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Rural Financial Institutions and Agents in India: A Historical and Contemporary Comparative Analysis

by Howard Jones, Marylin Williams and Yashwant Thorat

This paper was chosen through an open call for research in rural finance, whereby the selected individuals were invited to Rome, Italy, to share their results during the conference and to discuss key issues in shaping the rural finance research agenda as well as ways of strengthening the ties between research, policy and practice.

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(Theme 3: Improvements in Operational Management of Rural Financial Institutions)

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Abstract

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Late 19th century concerns with rural unrest and indebtedness in India led to a policy approach involving moneylender regulation, and replacement of moneylender finance through institutional credit provision in various forms. The emergence, growth, interaction and comparative performance of these different institutional forms - co-operatives, public-sector banks, regional rural banks, microfinance institutions and private sector commercial banks, are reviewed in relation to the financial service needs of the rural poor. Even with this long history of institutional credit provision and the dramatic expansion of the Self Help Group-Bank linkage programme since the early 1990s, very substantial proportions of the rural population are still without access to formal finance. Moreover, nationally, the share of informal finance in rural household debt has actually increased at the start of the 21st century. Against this background, measures to improve performance, both within and between different kinds of formal financial institutions and informal financial agents, are assessed; the paper concludes with a discussion of policy options for the future.

Introduction

The present rural financial infrastructure in India comprises a very wide variety of formalⁱ, semi-formalⁱⁱ and informalⁱⁱⁱ financial service providers, each with distinctive cultures and characteristics. The numbers of organizations and agents is very substantial: e.g. over thirty thousand rural and semi-urban branches of commercial banks, nearly fourteen thousand rural and semi-urban branches of Regional Rural Banks, just over one-hundred thousand primary cooperatives at the village level, one thousand NGO-MFIs, twenty MFIs registered as companies and well over two million Self-Help Groups (SHGs). Even more numerous are the myriad of informal agents constituting a great range of financial service providers across the country (Jones, 1994; Jones, 2006).

Different segments of the financial infrastructure have not developed uniformly or simultaneously, and their relative standing and favour in terms of government policy and intervention has changed over time.

The purpose of this paper^{iv} is to trace the forces that have led to the development of particular rural financial institutions in the country, to outline the changing fortunes and shares of these different systems, to show the present gap between rural financial needs and provision, and to assess policy options to reduce this gap through institutional development, linkages and reform. The paper is based on historical analysis^v, on the evidence base which has informed rural finance policy innovations over time, and also refers to two specific research areas; rural informal finance (Jones, 2006), and research on

attitudinal constraints within the rural banking system towards providing financial services to the poor (Jones, Williams and Thorat, 2003). In order to examine links between policy and practice, the paper discusses recent high-level policy recommendations related to reducing rural financial exclusion in India^{vi}.

We begin this process by starting with the latter years of pre-independence India, as the official responses to the perceived problems of rural indebtedness and land transfers at that time have largely shaped rural finance policy to date. We then examine post-independence policy up to the 1990s reform process in terms of the successive institutional forms favoured by the state to provide financial services to the rural sector—namely cooperatives, commercial banks and Regional Rural Banks. Following a brief outline of the reform process, three further institutional developments are examined: the entry and growth of Microfinance Institutions (MFIs), the promotion of the Self-Help Group (SHG) - Bank Linkage Programme, and the Business Facilitator/Correspondent Models.

Notwithstanding the development and expansion of the rural finance infrastructure and institutions, a very substantial number and proportion of rural households remain excluded from the banking system (Basu, 2006). The paper examines the characteristics of this exclusion and outlines recent institutional moves aimed towards reducing this gap. This leads to an assessment of further policy options for reducing rural financial exclusion and the implications of these for institutional development and reform. A study of the history of rural financial institutions is important for understanding present-day policy imperatives and options. The historical forces that shaped pre-independence rural financial service policy are still evident today. Perceptions of moneylenders in the face of 19th century peasant revolts find striking parallels in present-day press portrayals of moneylenders and also Micro Finance Institutions in the light of farmer suicides in India.

Pre-Independence India

India is a country with a long history of indigenous banking and moneylending. The bankers financed the needs of trade, nobles and the state (Habib, 1964; Schrader, 1992), while moneylenders advanced loans to cultivators. During the medieval^{vii} period, peasants had recourse to moneylenders to meet land revenue demands, subsistence needs between uncertain harvests, and for social expenditures and litigation (Habib, 1964). During British rule, official attitudes towards rural moneylenders, at least initially, were generally favourable; such agents were regarded as important links with more remote and “backward” areas (ibid).

However, following the Deccan Riots of 1875 in Western India, perhaps fearing a wider peasant revolt and disruption to life and property, more critical views of moneylenders, particularly in relation to land transfers, became evident on the part of the colonial authorities (ibid). The subsequent Deccan Riots Commission (1876) identified two ways of dealing with rural indebtedness in an effort to prevent similar disturbances in other parts of India. These set the agenda for future policy intervention: regulating moneylenders, and competing with the moneylenders by institutionalising the provision of rural credit through alternative channels (Catannach, 1970).

For the British, following much debate concerning possible alternatives e.g. agricultural credit banks, it was decided, given the scale and local nature of the problem, that competing with the moneylender was to be through small village-level service providers i.e. co-operative credit societies. This initiative was formalized through the Cooperative Societies Act of 1904 which included provision for establishing the Registrar of Cooperatives, later amended in 1914 to provide for the setting up of urban cooperatives. By 1925, some fifty thousand rural cooperatives had been established, and they constituted the principal institutional form for the provision of formal agricultural credit. However, rather than being a system emerging and being allowed to develop spontaneously from below, it was decided that cooperatives in India would have to be actively fostered from above (ibid.). Not only did this set a course for institutional provision as an alternative to that provided by the rural moneylender, but it also initiated extensive government involvement in, and control of, such institutions. The Registrar of Cooperatives was not a temporary phenomenon, but took an active role in working out overall policy and intervened frequently in cooperative matters (Catanach, 1970)

The Reserve Bank of India (RBI), established in 1935, played an important role in the task of building the Cooperative Credit Structure which gradually evolved into two separate arms, one for short-term credit and the other for investment credit.

However, rather than becoming an alternative to the moneylenders, the cooperatives started to constitute a parallel system. Even by 1951, a few years after independence, although there were many thousands of cooperatives established, only just over three per cent of cultivators had access to credit from them (All-India Rural Credit Survey, 1954). Then, as now, and as with most forms of institutional credit, cooperative credit acted as a supplement rather than an alternative to that from the moneylender.

Post-Independence India until the Reform Process

Following independence, the imperative to facilitate improvements in agricultural output and attain food self-sufficiency led to a policy of providing credit at “reasonable” rates of interest to as large a segment of the rural population as possible. The strategy to achieve this was threefold: expansion of the institutional base, directed lending to disadvantaged borrowers, and credit provision at concessional rates of interest. The latter was justified in terms of the perceived mismatch between the longer term returns of farm investment compared to cultivator households’ short term consumption needs and requirements to service the loans.

The Central Bank played an important role in addressing factors discouraging the flow of credit to the rural sector: absence of collateral among the poor, the high cost of servicing geographically dispersed customers, and lack of trained and motivated staff. The policy response included special credit programmes for channeling subsidized credit to the rural sector, operationalising the concept of priority sector in the late 1960s and focusing attention on the credit needs of neglected sectors and underprivileged borrowers.

Fisher and Sriram (2006) identify three post-independence phases in rural credit provision: first, during the 1950's up to the mid-1960's the cooperatives were the institutional vehicle of choice; second, in the 1970's and 1980s, attention shifted to commercial banks and regional rural banks and third, the reform period in the early 1990's saw the re-structuring of the banking system, the emergence of Self-Help Groups, and a growing number of Microfinance Institutions (MFIs).

Co-operatives

In post-independence India, the foundation for building a broad base for the agricultural credit structure was laid by the Report of the All-India Rural Credit Survey (AIRCS) of 1954. As noted above, the provision of cultivator credit through cooperatives remained meagre, at just over three per cent in 1951/52, and less than one per cent for the commercial banks. Furthermore, in the Committee's view, funds supplied by moneylenders were subject to usurious interest rates and other malpractices. The Committee observed that agricultural credit fell short of the right quantity, was not of the right type, did not fit the right purpose and often failed to go to the right people. It was observed that the performance of the cooperatives was deficient in many ways but, given their spatial spread, their vital role in channeling credit to farmers was recognised. This was summed up in the Committee's famous dictum that: "...cooperation has failed but it must succeed".

Much debate occurred regarding the optimum size of cooperatives, the services to be provided, relations with government schemes, their role in poverty reduction, and their viability. The partnership with the State to enhance cooperatives' lending capacity through provision of equity capital soon resulted in increased State involvement in the running and control of these organizations. With the Reserve Bank of India (RBI) providing re-finance capital, little attempt was made to look at cooperatives as financial intermediaries, and instead, they largely became windows through which re-finance was channeled.

By the mid-1960s, disenchantment with the cooperatives had set in. Successive committees identified problems of mounting overdues, politicisation, weak governance and management, and failure to achieve effective lending to the poor. Attention therefore shifted to the commercial banks as an additional, and later the primary, institutional channel for the provision of rural credit.

Commercial Banks

In 1954, The All-India Rural Credit Survey Committee, in addition to conceiving of the cooperatives as the main agency for providing credit to agriculture, had also urged a well defined role for the commercial banks in delivering credit to this sector in specialized areas such as marketing, processing, storage and warehousing. Towards achieving bank involvement in rural credit provision, it recommended the establishment of the State Bank of India (SBI), through the nationalization of the then Imperial Bank of India, and, through the SBI, extension of commercial bank facilities to rural and semi-urban areas.

Against this background, weaknesses in the cooperative system became increasingly apparent; the pressures to find institutions complementary to the cooperatives became greater. In 1969 the major commercial banks were nationalized, beginning a huge expansion of the rural banking infrastructure and the second phase of institutional rural credit provision. The focus shifted from cooperatives as the sole providers of rural credit to a multi-agency approach. The Lead Bank Scheme was devised, under which a lead bank in each district took responsibility to plan, monitor and coordinate credit provision, identifying development needs and how these could be shared by the banks. The aggregation of district plans led to the State Credit Plan which was monitored by the State Level Banking Committee.

During the 1980's, problems became apparent with this top-down planning mechanism. Little credit was flowing to the agricultural sector and the banking system had yet to adjust itself to the rural sector. In contradistinction to the top-down planning process under the lead bank scheme, it was felt necessary by the RBI in 1989 to design a bottom-up planning approach, termed the Service Area Approach. Under this approach specific geographical areas were defined for each bank branch. The branch was required to conduct village-level surveys, to identify credit requirements, to conduct inventories of assets held, and to make plans to meet any resource gaps. The village level plans were then aggregated into block, district and State plans. The rural branch manager was to be the friend, philosopher and guide to the rural population. However, once again, the suitability and capacity of a particular institutional form to reach the rural poor came to be questioned.

Regional Rural Banks

Even after nationalization of the major commercial banks, and the development of the lead bank and service area approaches, a large proportion of the rural population still remained outside the banking fold. In the mid-1970's it was recognized that, though the commercial banks had done well in terms of branch expansion, they were tending to reach only the middle-income and rich farmers. Moreover, as a group of institutions, banks were felt to be out of touch with local requirements. The cooperatives continued to be dogged by insufficient resources, and organizational and governance weaknesses. A Committee was appointed in 1975, chaired by M. Narsimham, to examine whether another type of institution could target the unbanked - one that combined the local knowledge and feel of cooperatives with the professionalism and resources of the banks. This resulted in the establishment of a new kind of bank, the Regional Rural Bank (RRB), mandated to reach the poorest in credit-deficient areas of the country.

The number of RRBs expanded rapidly: from just five in 1975, to 121 in 1980 (with 5,400 branches) to 196 in 2003 (with 14,522 branches). The RRBs were "sponsored" by commercial banks which held 35 per cent of the equity, the balance being held by the Government of India (50%) and the respective State Government (15%). The RRBs were to be low cost institutions, at least compared to the commercial banks, and staff salaries were to be on par with those pertaining in state governments. The sponsor commercial banks were to provide management and training, in addition to credit support.

However, the design structure of the RRBs was flawed. They had high co-variance of risk and were specially mandated only to lend to weaker sections of society at concessional rates of interest. Furthermore, the staff soon gained pay-scale parity with their commercial bank counterparts, thus defeating the objective of developing a low-cost alternative to the commercial banks. With weaknesses steadily developing in the system, the RRBs made substantial losses, which on the eve of the reform process aggregated to Rs10 million per day.

The Reform Process

The reform process was prompted by the financial crisis of the early 1990s. Despite the large network of Rural Financial Institutions (RFIs), a significant proportion of the rural population were excluded from the banking system. Various committees and working groups were formed post-1991 to address this situation.

The aim of the reforms was to improve the efficiency and productivity of all credit institutions. For rural financial institutions the reforms sought to:

- Enhance areas of commercial freedom
- Increase outreach to the poor
- Stimulate additional credit flows to the sector
- Change the incentive regime by liberalizing interest rates for cooperatives and Regional Rural Banks
- Relax controls on where, for what purpose, and to whom the RFIs could lend
- Introduce prudential norms
- Restructure and recapitalize Regional Rural Banks.

Although India did not abandon the concern with poverty, there was a growing realization that social lending was flawed and that there was a need to address weaknesses in the institutional structure. The health and sustainability of financial institutions became imperative - a change in emphasis from the poverty school of lending towards the finance school approach (Fisher and Sriram, 2002).

The Self-Help Group (SHG) Bank-Linkage Programme

The late 1980's and early 1990's saw the beginnings of what was to become the Self-Help Group (SHG) Bank-Linkage movement in India, a movement that has been described as the largest microfinance intervention in the world (Christen, 2006). At present, the major involvement of commercial banks in Indian microfinance is through such groups. Self-help affinity groups were started by NGOs which were donor-funded and established for a range of community purposes. With increasing scepticism about the ability of the commercial banks and the RRBs to lend directly to the rural poor, officials of the National Bank for Agriculture and Rural Development (NABARD) proposed that, if such groups could be linked to wholesale suppliers of credit, then this could be a way to channel institutional credit to the poor. This led to a pilot project, in 1992, and subsequent mainstreaming of the approach.

The SHG model is a financial delivery model which has as its objective reaching out to the poor in conjunction with achieving cost-effectiveness for the participating financial institutions. It involves three partners: (i) the SHGs, (ii) the Banks as wholesale suppliers of credit, and (iii) NGOs, government agencies and individuals as agencies to organize the poor, build capacities, and facilitate empowerment. SHGs have been described as a unique form of Community Level Financial System (CLFS), sharing a number of characteristics with credit unions (CUs), though lacking even a minimal legal structure (Christen, 2006). Harper (2002) provides a very useful comparison of SHGs, such as those found in India, with Grameen-type groups pioneered by the Grameen Bank in Bangladesh. The former, are, amongst other things, rather more independent, flexible and democratic than the latter.

Three broad stages of evolution have been identified for such groups (Rangarajan, 2006): those used to meet basic survival requirements, those used to diversify income and/or to meet the working capital requirements of traditional activities, and those used to help set up specific enterprises or to facilitate entry into wage employment. SHGs in Andhra Pradesh, a southern state, are reported to have reached this third stage.

As reported under the NABARD-GTZ Rural Finance Programme, at around 98 per cent, on-time repayment to the SHGs is reported to be very high (NABARD/GTZ, 2005). Furthermore, the SHGs are also reported to have very positive impacts in a number of areas such as education, empowerment of women, child mortality and decreased dependency on moneylenders (Thorat, 2006), though the difficulties of attribution in evaluation of microfinance are acknowledged (Sinha & Sinha, 2006). In some areas, SHGs have employed accountants to keep their books, and IT applications are now being explored by almost all SHGs for better Management Information Systems (MIS), accounting and internal controls. Furthermore, the programme has provided space for stakeholders to innovate and learn.

However, the SHG-Bank linkage programme faces a number of challenges. The SHGs' geographical concentration is skewed towards the Southern States of India. In 2001 just over 70 per cent of SHGs were located in four Southern States, and even now this figure is still 45 per cent. Conversely, some Northern States with a high incidence of poverty e.g. Bihar and UP, have lagged behind in the formation of SHGs linked to the banks. The quality of SHGs can suffer with ambitious formation targets and members can migrate to other groups in government programmes offering subsidized credit. Skill sets can also diminish over time within the groups. Where SHGs are performing badly, Christen (2006) identifies problems of capture of SHGs by local elites, inadequate risk management, and staffing issues.

In addition, the total disbursement of credit through the SHGs is limited. For 2005/06 the average loan per member was less than Rs. 4,000 (approximately £47). It is argued that SHGs need to graduate to promoting enterprises and factor in livelihood diversification. They also need to increase their access to the supply chain and to the capital market, and to appropriate production and processing technologies (Rangarajan, 2006; Thorat, 2006). Their legal status also needs to be clarified (Rangarajan, 2006).

In recent years, federations of SHGs have also emerged. This has raised new challenges. On the one hand, such federations represent the aggregation of collective bargaining power, economies of scale, and provide fora for addressing social and economic issues. On the other hand, there is evidence to suggest that the addition of each new tier, in addition to raising costs, tends to weaken the primary levels.

In addition to issues regarding the quality and functionality of individual SHGs, Christen (2006) questions the longer term sustainability and health of the SHG infrastructure. He notes how the banking system has an inbuilt supervisory ability to prevent and correct malfunctioning units, and crucially, the costs of doing so are built into the system through the costing of its products. In contrast, community level financial systems usually have neither the resources to ensure strong management, nor the mechanisms to purge poorly performing individual groups. The author argues the need to ensure a systemic capacity to look after the health of the entire SHG system, the costs which should be factored into the cost of the financial products they provide to customers.

Micro-Finance Institutions (MFIs)

As noted in the previous section, NGOs initiated the development of the self-help affinity groups. A number of these NGOs have themselves developed into Microfinance Institutions (MFIs). Although early examples of MFI establishment included such organizations as the Self Employed Women's Association (SEWA) set up in 1974, it was during the 1990's that many MFIs emerged to address the gap between demand and the formal sector's limited supply of credit (Fisher and Sriram, 2002).

The Rangarajan Committee on Financial Inclusion describes three main forms of MFIs. First, are NGO MFIs which number about one-thousand. Second, Cooperative MFIs (Mutually Aided Cooperatives) number around thirty-thousand. Third, are Company MFIs. The Company MFIs number fewer than twenty but account for over 80 per cent of the MFI portfolio.

The total number of MFI clients was estimated to be around half a million in 2002 and only about 12 MFIs have an individual outreach in the order of 100,000 clients. Thus, the large majority of MFIs operate on a small scale and have client numbers ranging from just 500 to 1,500.

Thorat (2006) identifies two critical issues for these organisations. The first concerns the sustainability of the MFIs: he quotes a study indicating that eighty-nine per cent of 36 MFOs were subsidy-dependent, and only nine were able to cover more than 80 per cent of their costs. Costs of supervision are high, but loan volume and loan size is low. Secondly, lack of capital is a critical constraint for those MFIs on a growth path. In 2000, the Reserve Bank of India allowed banks to lend to MFIs to help fulfill their priority sector funding obligations. Subsequently, some private sector banks, e.g. the ICICI bank, have developed innovative funding products for MFIs through the "partnership mode".

Ananth (2006), writing of the ICICI Bank's entry into the microfinance market in India, explores three financing models with reference to capital allocations and incentive alignments. First, the SHG-Bank linkage model, indicated in the previous section - here the NGO promoter costs are largely met through external grant sources. This model, by far the dominant one, accounts for some 20 million clients. Second, direct financial intermediation by the MFI is facilitated by borrowing from commercial sources. Third, is the partnership model, a model developed by the ICICI - a bank without a rural branch network and where the SHG-bank linkage model was therefore not an option. The partnership model is based on securitization of an MFI's microfinance portfolio and, in Ananth's view, differs from the intermediation model in terms of financing structure, not in terms of operating methodologies. With this "new" partnership model, the ICICI bank is now working with 30 MFIs with total outstanding loans of US\$55 million (in December, 2004). In contrast, using the financial intermediation model, financing to MFIs by ICICI did not exceed US\$5 million in 2001/02. The aim of the bank is to work with 200 MFIs using the new partnership model.

Securitization of microfinance portfolios is of increasing interest to fund managers. The Economic Times (31, August, 2006) reports a dozen funds dedicated to this market. Foreign investors are also lining up to enter the market but, to date, the Reserve Bank has not allowed foreign investment in securitization of microfinance projects in India.

Business Facilitator/Business Correspondent Models

With the objective of achieving greater outreach of the banking sector, the Reserve Bank of India in January 2006 permitted these institutions to use a variety of organizations as intermediaries under two kinds of model: the Business Facilitator and the Business Correspondent Model.

Under the Business Facilitator model the services an intermediary will provide can include identification of borrowers and activity, collection and preliminary processing of loan applications, financial education, submission of applications to banks, promotion and nurturing of joint liability groups, monitoring and recovery of loans. A wide variety of locally based organizations were identified as suitable for fulfilling such an intermediary function as well as one type of individual: insurance agents.

A narrower range of organizations (NGOs/MFIs, Cooperatives, Registered Non-Bank Financial Companies) were identified as suitable intermediaries in the Business Correspondent Model which in addition to the functions listed above for the Facilitator Model included disbursement of small value credit, collection of principal/interest, sale of other microfinance services (e.g. insurance) and receipt of small value remittances and other payments.

To date there has been a relatively lukewarm response from the public sector banks. This is examined below when official views on policy options for greater financial inclusion are discussed.

Financial Inclusion and Exclusion

What has been the impact of this institutionalization of rural credit provision on rural financial inclusion? From the 1950's up to the 1980s it appeared that the wish to compete away the moneylender was being achieved (AIRCS, 1954, quoted in Bell, 1993:187). The share of cultivator debt sourced from formal sources increased from 18 per cent in 1961/62 to 63 per cent in 1981/82, while the combined share of landlord, agriculturalist, professional moneylender and trader credit decreased from 70 per cent to 23 per cent over the same period of time. For methodological, conceptual and contextual reasons, it is likely that the official figures underestimated the relative share of informal finance in overall rural household debt (Jones, 1994).

Be that as it may, the subsequent figures for 1990/91 and 2000/01 give further pause for thought. In contrast to previous decennial increases, the share of formal debt in total indebtedness of rural households had increased very slightly to 64 per cent in 1991. After a further ten years, the share of institutional credit actually decreased to 57 per cent in 2002. Moreover, debt sourced from moneylenders, the very informal agents the institutionalization of credit was designed to replace, increased in overall share of rural debt from nearly 18 per cent in 1991 to nearly 30 per cent in 2002. Thus, after over a hundred years of policies designed to progressively institutionalize rural credit provision, nearly one-third of all rural debt is still sourced from the very informal lenders the financial institutions were to replace. Intriguingly, Andhra Pradesh, the State with the highest concentration of Self-Help Groups, MFIs and Banks, reports the highest proportion of rural non-institutional debt (nearly 73%) and the highest proportion of rural moneylender debt (57%) for all the States in India (AIDIS, 1991 and 2002).

History, as always, is instructive. Hardiman (1996) notes that early experimentation with cooperatives did not provide an effective replacement for the moneylenders. In terms of loan use, timeliness, discretion, amounts requested and granted, and flexibility in repayment demands, the former was no match for the latter. Similarly, the same author notes the clash between banking culture and the needs of subsistence agriculture and social expenditures, an observation reinforced in Jones' (1994) study of village moneylenders and banking in Rajasthan.

Such cultural differences are unlikely to have disappeared, and may indeed have strengthened. Thorat (2006) notes how rather too much emphasis has been on quantitative targets rather than on the qualitative aspects of lending. He further notes how, traditionally, banks have been unable to internalize lending to the poor as a viable business activity but see it rather as a social obligation, something that *has* to be done. Fisher and Sriram (2006) lay the blame for this on the approach of directed, subsidized lending. Others criticize the heavy hand of government and resultant rolling out of uniform financial products (Titus, 2006).

It remains the case that formal institutional credit provision in India now accounts for just 27 per cent of total cultivator debt, and that this reduces to just 20 per cent if data for the

five States reporting the highest proportions of formal rural debt are removed. Moreover, nearly 90 per cent of households reporting no debt, either formal or informal, are headed by small and marginal farmers, suggesting institutional- rather than self-exclusion. What is underway to address such exclusion?

Official Views on Future Policy Options

Recently, a series of high-level Committees has been examining different aspects of financial exclusion in the country. Some of these Committees have recently reported their findings, others are presently deliberating.

For the purposes of this paper let us mention three Committees. First, the Vaidyanathan Committee, set up in 2004 to examine cooperatives in the country, which reported in 2005. Second, the Rangarajan Committee on Financial Inclusion, was set up in 2006 and has just submitted its report. Third, is a Committee on moneylender legislation which has yet to report.

The Vaidyanathan Committee

We noted previously that cooperatives were the first vehicle of choice for the institutionalization of rural credit provision. Over the years, there has been an increasing disjuncture between the theory and practice of cooperation in the rural sector, and in 2004 the Vaidyanathan Committee^{viii} was constituted to examine and advise on the future of these institutions. The case for reviving rural cooperatives was weak. They were impaired financially, with around half the primary agricultural cooperative societies making a loss. They were also impaired in terms of governance, management and operations.

On the other hand, the spatial spread of cooperatives across the country, especially in more remote and economically deprived areas, made a powerful argument for revival rather than termination. Today, every sixth village in India has a cooperative; cooperative membership touches the lives of nearly 480 million rural households, more than half the aggregate rural population. Seventy per cent of rural cooperative clients are marginal and sub-marginal farmers. Thus, it was felt that any initiative to wind up the cooperative credit structure would have serious implications for the agrarian economy and population.

In the event, the Vaidyanathan Committee opted for a revival strategy. However, it is a strategy whereby further financial assistance is contingent on financial, legal and institutional reforms, i.e. such assistance is to be provided only after significant action is taken by the participating State Governments and the Cooperative Credit Societies. The State Governments are free to accept or reject the strategy. However, if they do accept, they are required to commit themselves to a phased process of legal reforms, changes in the regulatory and supervisory framework, improvements in governance and management structures, and improvements in HRD, methods of operation, internal control and leveraging of technology.

In the words of one Committee member^{ix} the essence of the revival approach is to make “cooperatives cooperative”. It will be interesting to see if the Committee’s recommendations are able to effect such change in these particular financial institutions.

The Rangarajan Committee on Financial Inclusion

Commercial Banks.

The recent report on financial inclusion recognizes the role commercial banks have played in the promotion of the SHG movement in the country and the institutional and operational reforms that have made for simpler and more efficient procedures. At the same time it is argued that a greater pro-poor focus is needed. To this end it is proposed that State and District-wise targets should be established to reduce rural financial exclusion, following the mapping of financially excluded rural households by the banks. Branch expansion may be warranted in areas of particularly high exclusion, and in general it is proposed that the capacity of rural bank branches is to be enhanced through training (including training addressing attitudinal constraints) and development of IT. On the demand side the Committee advocated increasing the credit absorption capacity of marginal farmers through, for example, enhancing irrigation facilities and better marketing linkages.

Regional Rural Banks

With recapitalization and lending restrictions liberalized there has been improvement of the RRBs by 2000 compared to the 1990s. There was an increase in the number of RRBs reporting a profit, but to achieve this many RRBs had taken a narrow banking route. There has also been amalgamation of RRBs on a sponsor-bank-wide basis within States. The financial inclusion report regards post-merger RRBs as a powerful instrument to increase rural financial inclusion and recommends further merging (but not beyond each State), together with a range of measures to address the challenges these particular rural financial institutions face. Like the commercial banks, the RRBs will be required to map excluded rural households and meet financial inclusion targets based on these mapping exercises. Further recapitalization may be provided and the boards of post-merger RRBs strengthened.

Self-Help Groups

In March 2006 the number of SHGs stood at just over two and a quarter million, of which over one and a half million had outstanding bank loans. Even with this huge number of SHGs it is estimated by the Committee on Financial Inclusion that the number of SHGs will have to be doubled to cover all the fifty million poor households in the country.

The promotion of SHGs in financially excluded regions is thus encouraged, with an incentive package suggested for NGOs to work in more remote areas. The Committee recommends the setting up of Resource Centres which will help established SHGs to graduate from microfinance to larger scale livelihood activities. Such Centres will also help the SHGs to federate, expand and diversify their activities. Although the emphasis is on expanding the number of SHGs it is also recognized that the quality of such groups is also of great importance. Hopefully, the systemic issues that concern Christen (2006) will be addressed by these developments.

Micro Finance Institutions

With respect to MFIs, the financial exclusion committee recommends the need to create a separate category of MFI known as MF Non-Banking Financial Companies (MF-NBFCs) which would provide thrift, credit, micro-insurance and other services up to specified amounts in rural, semi-urban and urban areas. Such MFIs could also be recognized as business correspondents to the commercial banks.

Business Facilitator/Business Correspondent Models

The Committee on Financial Inclusion identified two main reasons for the banks', particularly the public sector banks', low key response to these two models: first, concerns regarding costs; second, some confusion regarding procedures.

To broaden the scope of these two models the Committee proposes including a wider range of individuals to qualify as business facilitators (e.g. retired officials such as school teachers, ex-service men); in some circumstances such individuals may act as business correspondents after initial induction as business facilitators. In districts characterized by high levels of financial exclusion, it is argued that MF-Non Bank Financial Companies may be permitted to act as Business Correspondents of the banks.

The Committee on Moneylender Legislation

What of the third Committee alluded to above, the Committee concerned with moneylender legislation? This is an interesting development, given that the historical antipathy towards such informal agents set the whole course for the institutionalization of credit provision since 1875. However, the results of the 2002 All-India Rural Debt and Investment Survey, showing an increase in the proportions of rural debt sourced from the informal sector, were impossible to ignore. The Reserve Bank of India has constituted a Committee to examine the role of rural informal financial agents, with a view to possibly considering some of these as potential channels for retailing formal credit.

Although Gandhi (quoted in Catanach, 1970) wondered if it might be possible to draw out the good in the Mahajan (moneylender), from the time of independence the prevailing view has been there is very little good, if any, that is there to be drawn out. However, over the years, there have been dissenting voices. Ghate (1988 and 1992) has long been an eloquent advocate of including the informal financial sector in policy debate and has explored the possibilities of linking the formal and informal financial sectors. The Committee is yet to report, and it remains to be seen whether policy makers in India are able to break free from the traditional negative views associated with moneylenders and moneylender finance. Nonetheless, the setting up of this Committee is a very interesting development and its findings will be awaited with great interest.

Of course financial institutions themselves demonstrate new initiatives and change. Private sector banks, like the ICICI Bank, have been innovative, and institutional systems and products such as futures markets, weather and crop insurance, are emerging. Securitisation of microfinance portfolios remains popular, and this trend will no doubt continue. Training to address the attitudinal constraints in the banking sector towards the

provision of pro-poor financial services has shown positive results in helping to mitigate such constraints (Jones et al, 2004). At present, the Reserve Bank is examining policies to incentivise banks responsive to the issue of financial inclusion. Certain MFIs have devised strategies to de-risk loan portfolios through the provision of lift irrigation in rain-fed areas and by linking dairy producers to veterinary services (Titus, 2006). Titus also notes how some MFIs have endeavoured to address poor households' consumption needs through provision of super bazaars.

Conclusion

In understanding the emergence and operations of institutions, a study of their history is instructive. The institutionalization of rural credit provision in India started with the policy response to rural unrest in the latter part of the nineteenth century, and subsequent rural credit policy in the country has been largely shaped by this initial response. Moreover, the history of rural credit provision in India shows a successive enchantment and then disenchantment with various institutional forms, illustrating the strengths and weaknesses of different kinds of financial institutions in meeting the financial service needs of the rural poor.

The challenges facing rural financial institutions in India are formidable, and it is clear that no single institutional form is likely to address the needs of a large, poor, diverse and dispersed population. Although history may indicate a certain naivety in the belief that a particular institutional vehicle of choice could meet such needs, history also shows a readiness to acknowledge institutional weaknesses and address these. The spatial spread of certain institutional forms, notably commercial banks and cooperatives, is impressive. With an increasing awareness of the importance of understanding the financial service needs of the rural poor and designing products and processes to address these needs, the opportunities for institutional reform are extensive. However, while the Government, the central bank and apex development banks have played an important role in creating an enabling environment for financial institutions, the experience of cooperatives has shown the dangers of too much control. Nevertheless, it does seem that financial institutions are beginning to see the rural poor as a business opportunity rather than the recipients of charity, and this will be an important driver of institutional change and provision.

But what of those financial agents who have always seen the rural poor as a business opportunity – the moneylenders and other informal agents? Until the Committee on moneylender finance reports, it is difficult to judge. However, it is a new and innovative departure that the financial agents the financial institutions were designed to replace may now be viewed as potential partners and conduits for institutional credit. Even if the use of such channels does not prove feasible, the Committee's findings on informal financial agents will provide valuable insights as to how rural financial institutions may more effectively address the financial service needs of poor households.

The Government of India continues to draw upon a wide range of research findings and on-going national data sets in policy deliberations concerning rural financial provision and institutions. Increasingly, more and more research inputs are welcomed at the policy

level. High-level Committees require considerable gathering of background research findings and membership of such committees involves representation from a range of stakeholder organisations in the financial services sector, each with their own information resources. At the individual research project level, where possible and appropriate, involvement and buy-in by senior financial sector officials can greatly increase the opportunities of moving research into policy and practice. Also, research encompasses more than just academic activities. For example, the decennial national surveys on rural credit and investment, conducted since the middle of the last century, continue to propel official introspection regarding rural financial exclusion, and how this may be reduced. Furthermore, rural financial institutions in India did not evolve in a vacuum. The historical imperatives that drove policy towards the institutionalization of rural credit provision are still evident today. A study of successive enchantment and disenchantment with particular institutional forms not only informs us of the historical imperative to establish and maintain certain types of institution, but also, of the institutional improvements needed to better provide rural financial services. Policy is shaped and formed by many forces, but it is the case that both contemporary and historical research continues to inform rural finance debate in India, both with respect to improving the operations of existing rural finance institutions, and to consider the facilitation and creation of new institutional forms and linkages.

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ⁱ In India: Public Sector Commercial Banks, Private Sector Commercial Banks.

ⁱⁱ E.g. Co-operatives, Microfinance Organisations (MFOs)

ⁱⁱⁱ E.g. Moneylenders, Pawnbrokers, Traders, Shopkeepers etc.

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^v Of the informal financial sector and subsequent institutionalisation of rural credit provision

^{vi} Dr Yashwant Thorat was a member of a number of committees deliberating in this area

^{vii} The beginning of the thirteenth until the mid-eighteenth century (Habib, 1964)

^{viii} Dr Yashwant Thorat was the member-secretary of this Committee and this paper draws upon his knowledge of the Committee's findings and deliberations.

^{ix} Dr Yashwant Thorat