

Future of Rural Banking*

Respected Professor Khan, distinguished academics and friends,

I am grateful to the Ram Reddy Memorial Trust for giving me an opportunity to deliver this endowment lecture. I knew Ram Reddy Sab since 1960 and, like some of you here, we developed abiding affection towards each other. To me, he was indeed, a friend, philosopher and guide in every sense of the word. He won people's heart, made academic contributions and built lasting institutions, and he achieved all this without ever displeasing or hurting any one. A scholar and a gentleman to the core, I cannot think of anyone in India who has contributed as much to advancement of higher education as he did. He simply, with one stroke or may be two, one in Hyderabad and one at all-India level, made higher education open, virtually to all. I feel greatly honoured at being called upon to be with you, since some of us have grown up in the last three to four decades, as part of one extended family of Ram Reddy garu. Since we are aware of his abiding interest in rural areas, especially the dynamics of rural development, I will speak on Future of Rural Banking. I hope to reflect in the lecture, the pragmatism and analytical rigour that Ram Reddy Sab would always insist upon.

Banking in Ancient India

Let me start by sharing with you some features of banking in India in ancient times since you may still find traces of such ancient banking practices in isolated rural areas in our country.

Like in many other aspects, we have a long tradition of banking. Evidence regarding the existence of money-lending operations in India is found in the literature of the Vedic times, i.e., 2000 to 1400 B.C. The literature of the Buddhist period, e.g., the Jatakas, and recent archaeological discoveries supply

evidence of the existence of sresthis, or bankers. From the laws of Manu, it appears that money-lending and allied problems had assumed considerable importance in ancient India.

What were the interest rates? The role of interest rates was recognised in ancient India. Interest rates were prescribed by almost all Hindu law-givers Manu, Vasistha, Yajnavalkya, Gautama and Baudhayana as also Kautilya. A common base number was 15 per cent per annum – what the banker-economist Dr. Thingalaya calls Hindu rate of interest. Incidentally, this is higher than current Prime Lending Rate (PLR) of many banks!

It was not as though everyone used to get loans at PLR. Only prime borrowers got at PLR, though the basis was different then. According to Manu and Vasistha, the interest rates were not to vary depending on the risk involved or the purpose for which the money was borrowed. But, they were directly linked to the caste classification of the borrowers. Brahmin was to be charged 2 per cent, Kshatriya 3 per cent, Vaishya 4 per cent and Shudra 5 per cent per month. However, Chanakya's interest rate structure was risk-weighted since the rate of interest increased with the risk involved in the borrowers' business. The interest rate worked out to be 15 per cent per annum for general advances. The traders were charged a rate of 60 per cent per annum. Where

the merchandise had to pass through forests, the traders had to pay 120 per cent per annum while those engaged in the export-import business handling sea-borne cargo had to pay 240 per cent per annum.

Again, it was not everyone who could take up banking business. Only men belonging to the Vaishya caste could take up the money-lending profession. In other words, in ancient times, your caste gave you licence to banking and not RBI!

What about disputes and debt recovery? Manu specified the punishments to be given in case of disputes arising about loan repayment and listed 18 types of disputes. When a creditor sued the debtor for recovery of money, it was the duty of the king to ensure that the creditor got back his money. Manu permitted the king to employ all means, fair or foul, to recover the dues, for example, torturous punishment like killing the debtor's wife, children and cattle or obstructing his movements. Manu held the view that a defaulter could not absolve himself of his debt burden even by death. Chanakya said that sons should pay with interest the debt of a deceased person or co-debtors or sureties. Was a spouse, i.e., husband or wife responsible to pay for the debts incurred? Yes, and no. Wife was exempted from debt burden of her husband if she had not given her assent to his borrowings. However, for the debt incurred by a wife, her husband was liable for repayment. Perhaps, this was the background in which one of the committees on rural indebtedness concluded that "the Indian farmer is born in debt, lives in debt and dies in debt".

Approach to Rural Banking

The Reserve Bank of India has a mandate to be closely involved in matters relating to rural credit and banking by virtue of the provisions of Section 54 of the RBI Act. The major initiative in pursuance of this mandate was taken with sponsoring of All-India Rural Credit Survey in 1951-52. This study made agency-wise estimates of rural indebtedness and observed that cooperation has failed but it must succeed. The Report of the Committee on Directions is still considered a classic on the subject, and two of the four members were, incidentally, from Andhra Pradesh. This is the origin of the policy of extending formal credit through institutions while viewing local, traditional and informal agencies as usurious. In the first stage, therefore, efforts were concentrated on developing and strengthening cooperative credit structures. The Reserve Bank of India has also been making financial contributions to the cooperative institutions through evolving institutional arrangements, especially for refinancing of credit to agriculture.

While enacting the State Bank of India Act in 1955, the objective was stated to be the extension of banking facilities on a large scale, more particularly, in rural and semi-urban areas. SBI, therefore, became an important instrument of extending rural credit to supplement the efforts of cooperative institutions. In 1969, 14 major commercial banks were nationalised and the objective, *inter alia*, was "to control the heights of economy". The nationalised banks thus became important instruments for advancement of rural banking in addition to cooperatives and State Bank of India. The next step to supplement the efforts of cooperatives and commercial banks was the establishment of Regional Rural Banks in 1975 in different states with equity participation from commercial banks, Central and State Governments.

By 1982, to consolidate the various arrangements made by RBI to promote/supervise institutions and channel credit to rural areas, NABARD was established. Though several efforts were made to increase the flow of institutional credit for agricultural and rural lending, there were mismatches in credit and production. Field studies conducted to determine the reason, revealed that it was due to absence of effective local level planning. It was felt that with the establishment of large network of branches, a system could be adopted to assign specific areas to each bank branch in which it can concentrate on focussed lending and contribute to the development of the area. With a view to implementing this approach, RBI introduced a scheme of "Service Area Approach" for commercial banks. To further supplement the institutional mechanism, the concept of Local Area Banks was taken up in 1996-97 and in-principle approval has been given for 8 Local Area Banks.

As regards cost of credit, for most of the period, the administered interest rate regime was applicable for bank lending and this included concessional terms for priority sector. Currently, all interest rates on bank advances including in rural areas are deregulated and there is no link between priority sector and interest rate, though there are some regulations on interest rates by size of advance i.e. below Rs. 2 lakh in respect of commercial banks.

As regards policy measures to enhance flow of credit to rural areas, apart from availability of credit lines from Reserve Bank of India, the concept of priority sector was evolved to ensure directed credit. Currently, the stipulation is that domestic commercial banks should extend credit to the extent of 40 per cent of the total net bank credit to priority sector as a whole, of which 18 per cent should be specifically for agriculture. Out of the target of 18 per cent for agriculture, at least 13.5 per cent should be by way of direct loans to agriculture and remaining could be in the form of for indirect loans.

Where a bank fails to fulfil its commitment towards priority sector lending, it is currently required to contribute to Rural Infrastructure Development Fund set up by NABARD. NABARD in turn provides these funds to State Governments and state owned corporations to enable them to complete various types of rural infrastructure projects.

It is pertinent to recognise that there are a large number of credit linked programmes sponsored by the Government for direct assault on poverty. In programmes relating to self-employment and women welfare, the multiplicity of programmes has been reduced by having a comprehensive and consolidated programme named Swarnajayanti Gram Swarajgar Yojna.

The financial sector reforms, which were introduced from 1991 onwards were aimed at transforming the credit institutions into organisationally strong, financially viable and operationally efficient units. The measures introduced include reduction in budgetary support and concessionality of resources, preparation of Development Action Plans and signing of Memoranda of Understanding with the major controllers, and introduction of prudential norms relating to income recognition and asset classification for RRBs and cooperative banks. The lending rates for these institutions have also been deregulated. Other measures of liberalisation include

allowing non-target group financing for RRBs, direct financing for SCBs and CCBs, and liberalisation in investment policies and non-fund business.

These measures have contributed to many RRBs turning around and becoming more vibrant institutions. In the case of cooperative banks, there is greater awareness of the problems of officialisation and politicisation and initiatives in this regard include legislative actions on cooperative banks in Andhra Pradesh.

Recently, several policy initiatives have been taken to advance rural banking. These include additional capital contribution to NABARD by RBI and Government of India, recapitalisation and restructuring of RRBs, simplification of lending procedures as per the Gupta Committee recommendations, preparation of a special credit plans by public sector banks and launching of Kisan Credit Cards. Finally, a scheme linking self-help groups with banks has been launched under the aegis of NABARD to augment the resources of micro credit institutions. A Committee has gone into various measures for developing micro credit, and has submitted its report, which is under the consideration of RBI. In respect of cooperatives, a Task Force under the chairmanship of my esteemed and affectionate colleague Shri Jagdish Capoor, Deputy Governor has been constituted to review the status and make recommendations for improvement.

Undeniably, these initiatives have enabled a very wide network of rural financial institutions, development of banking culture, penetration of formal credit to rural areas and a counter to the dominance of moneylenders. These initiatives have also financed modernisation of rural economies and implementation of anti-poverty and self-employment programmes. However, for the purpose of focussing on the future, generalisation on some concerns regarding the current approach to rural credit and banking would be appropriate.

Firstly, the cooperative banks have different layers and many of them have significantly large non-performing assets (NPAs). Many cooperatives are undercapitalised. The public sector banking system also exhibits NPAs, and some of them have so far been provided with recapitalised funds. The RRBs also exhibit NPAs and these have been recapitalised from Government of India so far, which would imply a total recapitalisation of double the amount provided by Government of India.

Secondly, according to the All-India Debt and Investment Survey, 1991-92, the share of debt to institutional agencies in the case of rural households has increased marginally from 61.2 per cent to 64 per cent between 1981 and 1991. However, it must be noted that this figure relates to debt outstanding and the overall share of the institutional credit in the total debt market is likely to be smaller than what this figure indicates.

Thirdly, the cost of financial intermediation by the various rural financial institutions is considered to be on the high side. The difference between the cost of resources made available to NABARD by Reserve Bank of India and the commercial rates of interest at which the cooperative banks lend for agriculture in the deregulated interest rate regime is also considered to be on the high side.

Fourthly, empirical studies indicate that institutional credit is more likely to be available for well to do among the rural community.

Fifthly, empirical studies also indicate that relatively backward regions have less access to institutional credit than others do.

Sixthly, the non-availability of timely credit and the cumbersome procedures for obtaining credit are also attributed to the functioning of the financial institutions, though this is equally valid for rural and urban banking.

Finally in regard to Government sponsored schemes, there has been overlap in accountability in as much as the beneficiaries are identified on a joint basis. Banks have been indicating that NPAs are proportionately more due to this overlapping.

An important development in the formal segment of the rural financial markets is the growing significance of non-banking financial companies, in particular, in hire purchase and leasing operations. They also finance traders of agricultural inputs and output. The NBFCs have only recently been brought under the regulatory regime of RBI. While their importance is recognised in financing diversified rural agriculture, its extent and scope of operations has not been adequately researched.

Dynamics of Rural Economy

Problems, prospects and solutions to many of the issues mentioned have been researched and debated, primarily with a view to strengthening, revamping or re-orienting rural financial institutions. However, there is merit in viewing the problems of rural credit and rural banking in a wider context. In this regard, it will be useful to recognise some dynamics of rural economy.

First, services sector is getting increasing importance in the rural areas also - from coffee shops to cable television operators. Assessing and meeting of credit needs of this sector is important.

Second, the integration between rural and urban areas has increased significantly, with the result, mobility of labour, capital, products and even credit between the two is increasing.

Third, commercialisation of agriculture, particularly the increasing role of cash crops like cotton has resulted in substantial role for suppliers' and buyers' credit. Thus, fertiliser and pesticide are supplied to farmers on credit, often on deferred payment basis. In such deferred payment arrangements, credit terms are built into price and hence it is difficult to isolate terms. Similarly, the commission-agents advance money towards purchase of output from farmers, which amounts to providing credit and includes an element of forward trading. These arrangements are often entered into on a voluntary basis. The present banking system does not generally encourage financing the transactions of this nature. However, a few non-banking financial companies do provide indirect finance for such purpose.

Fourth, compared to cereal production, other food items, including poultry and fish are growing at a faster pace. In other words, rural agriculture is getting increasingly diversified in terms of products and processes.

Fifth, in areas where commercialisation of agriculture has reached significant levels, the traditional landlord-based tenancy is replaced with commercial-based tenancy. Where intensive cultivation of cash crops such as cotton is called for, this has become quite common. However, the present credit and banking procedures do not cater to the working capital needs of such commercial based tenancy relationship.

Sixth, given the diversified activities, and large work force in rural areas, there is increasing recourse to multiple occupations to earn a decent livelihood. For example, a small farmer is also a petty trader and may also be a satellite based cable television operator in the village. The end-use specification and monitoring of credit is more difficult in such circumstances.

Seventh, to the extent employment and indeed incomes could be seasonal, especially for agricultural labour, there is reason to seek and obtain consumption loans. Such assurance is possible with prosperity in rural employment. Present arrangements in formal credit markets are inadequate to meet such requirements.

Eighth, while there is significant commercialisation and diversification of rural economies, progress is very uneven in different parts of the country. So, there are still many areas, where exploitation of tribals by money lenders or of agricultural labourers by landlord-money lenders, still persist. Norms and procedures of credit, therefore, need to be different to meet varying circumstances.

Ninth, from the data on credit deposit ratios, it is clear that the banking system is a conduit for net transfer of financial savings from rural to non-rural sectors. On the other hand, a major part of informal markets would be local and hence savings would be locally deployed, within the rural areas.

Rural Credit Markets : New Realities

As mentioned earlier in the approach to rural banking, the basic thrust of our policy has been to promote institutional credit and eliminate or ignore informal finance. However, in reality, while formal credit has expanded its share, informal finance continues to be significant. The idea of promotion of Self-Help Groups and micro financing is an indirect admission of necessity of informal finance. The future of rural banking cannot be appreciated without fully understanding both formal and informal rural credit markets, especially their linkages. Since in the earlier sections, organisation and functioning of the formal credit system in the rural areas has been explained, in this section nature of informal markets and the linkages will be explored.

The informal financial market is legal but officially unrecorded and comprises of unregulated financial activities i.e. outside the orbit of officially regulated financial intermediaries. In the informal financial transactions, one could treat borrowing and lending among friends and relatives as occasional and not part of such an informal market. Consequently, there are three broad types of informal financial transactions,

viz., well-defined group, tied-lending/borrowing; and untied lending/borrowing activities. In the literature on well-defined groups, there are three broad types namely Rotating Savings and Credit Associations (ROSCA); Accumulated Savings and Credit Associations (ASCRA) and hybrid forms of both. There are some variations under each category. Basic characteristics of these groups are that they are voluntary in nature, usually among equals, with little or no outside support or interference. Often, members have some special bonds based on religion, caste, status, neighbourhood, etc. In brief, there is no patron-client framework. In essence, therefore, these arrangements among well defined groups, though important, should not in my view be included in the concept of informal financial markets. In the recent past, there have been efforts to provide a bridge between formal financial markets and these well defined groups in the form of 'micro-finance' initiatives. However, these initiatives do not constitute marketisation of activities of well defined groups. Thus, the informal financial markets are those which are outside the orbit of officially regulated institutions. These informal debt transactions may involve tied debt transactions and untied debt transactions.

The general approach, at least at the policy level, to informal market whether tied or untied, has not been positive since informal debt market has been historically equated with either landlord or moneylender. The transactions are considered to be expensive, especially in view of what is held to be of usurious nature of interest rates. It is considered to be financing unproductive expenditures since consumption needs are financed. Sometimes, it is said that there are often unequal and exploitative arrangements, say, between the landlord and the tenant or the agricultural labourer. Finally, it is held that, since these are unregulated, they are *prima facie* not desirable.

Yet, the fact remains that informal debt markets do prevail, and studies have shown that in some areas in our country, they account for 70 to 80 per cent of debt transactions. Studies have also shown that many poor people have no access to institutional credit. The arrangements in informal debt markets are said to be flexible, and sometimes have in-built risk sharing arrangements. These credit arrangements do provide for smoothening of consumption and production requirements. Transaction costs in terms of certainty, timeliness, procedural requirements, number of trips, etc. are somewhat negligible although there may be hidden costs in tied lending. Moreover, while formal markets tend to cater to less risky borrowings, informal markets provide for the more risky borrowings and thus serve a purpose. Finally, it has been stated in the literature that financial repression like directed credit, high reserve ratios, interest rate ceilings, branch licensing, etc. make informal financial markets relatively attractive and popular.

Perhaps, one way of reconciling the conflicting views on usefulness of informal credit is to recognise some emerging realities of both formal and informal markets. This would also help a rethink on approaches to rural credit and rural banking.

First, it is no longer the case that the money lender and informal financing are always synonymous, in view of the dynamics of rural economy already described involving suppliers credit, buyers credit and credit for services sector.

Second, informal markets are less significant now than before, and have to face competition or at least accept benchmarking of formal credit. The concept of monopoly of moneylender in rural areas is not true in many areas now.

Third, when informal financial market is linked to socially undesirable activities, there is certainly a cause for concern though the available evidence shows that such a link is more a metropolitan or urban phenomenon rather than a rural one.

Fourth, bank credit is really not severely restricted to what can be officially determined as productive, since most of the credit-card financing by the banks is, in fact, financing of consumption and at interest rates comparable to those prevailing in the rural informal debt markets. In other words, it is no longer unethical for banks to finance consumption credit through the credit card route. Credit card business, so far, is an essentially urban phenomenon. Hence the financing of consumption by informal markets in rural areas cannot be frowned upon when it is being done by banks through their credit card business.

Fifth, the real extent of informal markets is grossly understated in any survey that views data on outstanding debt since the turnover of debt is admittedly much lower for public institutions than for private lending. The turnover-differential is on account of several factors, including preference for short term finance and better recovery-performance in informal markets.

Sixth, the social significance of informal credit is more than its proportion in financial terms since the poorer sections draw far larger amounts from informal than formal markets.

Seventh, a significant part of informal market is through leasing, hire purchase, deferred payment, etc. with finance often provided by NBFCs. The informal market is providing a range of financial products, which the formal banking system is not able to.

Eighth, studies have demonstrated that expansion of literacy and education tends to increase the access of rural folk to formal credit, reduce the informal transaction costs in dealings with formal credit institutions and improves their resistance to malpractices attributable to landlord or moneylender. The exploitative nature of informal markets is more pronounced in tribal or less developed areas while productive nature of informal markets is more pronounced in prosperous villages. Indeed, one can argue that in many areas, the formal credit structure has provided a positive institutional alternative to the moneylenders and thus marginalising his role in providing credit to rural masses.

Linkages in Rural Debt Markets

Having recognised that one cannot wish away informal markets, some tentative generalisations on the relative roles of formal and informal markets and on the linkages between them would also be necessary to capture the emerging but complex realities. Such generalisations are possible on the basis of empirical studies.

First, the formal credit has a tendency to flow more easily to agriculturally developed regions and to relatively larger farmers leaving the backward regions and small farmers to be largely served by the informal market. This phenomenon is generally explained by four factors viz. poor-resource endowment features of the borrower, poor personal factors (education, social contact etc), underdevelopment of a region and higher transaction costs.

Second, as per empirical studies, transaction costs associated with formal credit include fees for procuring necessary certificates (open), travel and related expenses including loss of wages etc., and informal or unofficial commissions (hidden). The transaction costs vary with type of credit agency involved, the type of borrower and farm-size.

Third, uncertainties and delays usually associated with formal credit can also be treated as additions to the transaction costs.

Fourth, the true cost of borrowing from the formal credit system is thus higher than nominal cost if the above informal transaction costs are also included. To the extent some transaction costs are fixed, the effective cost of borrowings for smaller loans tends to be relatively higher than for a larger loan.

Fifth, there are usually hidden costs or concealed interest rates in respect of informal credit also, which have to be added to the nominal costs to arrive at the true cost. These hidden costs generally relate to tied lending, tied to land, labour, input or output. The tied advance in respect of labour is particularly relevant for migratory labour. The hidden costs are usually in the form of undervaluation of labour and output of borrowers and overvaluation of inputs supplied by lender.

Sixth, the choice between formal and informal credit depends on both the access and relative true costs. Thus, recourse to informal credit, admittedly at far higher nominal costs, is to be explained partly in terms of effective costs and the extent of supply of formal credit.

Seventh, in assessing relative roles, both supply and demand side bottlenecks of formal credit need to be appreciated. The former relate to asset-based lending policies and complex formalities and procedures while the latter relate to poor endowment, lower education and social-contact, usually caste-based in backward regions. Viewed differently, a larger role for informal credit may arise due to low level of commercialisation and monopoly power of moneylender; and it may also arise due to high level of commercialisation of agriculture when supply from formal channel cannot match significant demand for credit.

Eighth, it is also necessary to recognise that, to the extent informal markets tend to lend to borrowers who are relatively less creditworthy, risk-premium is bound to be higher. This would also get reflected in higher nominal interest rates in informal markets and indeed higher true cost, though it may not be so high if it is net of risk premium.

It is clear that the critical issue in respect of informal credit is the manner in which the linkages among the participants in the market operate and result in varying

degrees of hidden costs. It is possible to make some exploratory postulates here. First, trader-lenders are likely to provide most of production-credit, while farmer-lender or moneylender is likely to provide most of consumption credit. It is, of course, possible that some individuals combine the functions of farmer, trader and moneylender. Second, informal markets are unlikely to finance credit for investment purposes, given the time preference. Third, the levels of education are likely to reduce the scope for gross overvaluation or undervaluation in linked-transactions. Fourth, the inter-linked transactions among parties with equal bargaining power are likely to minimise the hidden costs. Fifth, from the supply side, farmer-lenders may tend to be associated with land and labour market linkages while trader-lender is likely to be associated with input-output markets. On the demand side, agricultural labour may be associated with land and labour markets while the farmer-cultivator with input-output linkages. In the process, it is likely that a farmer would be a borrower from a trader and a lender to agricultural labour, a common phenomenon in villages. It will, therefore, be over simplification to divide the rural population into lenders and borrowers or exploiters and exploited. Sixth, similarly it is necessary to appreciate the role of linkages in credit-risk-mitigation. In fact, the risk reducing element of linkages are not built into formal credit-channels. Incidentally to the extent the transaction costs are front loaded in respect of formal credit, there is no incentive to repay while the true costs of informal credit are spread out. Seventh, in terms of bargaining power among the class of borrowers, the agricultural labour and migratory labour appear to be weakest except in agriculturally prosperous areas where labour-shortage is acute to cater to agricultural and other operations. Similarly, the differential in bargaining power between large and small borrowers is similar to that between large corporates and small-industrialists in urban areas.

In brief, the linkages between formal and informal markets are complex, contextual and dynamic. The two markets appear to compete with and also supplement each other.

Technology and Rural Banking

We should recognise that the role of banks, which is central to formal credit in rural areas, is fast changing. Many non-banks are providing avenues for savers and funds for investment purposes. Banks themselves are undertaking non-traditional activities. Banks are also becoming what are called universal banks and are already providing a range of financial services such as investments, merchant banking and even insurance products. Similarly, non banks are also undertaking bank like activities. At present in India, these are mostly confined to urban areas, but they will sooner than later spread to rural areas.

Another development relates to the gradual undermining of the importance of branches of banks. The emergence of new technology allows access to banking and banking services without physical direct recourse to the bank premise by the customer. The concept of Automated Teller Machines (ATMs) is the best example. At present, ATMs are city oriented in our country. It is inevitable that ATMs will be widely used, in semi-urban and rural areas.

The technology-led process is leading us to what has been described as virtual banking. The benefits of such virtual banking services are manifold. Firstly, it

confers the advantage of lower cost of handling a transaction. Secondly, the increased speed of response to customer requirements under virtual banking *vis-à-vis* branch banking can enhance customer satisfaction. Thirdly, the lower cost of operating branch network along with reduced staff costs leads to cost efficiency. Fourthly, it allows the possibility of improved quality and an enlarged range of services being available to the customer more rapidly and accurately at his convenience. It may not be possible to deny these facilities to rural areas in our country since, if banks do not provide them, some non-banks will do it.

Another development relates to the increasing popularity of credit cards, which are bound to reach rural areas. Many Public Sector Banks are already in credit card business. In fact, multi-purpose cards could be a facility that IT could usher in for rural population. The potential can be illustrated with SMART cards. SMART cards – which are basically cards using computer circuits in them thereby making them ‘intelligent’ – would serve as multipurpose cards. SMART cards are essentially a technologically improved version of credit and debit cards and could be used also as ATM cards. They could be used for credit facilities at different locations by the holders. SMART cards could also be used for personal identification and incidentally for monitoring credit usage.

For the spread of virtual-banking and SMART cards to rural areas, it is essential that electric power and telecom connectivity are continuous and supplies do not drop especially during the hours when a bank’s transactional activity is at relatively high levels. The banks could, under such assured supply conditions acquire the required banking software and also put in place the necessary networking for providing anywhere banking facilities in rural and semi-urban areas also.

Like banks in other parts of the world, Indian banks will have to get interested in providing diversified range of financial products and services along with those that they are already providing, by using technological advances. As the level of education in rural areas rises and affluence spreads, customers will start seeking efficient, quicker and low cost services. As the financial system diversifies and other types of financial intermediaries become active, in rural areas, savers would turn towards mutual funds or the savers themselves decide to deploy part of their financial surpluses into equities and debentures as also other fixed income securities. The bulk of bank deposits in the rural areas are currently longer term deposits and as these come down, there would be a distinct shortening of the average maturity structure of bank deposits with an increase in asset liability mismatches. The spreads that the banks now enjoy will progressively shrink making it more difficult for them to survive. As more and more intermediaries enter rural areas with greater level of technology, traditional banking business will come under pressure. In order to face the competitive pressures being exerted by the recently set up market savvy banks, banks which have extensive branch network in most of the existing and potential rich rural and semi-urban areas may have to provide such services.

Issues

It is clear that significant progress has been made, since independence, in expanding bank branches and banking habits in the rural areas, through a variety of institutional innovations. An impressive segment of rural economy has been brought

into the ambit of formal financial intermediation, mainly through the public sector banking system, and to some extent, through cooperatives and RRBs. The future of banking in rural areas would, however, depend on several factors that have been described, namely, how the current concerns are addressed taking into account the dynamics of transformation in rural economies, the new realities in credit markets, the linkages between formal and informal markets, and the impact of financial as well as technological progress on the systems of financial intermediation.

Consequently, public policy will have to address several issues to ensure a sound and efficient banking system in the service of rural areas. The more important of such issues relate to the approach, institutions, supply, cost, and related policies

Approach

In the past, the major instruments of public policy were cooperatives and public-sector banking system. However, with the diversification of ownership of public sector banks and the overall thrust of financial-sector reform, a review of institutional arrangements, mainly in the incentive-framework for credit-delivery appears necessary. Similarly, in the area of cooperatives also, a reduced role for Government including in providing refinance is being advocated. This desirable approach would also need a review of institutional arrangements, in particular in delayering and debureaucratising the cooperatives.

Further, there are new institutions and new forms of financial intermediation that are emerging – be it mutual funds or more important for rural areas, non-banking financial companies. Any approach to rural-development should consider capturing, at least the activities of non-banking financial companies as part of formal rural financial markets.

Moreover, in many parts of the country, growth of literacy and diversification of the economy have brought about new characteristics and linkages between formal and informal financial markets in rural areas. The latter does play a significant part in rural economy. Hence the two markets should be treated as competing and co-existing, and in fact the policy should seek to utilise informal markets also for public interest. A small beginning has been made in this direction, through initiatives on micro finance. A policy of analysing and monitoring of rural financial markets as a whole is critical for the future and devoting attention only to banks and cooperatives may not suffice. I would hasten to add that a policy-focus on informal markets does not at all imply extending regulation to informal markets. In fact, the Report of Task Force on micro-finance of NABARD (1999) has recommended extending regulatory framework for micro-finance institutions, and in my view this recommendation is fraught with difficulties. Funding by banks and regulated NBFCs of micro-finance institutions should be encouraged and guidelines provided, but regulation of micro-finance institutions may not be *prima facie* wise.

In any case, research, and micro studies encompassing both formal and informal segments would help the policy makers appreciate relative roles and linkages in rural financial markets as a whole. In other words, policy analysis should perhaps consider expanding its attention from rural banking to rural financial markets.

Enhancing effective supply of credit in such rural financial markets would be a logical objective of policy, thus enlarging the current attention to include both directly disbursed credit by the banking or cooperative sectors and indirect supply. Similarly, reducing the true cost of credit-availability to rural areas would be yet another objective, expanding the attention of policy to include both nominal cost of credit from banking or cooperative sector and true cost in formal and informal markets. In an increasingly deregulated environment, this objective would imply attention to competitive efficiency involving procedural-simplification also, in respect of banks and cooperatives.

Finally, the approach may expand from delivery of credit to rural areas to making available financial services and products to savers, investors and consumers in the rural areas. In other words, it should be recognised that rural financial markets comprise both depositors or savers and borrowers or investors.

Institutions

Among the institutions involved in rural credit, cooperatives have a special place in the RBI. There is full appreciation of the problems and efforts are underway to work out a package for revival and may be, rebirth of rural cooperative banks by a Committee headed by Deputy Governor Shri. Jagdish Capoor. The Committee would naturally address issues relating to legal framework, and incurring costs of addressing problems related to overhang of the past. In addition, the Committee, I trust, would consider desirability of cooperative banks' foray into non-fund-based activities, such as fee-based financial services on behalf of mutual funds or insurance-products. The cooperatives could, in fact help, retail Treasury Bills and Government Securities in rural areas. Diversified financial products will be increasingly demanded and supplied in the rural areas, and cooperatives should not be left out of this trend of providing multiple-products through a single window. This would also imply, going beyond the somewhat closed loop of preferred financial relations within cooperative system into a multiple contacts between cooperative banks and other financial intermediaries, largely utilising technological improvement.

Commercial banks are being reformed in accordance with recommendations of Narasimham Committee. The RRBs are being recapitalised. These efforts in regard to banks would presumably recognise the trends in providing financial services to enable them to exercise necessary flexibility and dynamism that is warranted by fast changing world. Similarly, the future role of NABARD could be addressed because the organisational setup, funding and activities will have to reflect the basic logic of financial sector reform viz. changing roles of owner, regulator, refinancing, subsidised credit, government-funding and cooperatives.

Enhancing Effective Supply

Some analysts argue that supply-leading strategy in regard to rural credit has not been successful, since institutional spread and directed-lending have not had the desired impact. While accepting that demand has to play its role, and real-demand also implies negotiating strength of the borrower in respect of financial institutions, it will be inappropriate to conclude that supply should necessarily follow demand. Mere presence of rural credit institutions, does not amount to availability of supply.

Similarly, mere prescriptions of priority lending would not ensure supply. For example, prescription of priority-sector lending relates to percentage of credit outstanding rather than advances. Further, there is no reward for overshooting the target and undershooting is not really penalised since amounts of shortfall need to be placed in a fund administered by NABARD with a totally risk-free return of 11.5 percent for a five-year advance. These funds are actually lent to State Governments, thus to an extent replacing rural credit to agriculture with credit to State Government for rural development. While as a transient measure during a period conspicuous for incomplete projects, such an arrangement was justifiable, this should not become a permanent feature as it would have obviously perverse effects. The coverage of definition of priority sector also leads to some difference between apparent supply and effective supply. Thus, the base for calculating priority sector excludes commercial banks' investments, which are expanding rapidly. The procedural bottlenecks resulting in delayed supply also, in some ways, amount to erosion of effective supply.

At the same time, there may be some effective supplies which are not reckoned for supply under priority-sector. There may be funds channeled by banks to rural area through urban-branches or through other intermediaries such as NBFCs.

There is perhaps a case for some research and studies on policy of directed lending so that we could improve on the incentive and policy framework to enhance effective supply. For example, the definition and coverage of priority sector for agriculture could be revisited and lending to agriculture by banks through NBFC's could be considered for inclusion in priority-sector, as has been done to ensure flow of credit to truck operators.

Yet another area in effective supply relates to lending by banks under government sponsored programmes, which has significant non-commercial considerations. Several issues relating to both supply and accountability arise due to involvement of both Government and banks. A more transparent approach, for example, by separately accounting for them as policy-induced lending would help isolate and monitor this supply, apart from isolating the non-performing assets on this account in the balance sheets of banks.

An important bottleneck in the delivery of credit has been the negligible use of bill-discounting for services sector. Current policies and procedures restrict this instrument to goods. It has been decided by the RBI to constitute a Committee to explore ways by which bank finance can be made available to service sector. The Committee, with representation from public, private sector and foreign banks also is expected to study international experience, our policies and procedures and make recommendations in two months. This important step recognises that about half of our Gross Domestic Product is in services sector and would also help flow of bank finance to the growing services sector in rural areas.

Reducing True Cost

The major reasons for the true cost of credit from rural financial institutions being higher than nominal costs are mainly scarcity of supply and transaction costs. Enhancing effective supply would be an important strategy of reducing the true cost. Encouraging competition would be yet another strategy. A review of procedural

requirements, such as eliminating mandatory forms and replacing them with locally determined procedures, could also be considered. All non-verified documentation could, for instance, be replaced with self-declaration by the borrower. Repeated visits and consequent transaction costs can be avoided by several procedural simplifications - going beyond Gupta Committee recommendation. In particular, growth of information technology and its application in banking would warrant a thorough review of products, procedures and linkages among rural financial institutions.

Arbitrage in financial markets is inevitable and prevalence of such operations cannot be ignored. Arbitrage between formal and informal markets, and between production loans and consumption needs is also common. Thus, keeping the true cost artificially low in formal markets, the rural financial institutions would encourage arbitrage and erode the clear potential for profit. Indeed, an appropriate strategy may be to reduce the difference between nominal and true cost and ensure that true cost reflects market conditions, including premium for credit risk.

As already mentioned, provision of diverse financial products and services in the rural areas would enhance income to banks and help reduce the admittedly large spreads in interest rates. Thus, among the efforts to reduce nominal and true costs of credit in rural areas would be provision of multiplicity of financial services by rural financial institutions, taking advantage of developments in technology and financial markets.

Related Policies

There is increasing recognition that, the spread of literacy and generation of growth impulses in the rural sector would be very significant factors in enhancing effective supply and reducing true cost of rural credit. More specifically, the desired spread of technology and trickledown of urban financial products to rural areas would require concerted action in four areas. First and foremost, insurance, especially of crops, should penetrate the rural areas to mitigate the risks to both farmer and lender. The lack of penetration of insurance is perhaps an important reason for lenders seeking tied and other risk-mitigation arrangements through informal markets. Second, there should be assured supply of electric power so that functioning of systems is not disrupted. Third, telecommunication net work needs to be dependable and financial sector needs to ensure a net work. We, in the RBI, have already launched INFINET. Fourth, the institutional and regulatory framework should enable rural financial institutions to operate in diverse financial products and services. We, in the RBI are currently engaged in a number of initiatives and studies. We hope to continue the process, and focus on rural credit, as mandated by the RBI Act. We would seek advice and guidance in this endeavour.

Thank you.

* Prof.G.Ram Reddy Third Endowment Lecture by Dr.Y.Y.Reddy, Deputy Governor, Reserve Bank of India, at Potti Sreeramulu Telugu University Auditorium Public Gardens, Hyderabad, on December 4, 1999.