CHALLENGES AND ISSUES OF INDIAN RURAL BANKING INDUSTRY

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Abstract

Regional Rural Banks (RRBs) were established in 1975 under the provisions of the Ordinance promulgated on the 26th September 1975 and followed by Regional Rural Banks Act, 1976 with a view to develop the rural economy and to create a supplementary channel to the 'Cooperative Credit Structure' with a view to enlarge institutional credit for the rural and agriculture sector. The Government of India, the concerned State Government and the bank, which had sponsored the RRB contributed to the share capital of RRBs in the proportion of 50%, 15% and 35%, respectively. The area of operation of the RRBs is limited to notify few districts in a State. The RRBs mobilise deposits primarily from rural/semi-urban areas and provide loans and advances mostly to small and marginal farmers, agricultural labourers, rural artisans and other segments of priority sector. The amalgamated RRBs also benefit from larger area of operation, enhanced credit exposure limits for high value and diverse banking activities. As a result of amalgamation, number of the RRBs has been reduced from 196 to 64 as on 31 March 2013. The number of branches of RRBs increased to 17856 as on 31 March 2013 covering 635 districts throughout the country.

MODERN economy may he called "bank economy". The banking system spares the individuals and tile communities the trouble of stockpiling bulky chattels and enables them to attain domestic security and transact business by means of ever negotiable bank accounts. The importance of the rural banking in the economic development of a country cannot be overlooked. As Gandhiji said "real India lies in villages," and village economy is the backbone of Indian economy. Without the development of the rural economy, the objectives of economic planning cannot be achieved. Hence, banks and other financial institutions are considered to be a vital role for the development of the rural economy in India. Regional Rural Banks (RRBs) were established in October 2, 1975 and are playing a pivotal role in the economic development of the rural India. The main goal of establishing Regional Rural Banks in India is to provide credit to the rural people who are not economically strong enough, especially the small and marginal farmers, artisans, agricultural labours and even small entrepreneurs. The present study is a modest attempt to make an appraisal of the rural credit structure and the role played by RRBs in the development of rural economy. The objective of this paper is to analyze the rural credit and the role played by the RRBs in the priority and non-priority sector landings. The study is diagnostic and exploratory in nature and makes use of secondary data. The study finds and concludes that RRBs in India has significantly improved rural economy.

Keywords: *Regional Rural Banks (RRBs), NABARD, Bank Economy, Marketing Efforts, Indian Sectors, Banks, Loans, Savings, Time.*

Introduction

Activities of modern economy are significantly influenced by the functions and services of banks. Banking sector constitutes the core part of economic system. Indian economy is agricultural economy and real India lies in villages. Village economy is the backbone of Indian economy. Even after 60 years of independence, the rural economy in India is still handicapped in terms of infrastructure and other chronic problems of cultivators. In fact, economic progress and industrial development are determined by the rural sector. More than 70% of Indians depend on agriculture; 60% of industries are agro based; 50% of national income is contributed by rural sector and the agricultural sector is the largest foreign exchange earner to India. Such an essential and key sector is neglected by financial institutions and especially by the banks.

Rural development occupies a significant place in the overall economic development of the country. Ghandiji stressed a rural character of economy and the need for re-generation of rural life. Since independence, it has been constant endower of our policy maker to give adequate trust to rural development as the sector is directly related to agriculture. Rural banking in India started since the establishment of banking sector in India. Rural Banks in those days mainly focused upon the agro sector. Regional rural banks in India penetrated every corner of the country and extended a helping hand in the growth process of the country. SBI has 30 Regional Rural Banks in India known as RRBs. The rural bank of SBI is spread in 13 states extending from Kashmir to Karnataka and Himachal Pradesh to North East. The total number of SBIs Regional Rural Banks in India branches is 2349 (16%). Till date in rural banking in India, there are 14,475 rural banks in the country of which 2126 (91%) are located in remote rural areas.

Regional Rural Banks (RRBs) was established under the provisions of an ordinance promulgated on the 26th September 1975 and the RRBs Act, 1976 with an objective to ensure sufficient institutional credit for agriculture and other rural sectors. The RRBs mobilize financial resources from rural/semi-urban areas and grant loans and advances mostly to small and marginal farmers, agricultural laborers and rural artisans. The area of operation of RRBs is limited to the area as notified by Government of India (GoI) covering one or more districts in the State. RRBs are jointly owned by GoI, the concerned State Government and Sponsor Banks (27 scheduled commercial banks and one State Cooperative Bank); the issued capital of a RRB is shared by the owners in the proportion of 50%, 15% and 35% respectively.

Review Of Literature

The literature available in the working and performance of RRBs in India is a little limited. The literature obtained by investigators in the form of reports of various committees, commissions and working groups established by the Union Government, NABARD and Reserve Bank of India, the research studies, articles of researchers, bank officials, economists and the comments of economic analysts and news is briefly reviewed in this part.

Patel and Shete (1980) of the National Institute of Banking Management made a valuable analysis of performance and prospects of RRBs. They also gave a comparative picture of performance in deposits, branch expansion and credit deployment of the co-operative banks, commercial banks and RRBs in a specified area. This was an eye opener for many researchers engaged in this field of rural credit.

NABARD (1986) published "A study on RRBs viability", which was conducted by Agriculture Finance Corporation in 1986 on behalf of NABARD. The study revealed that viability of RRBs was essentially dependent upon the fund management strategy, margin between resources mobility and their deployment and on the control exercised on current and future costs with advances. The proportion of the establishment costs to total cost and expansion of branches were the critical factors, which affected their viability. The study further concluded that RRBs incurred losses due to defects in their systems as such, there was need to rectify these and make them viable. The main suggestions of the study included improvement in the infrastructure facilities and opening of branches by commercial banks in such areas where RRBs were already in function.

Naidu, L.K. (1998) conducted a study on RRBs taking a sample of 48 beneficiaries of rural artisans in Cuddapah district of Andhra Pradesh under Rayale Seen Gramin Bank. In this study, it was concluded that the beneficiaries were able to find an increase in their income because of the finance provided by the bank.

Kalkundrickars (1990) in his study on "Performance and Growth of regional Rural Banks in Karnataka" found that these banks had benefited the beneficiaries in raising their income, productivity, employment and use of modern practices and rehabilitate rural artisans.

Kumar Raj (1993) carried out a study on the topic "Growth and Performance of RRBs in Haryana". On the basis of the study of RRBs of Haryana, it is found that there was an enormous increase in deposits and outstanding advances. The researcher felt the need to increase the share capital and to ensure efficient use of distribution channels of finance to beneficiaries

A. K. Jai Prakash (1996) conducted a study with the objective of analyzing the role of RRBs in Economic Development and revealed that RRBs have been playing a vital role in the field of rural development. Moreover, RRBs were more efficient in disbursal of loans to the rural borrowers as compared to the commercial banks. Support from the state Governments, local participation, and proper supervision of loans and opening urban branches were some steps recommended to make RRBs further efficient.

L.K Naidu (1998) conducted a study on RRBs taking a sample of 48 beneficiaries of rural artisans in Cuddapah district of Andhra Pradesh state under Rayale Seen Gramin Bank. In this study, it was concluded that the beneficiaries were able to find an increase in their income because of the finance provided by the bank.

According to Nathan, Swami (2002), policies of current phase of financial liberalization have had an immediate, direct and dramatic effect on rural credit. There has been a contraction in rural banking in general and in priority sector ending and preferential lending to the poor in particular.

Chavan and Pallavi (2004) have examined the growth and regional distribution of rural banking over the period 1975-2002. Chavan's paper documents the gains made by historical underprivileged region of east, northeast and central part of India during the period of social and development banking. These gains were reversed in the 1990s: cutbacks in rural branches in rural credit deposits ratios were the steepest in the eastern and northeastern states of India. Policies of financial liberalization have unmistakably worsened regional inequalities in rural banking in India.

Professor Dilip Khankhoje and Dr. Milind Sathye (2008) have analysed to measure the variation in the performance in terms of productive efficiency of RRBs in India and to assess if the efficiency of these institutions has increased post-restructuring in 1993-94 or not.

Dr. M.Syed Ibrahim (2010) carried out a study on the topic "Performance Evaluation of Regional Rural Banks in India". In this study, it was concluded that RRBs in India showed a remarkable performance in the post-merger period.

As none of these studies told about the Indian Rural Banking Challenges and Issues in priority sector lending, there was a need to carry out the present study.

Rural Banking: The Indian Landscape

"Financial Inclusion" and "Rural Banking" are often used interchangeably to denote the mandate of reaching financial services to the huge unbanked masses of rural India. In effect, the former is a strategy or, as NABARD defines it, a process, while the latter denotes a paradigm and style of banking. A rural bank, while essentially a vehicle of financial inclusion, exists solely to service the specific financial needs of a people that survive on farming and animal husbandry in Indian villages. In a social sense, a rural bank enters the daily lives of its customers and becomes a partner in their well-being and distress. It may add on services in response to shifts in demographic patterns - for example, facilitating payments to and from farmers' family members studying and working in cities. It may take extensive recourse to technology to cut costs, to extend outreach and to improve processes - mobile banking, bank-ina-kiosk, biometric ATMs and smartcards all being good examples. But, its objectives, business lines and style are always defined by the peculiar financing requirements of farmers, by crop cycles, by the vagaries of weather and by seasonal events like festivals. The traditional banking system, the systems and procedures of which are actually designed for the urban industrial and business financing, has limitations in reaching out to the last mile. That is the gap that the rural banking system addresses. The principal stated objective of rural banks in India is to reach timely credit, at terms dictated by social considerations rather than economic ones, to needy farmers, so that they do not fall victim to the schemes of unscrupulous moneylenders. As the chart below shows, this aim is still a long way from being achieved. Shockingly, more than half of Indian farmer households, mostly share-croppers and marginal farmers, are outside the ambit of any kind of financial services - formal or informal!

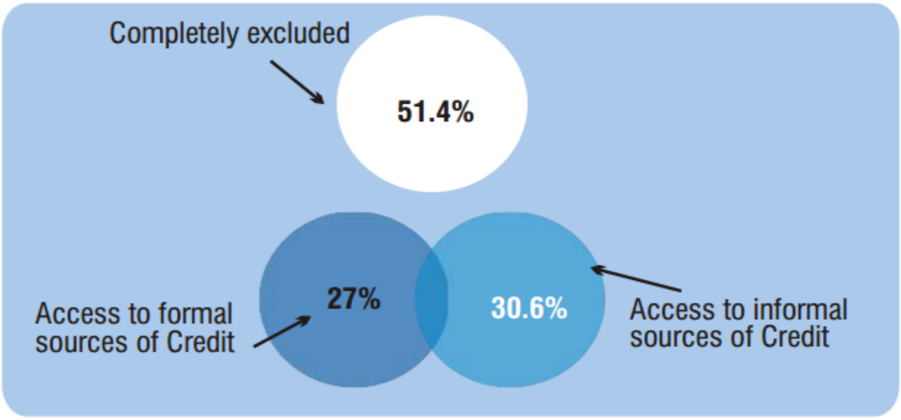


Figure-1: Farmer households having credit access

Reaching out to the target market

In a multi-agency approach to address the need for providing rural credit, various institutions and conduits have been set up by the Government of India, largely through legislation. The following is a schematic view of the flow of funds through these conduits. The view is more indicative than comprehensive and other players and channels do exist. For example, a sufficiently large self-help group (SHG) may be funded directly by the state-level NABARD. Also, Nonbanking Finance Companies (NBFCs) and other organizations engaged in micro-finance have not been shown in the view. Apart from having access to funds through the channels shown below, the players finance their lending's by taking deposits and/or resorting to commercial borrowings and bond issuances.

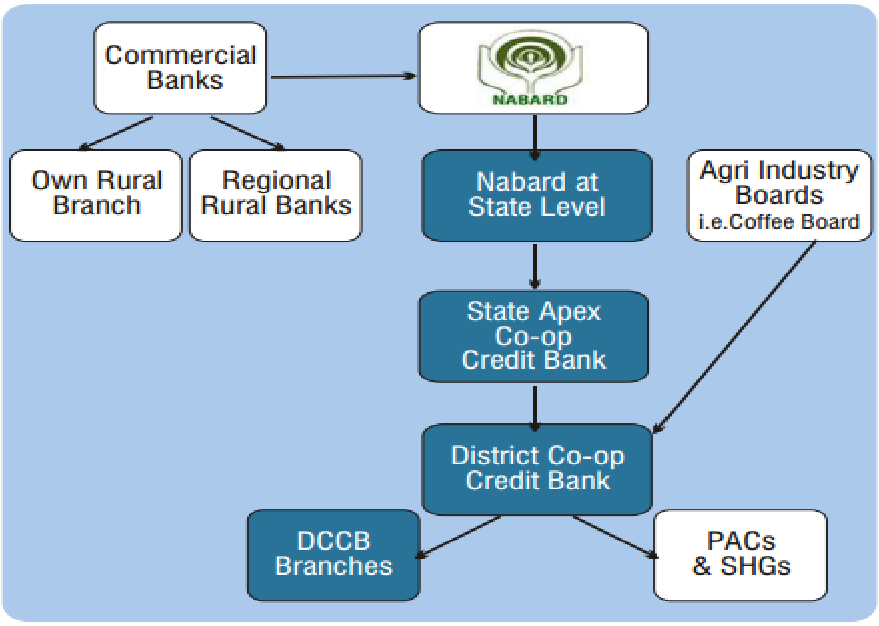


Figure-2: The route the funds take

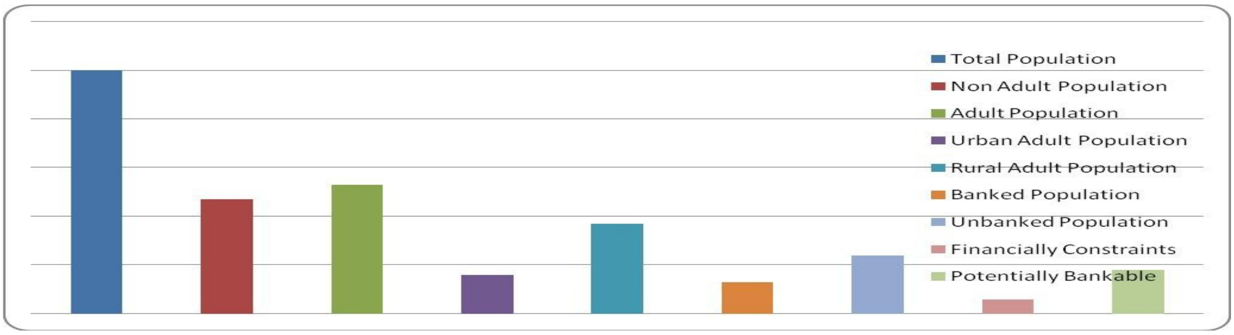
RBI sets priority sector lending guidelines to commercial banks as a percentage of their net bank credit (ANBC) or credit equivalent of their off-balance sheet exposure (whichever is higher). Priority sector lending for a commercial bank includes mandates for rural credit, which it can meet in one or more of 3 ways:

- By building up a rural credit portfolio through its own rural branches. Normally, the size of this portfolio, by itself, falls short of the lending norms.
- By placing low-interest deposits with NABARD.
- By sponsoring a Regional Rural Bank (RRB). An RRB is owned and sponsored by the Union government, the State government and a commercial bank in a 50:15:35 ratio of paid-up capital. As of end-2007, RRB offices accounted for 37% of the total rural offices of all scheduled commercial banks, and held 31% of the deposit accounts and 37% of the loan accounts in rural areas. Put together, commercial banks and RRBs have nearly 50,000 rural and semi-urban branches in India.

Key Drivers Of Financial Exclusion Of Rural Banking

Approximately 245 million adults in rural India do not have a bank account today. As depicted in Following Table, this reflects 24% of the total population. While 60 million out of 245 million may not need banking services because they are below the poverty line, Diamond believes that approximately 185 million ―potentially bankable‖ people do not use formal banking services because of reasons like poor access or usage.

otal opul ati on	Non dult opul ati on	dult opu lati on	Jrba n dult opu lati on	ural dul t opu lati on	ank ed opu lati on	nba nke d opu lati on	inan cial ly onst rai nts	oten tial ly ank abl e
100	47	53	16	37	13	24	6	18



Source: Census India; BSR 2008-Reserve Bank of India; World Bank & NCAER (2008).

Reasons For Unprofitable Of Rural Banking In India

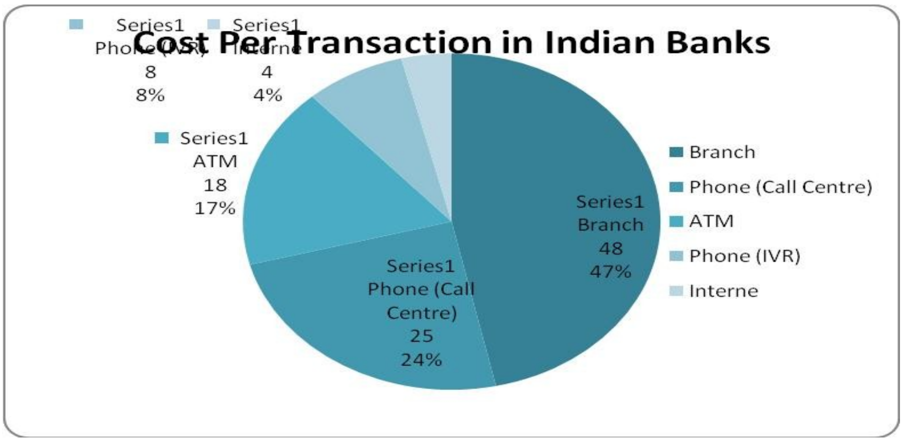
High Non-Performing Loans (NPL): Banks have higher non-performing loans in rural areas because rural households have irregular income and expenditure patterns. The issue is compounded by the dependence of the rural economy on monsoons, and loan waivers driven by political agendas. NPLs from the agriculture sector are 7.7%, compared to 3.5% across non-agriculture sectors. In order for banks to view rural India as a growth opportunity, rather than a regulatory requirement, a combination of these issues must be addressed. Increasing financial access to rural areas is contingent upon basic conditions such as proper infrastructure and an enabling regulatory framework, as well as innovative thinking on the part of commercial banks. Access issues, however, explain only one part of the problem. Usage is an equally important issue for rural customers.

Low Ticket Size: The average ticket size of both a deposit transaction and a credit transaction in rural areas is small. This means that banks need more customers per branch or channel to break even. Considering the small catchments area of a branch in rural areas, generating a customer base with critical mass is challenging.

High cost to serve: Branches are the most used channel in rural areas. This is because many rural people are not literate and are not comfortable using technology-driven channels such as ATMs, phone banking or internet banking. On the other hand, a branch is an expensive channel for banks (Following Table). In addition, rural people, whenever they have access to banks, have frequent low ticket and cash-based transactions, which increase the overall transaction cost for their bank.

Cost Per Transaction in Indian Banks

Branch	Phone (Call Centre)	ATM	Phone (IVR)	Interne
48	25	18	8	4



Source: Reserve Bank of India; CGAP, World Bank.

Higher risk of credit: Rural households may have highly irregular and volatile income streams. Irregular wage labor and the sale of agricultural products are the two main sources of income for rural households. The poor rural households (landless and marginal farmers) are particularly dependent on irregular wage employment. Rural households also have irregular expenditure patterns. The typical expenditure profile of rural households is small, with daily or irregular expenses incurred through the month. Furthermore, a majority of households incur at least one unscheduled expenditure per year, with the most frequent reasons being medical or social emergency. In short, the rural customer is generally considered to be a risky one.

Issues and Challenges

Even if access to formal banking is provided to rural customers, there is no guarantee that these services will be used. According to a study conducted by the World Bank, many households, even in developed countries, choose not to have a bank account as they do not engage in many financial transactions they collect wages in cash, spend in cash and do not wish to be burdened by a bank account. To compound the situation many customers in rural India, who have access to and would otherwise choose to use formal financial services, do not do so because the product and service mixes do not meet their needs. The financial service **needs** of rural customers are not confined to just savings and credit, as is usually assumed. Their financial needs are linked to their life cycle needs, ranging from savings to credit to insurance to remittances. In fact, even the savings and credit products currently offered to rural customers do not entirely meet their needs.

Access to savings and investment facilities is critical for the poor. The two critical needs for the rural poor are **micro-savings and frequent withdrawals**. These needs facilitate a customer in building capital over the long term, as well as coping with income shocks in the near term. However, banks do not offer adequate services to address these needs. The lack of services, therefore, leaves the rural poor with little option than to transact with the informal banking market. A study conducted by Micro Save also concludes that the poor transact with the informal sector because it will accept small amounts, provide doorstep service, and ensure ease of enrolment. Rural customers need **loans** not only for productive purposes but also for consumption needs (Following Table). A part from agricultural support, rural customers need micro credit for consumption, education and emergencies. Though banks offer purpose free loans (personal loans and credit cards) in urban areas quite liberally, in rural areas sanction of such loans is significantly restricted. Therefore, the poor raise these loans through the informal financial system (it is worth noting that these loans taken from the informal system are almost always repaid or renewed12). In addition, larger households need occasional high value micro-enterprise loans for small capital investment. Though banks offer these loans, they require excessive documentation and time-consuming processes which discourage customer applications.

Purpose of borrowing

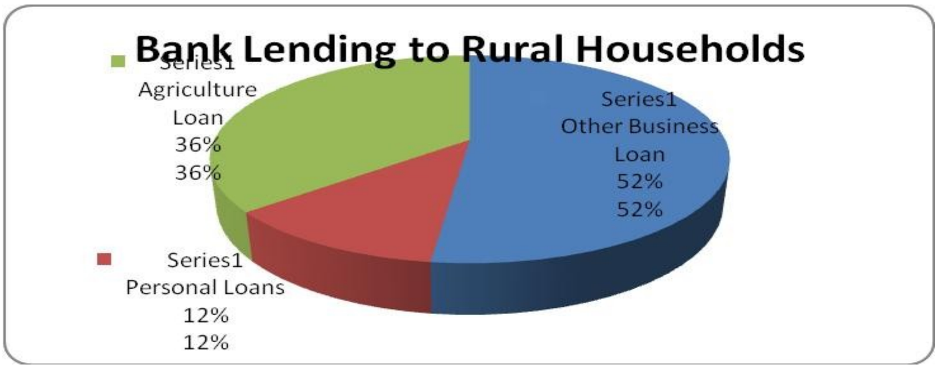
1. **Rural Household Borrowing**
2. **Bank Lending to Rural Households**

Rural Household Borrowing

Agriculture Expenditure	Household Expenditure	Other business Expenditure
38%	48%	14%

Bank Lending to Rural Households

)ther Business Loan	ersonal Loans	griculture Loan
2%	2%	6%



Source: AIDIS-2008, National Sample Survey Organization (NSSO); Diamond analysis.

Insurance reduces the vulnerability of poor households by replacing the uncertain prospect of large losses with the certainty of payout against small, regular premium payments. It is integral to a comprehensive risk management strategy for poor households. This includes life, health, accident and asset (dwelling, crop, and livestock) insurance. Banks and insurance firms do not offer these services in many rural areas, leading the poor to rely on the informal financial system.

There are many rural households which depend on weekly or monthly **remittances** from their family members who have moved to urban areas. At present, they depend on informal channels to remit the money and consequently either risk the loss of money or pay high transaction fees. Banks do not offer seamless remittance facilities between urban and rural branches as many of the rural branches are not computerized and connected to the main bank's computer systems. This often results in the beneficiary receiving the amount two weeks after it has being transferred. This represents yet another key service which is not provided.

The **transaction cost** for a rural customer to receive credit primarily constitutes four attributes: the interest rate, loan amount received as a percentage of amount applied, bribes paid, and the lead time to process the loan. Though the formal banking system offers loans at interest rates lower than informal banking systems, the time taken for a loan to be sanctioned is high which increases uncertainty and opportunity cost. In addition, the customer needs to pay almost 10% of the loan amount in bribes and eventually receives an amount that is less than what was applied for. Therefore, while the interest rates are usurious in the informal financing system, rural customers still resort to this channel because the waiting time to receive the loan is negligible and there are no indirect costs or commission. Banks also insist on collateral security which many rural poor cannot afford.

As far as savings are concerned, though the formal banking system provides financial security, the cost of opening and operating an account is high. The overall cost of transacting with the formal financial system increases for a rural person because of additional costs such as expenses incurred to reach a branch and the opportunity cost of lost wages. Since rural banks are generally not within an accessible area and do not operate at convenient times, the rural customer must forgo a day's wage to reach a branch. Informal systems, on the other hand, involve a lower transaction cost, but they are risky and in some cases result in the loss of one's entire capital. In short, this leaves the rural customer to choose between two unfavourable options.

Limitations:

1. The study proposed to collect the data from a defined sector i.e. Banking sector.

2. The study is limited to the extent of issues and challenges in rural banking sector, but not with other cost and other sector.

However effort would be made to minimize the impact of all these limitations by incorporating appropriate measures.

Conclusion

There are 185 million bankable adults in rural India who are unbanked because of access and usage issues. This presents a significant opportunity for commercial banks. However, to reach this market and subsequently build an inclusive financial system, there must be a coordinated and concerted effort by the three key stakeholders: the Government of India, the Reserve Bank of India and the commercial banks. In addition, a partnership between banks and business correspondents, and collaboration amongst banks is critical. Furthermore, banks should tailor their product and service mix to meet rural.

The real growth of Indian economy lies on the emancipation of rural masses from poverty, unemployment and other socio-economic backwardness. Keeping this end in view, Regional Rural Banks were established by the Government of India to develop the rural economy. With the passage of three decades, the RRBs are now looked upon with hope for rejuvenating the rural India. In the present study, the role of RRBs in the rural credits structure has been deeply analysed. The rural credit structure consists of priority sector and the non-priority sector. There has been tremendous achievement in disbursing loans to both the sectors. The priority sector loans constituted higher in percentage throughout the study. RRBs have lent money to the agricultural sector through the short-term and term-loans for the development of the agriculture sectors in the economy. The disbursements of short-term loans for crops during the study period are encouraging and it constituted a higher rate than that of term-loans. Also the loans provide by the RRBs to various groups in the priority sector shows an increasing trend. The years 2007-08 and 2008-09 registered higher growth. When compared to the loans to non-agricultural activities, the highest share is recorded in the agriculture. However, it is the responsibility of the banks and the management to look into the matter of providing sufficient amount of loans to non-priority sector as well. The gap between short-term loans for crop and the term-loans for agricultural and allied activities need to be minimized. The banks need to encourage the agricultural sector by providing larger amount of term loans. Generally, non-agricultural sector indirectly helps the rural economy in many ways. Keeping in view, the RRBs may enhance the percentage of loan to this sector. This finding may be considerable use to rural banking institutions and policy makers in developing and shaping the appropriate credit structure as RRBs are integral part of the rural credit structure in India.

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