany, Switzerland); credit planning at the district level; research and publications; liaison with RBI and GOI; training for the staff of client banks; and institutional development. In this paper only the refinancing role is discussed since the developmental and promotional roles, however useful, do not fetch any revenue to NABARD.

Under the NABARD Act, the Bank has been conceived primarily as a refinancing institution, though Section 30 of the Act enables it to give direct loans and advances to *institutions* approved in this behalf by the Central Government. However, until the end of March 1993, NABARD had given no direct loans.

The refinance for agriculture, which augments the flow of direct credit to farmers, is for crop loans (short-term) and fixed farm investments (medium- and long-term). The latter falls into two types: (i) non-schematic medium-term refinance to RRBs and State Co-operative Banks against loans issued by them for replacement of worn out assets such as pumpsets, other farm implements and draught animals,[2] and (ii) medium- and long-term schematic refinance to facilitate new capital formation. The RRBs are sanctioned a composite refinance limit for both short-term and non-schematic medium-term loans given to the farmers and rural artisans, weavers, etc. The sources of funds with NABARD for these facilities are: For crop loans, a General Line of Credit (GLC) from RBI and for all medium-term and long-term loans, borrowings from GOI against external credits, National Rural Credit Long-Term Operations (LTO) Fund and NABARD's own resources such as share capital, reserves, etc. In regard to GLC used for crop loans, NABARD channelises RBI money to SCBs and RRBs back and forth and since March 1989 it enjoys no margin against this transaction. The rates of interest on such refinance are fixed by RBI and the entire amount of interest charges collected is passed on by NABARD to RBI. The drawals of refinance (maximum outstanding amount) by SCBs against crop loans have increased from Rs. 858 crores in 1982-83 to Rs. 2,545 crores in 1992-93. As against these levels of refinance, the crop loans disbursed by the PACS amounted to Rs. 1,908 crores in 1982-83 and to an estimated Rs. 5,096 crores in 1992-93 (CMIE, 1993, Table 6-15). The ratio of refinance to grass root level disbursements of crop loans thus works out to 45 per cent for 1982-83 and 50 per cent for 1992-93. The increase in the disbursement of schematic refinance over the same period has been from Rs. 703 crores to Rs. 2,174 crores (excluding non-farm sector loans). The proportion of such refinance to the term loans issued by all credit agencies during 1991-92 was 50 per cent.

The outstanding amounts against sources of funds for schematic investment loan refinance were:

| Source | Amount as on 31.3.1993 |
|---|---|
| | (Rs. crores) |
| 1) GOI loans | 1,463 |
| 2) Reserves | 654 |
| 3) Capital | 100 |
| 4) LTO Fund | 7,127 |
| 5) Market borrowings | 832 |
| Total outstanding schematic refinance | 8,085 |

*Note:* The total of the five items, Rs. 10,176 crores, exceeds the outstanding schematic refinance because the LTO Fund is also used for other purposes such as loans for the non-farm sector and loans to State Governments for contributing to the share capital of co-operatives.

Thus the LTO Fund in March 1993 was 88 per cent of the outstanding schematic refinance on the same date. Capital and reserves formed 9 per cent, while GOI loans another 18 per cent of outstanding schematic refinance. In other words, only 18 per cent of the outstanding schematic refinance was funded by GOI loans whose average interest cost to NABARD works out to 6.46 per cent and another 10 per cent by market borrowings (bonds) with an average cost of 11.2 per cent while the rest of the money (72 per cent) was totally cost-free. If opportunity cost is imputed to the latter, NABARD would post losses instead of the surplus of Rs. 613 crores (of which credits to different funds amounted to Rs. 535 crores) earned during 1992-93.

With refinance for schematic loans having become unattractive to commercial banks since March 1994, the demand for it from these banks is reportedly on the wane. The impact of this reaction, if it continues, will become visible only some time later. Even with a diminished demand for such refinance, NABARD will continue to earn profit because its surplus funds are invested in interest-bearing Government securities. The paradox is that even the revised rates on refinance to banks are well below the market rate on long-term funds (bonds), which stood at 13 per cent in 1992-93, and yet commercial banks find their deposits low cost relatively to refinance. Unless NABARD reduces its rate on refinance to 6 per cent, commercial banks will not be attracted to borrow it without inhibitions. The decision by GOI to prevent RBI from crediting a part of its surplus to LTO Fund since 1992-93 was reportedly taken to deny NABARD this cost-free resource and to reduce GOI's budget deficit. When the relative weight of LTO Fund in the total resources of NABARD declines in the distant future, there would be a further step-up in the rates on refinance. Similarly, if World Bank renews its line of credit to NABARD in the future, there could be an increase in the rates on refinance since the former is likely to insist on a complete package of financial sector reforms.

Another two anomalies in the present financial system may be pointed out. The maximum deposit rate (10 per cent) is on one-year deposits and when banks give medium-term/long-term loans (5 to 15 years) without refinance, they are borrowing short and lending long, creating a strain on their liquidity. This may induce the banks to reduce the maturity of their term loans to the farmers, thereby creating loan repayment problems for the latter. Secondly, the long-term deposit rate is barely positive. Even so, if banks were to give all term loans from such deposits, the present rates on term loans (with margins of 2 to 5 per cent) do not appear adequate. In other words, to avoid a strain on their liquidity and to optimise profits, commercial banks may continue to borrow limited amounts of refinance from NABARD.

The demand for crop loan refinance will continue unabated, thanks to the rates on refinance being 7 to 9 per cent below the Bank Rate and well below the cost of deposits raised by co-operative banks and RRBs. But such low rates induce substitution of cheap refinance for banks' internal lendable resources, which are more expensive, after satisfying the minimum involvement condition. Thus RBI is heavily subsidising crop loans dispensed by co-operatives and RRBs.

All the 300 scheduled banks in India, including co-operative banks, held deposits of Rs. 2,52,255 crores as on the last Friday of June 1992. Total direct and indirect outstanding agricultural credit by co-operatives, RRBs and commercial banks as on 30th June 1992 amounted to Rs. 30,559 crores, forming 12 per cent of the deposits. If interest rates on

agricultural loans get rationalised following deregulation, the flow of credit to agriculture is likely to witness a rate of growth commensurate with demand and there may be no need for continuance of directed lending.

To sum up the discussion of NABARD's future role:

(i) The demand for crop loan refinance will grow due to the extremely low rates on such refinance.

(ii) The demand for investment loan refinance may diminish if the average cost of deposits continues to be lower than the rates on refinance. In that event, the total supply of investment credit for agriculture is likely to fall short of demand, leading to reduced capital formation in agriculture.

(iii) Owing to its access to large amounts of cost-free resources accumulated in the past, NABARD may continue to post profits in the foreseeable future despite the low rates on refinance.

The above discussion raises some basic points about the role of refinancing agencies: Should refinancing institutions charge a rate on refinance that is below the average cost of deposits of the borrowing banks and, if so, how should the former raise resources for the purpose without sacrificing their viability? If subsidisation of refinance rates is deemed essential, who should bear the cost of such subsidy? Is it possible for NABARD to devise a package of refinance and non-financial services, the latter facilitating the borrowing banks to curtail their transaction costs, and make the package attractive to the borrowing banks? Should refinance supplement the internal lendable resources of banks or substitute the latter, as has been happening with NABARD? If demand and supply forces were to determine the size of agricultural credit and interest rates to the farmers, what would be the role of NABARD? A discussion of these and related issues is not feasible within the compass of this paper. Nevertheless, they deserve the attention of scholars and policy makers.

## NOTES

1. The RRBs obtain crop loan refinance from NABARD (60 per cent) and sponsor commercial bank (40 per cent) at the prescribed rate of 6.5 per cent. On the other hand, the minimum involvement of their own lendable resources (with an average cost of about 10 per cent) required of the co-operatives is: State Co-operative Banks (25 per cent) and District Central Co-operative Banks (40 per cent).

2. In view of the insignificant amount of refinance for this purpose, it is disregarded in this discussion.

## REFERENCES

Centre for Monitoring Indian Economy (CMIE) (1993), *Basic Statistics Relating to the Indian Economy*, Vol. 1: All India, CMIE Publications, Bombay.

Gadgil, M.V. (1992), "Future of Institutional Agricultural Credit in India: Likely Impact of Narasimham and Khusro Committee Reports", *Indian Journal of Agricultural Economics*, Vol. 47, No. 2, April-June.

National Bank for Agriculture and Rural Development (NABARD) (1993), *Annual Report, 1992-93*, Bombay.

NABARD (1994), *Statistical Statements Relating to the Co-operative Movement in India, 1987-88, Part I: Credit Societies*, Bombay.

Reserve Bank of India (1989), *A Review of the Agricultural Credit System in India: Report of the Agricultural Credit Review Committee* (Chairman: A.M. Khusro), Bombay, August.

Reserve Bank of India (1991), *Report of the Committee on the Financial System* (Chairman: M. Narasimham), Department of Banking Operations and Development, Bombay, November.

Reserve Bank of India (1993), *Report on Trend and Progress of Banking in India, 1991-92 (July-June)*, Bombay.

Reserve Bank of India (1994), *Report on Currency and Finance, 1992-93, Vol. I: Economic Review*, Bombay.

Venkitaramanan, S. (1994), "A Day in the Life of a Rural Banker", *The Sunday Times*, July 24.