REPORT OF THE

ADVISORY COMMITTEE

ON

FLOW OF CREDIT TO AGRICULTURE

AND RELATED ACTIVITIES

FROM THE BANKING SYSTEM

Submitted to

RESERVE BANK OF INDIA

Mumbai

June 2004

LETTER OF TRANSMITTAL

Vijay Shankar Vyas
Chairman

Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System,
Reserve Bank of India,
Central Office,
Mumbai.

30 June 2004

Dr Y V Reddy
Governor
Reserve Bank of India
Mumbai

Dear Dr. Reddy

I have great pleasure in submitting the Final Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System. This Report includes edited and revised contents of the Interim Report we had submitted to you on 30 April 2004. In addition, it includes our views on making RRBs and NABARD more effective in meeting the desired goals. We have also given our suggestions on improving the functioning of the Lok Nayak Jai Prakash Narayan Fund.

We trust that the Report we are submitting to you addresses key questions pertaining to the flow of credit to agriculture and allied activities. We have also attempted to suggest a road map to significantly augment flow of credit to different segments of agricultural producers without impairing the health of delivery systems.

On behalf of my colleagues and on my own behalf, I sincerely thank you for entrusting to us this task of current national importance and supporting us at all stages.

With kind regards,

Yours Sincerely

(V S Vyas)

ACKNOWLEDGEMENTS

This Report is the result of collective efforts of many people. The Committee met and discussed various aspects of rural credit with a large number of stakeholders –bankers, administrators, representatives of NGOs and farmers – in 18 states. It met with knowledgeable, articulate and sincere individuals. Regional offices of Reserve Bank and National Bank for Agriculture and Rural Development performed the difficult and delicate task of organising these meetings skilfully and efficiently.

The Committee wishes to place on record its debt of gratitude to Dr Y V Reddy, Governor, Reserve Bank of India, first of all for entrusting it this task of national importance, as also for providing it all the facilities needed for accomplishing it. His bold and refreshing approach to the economic issues facing our country in itself was a source of inspiration. His constant encouragement, mentoring, positive feedback and the enormous prestige of his backing played no small role in discharging the Committee's responsibilities. Smt K J Udeshi, Deputy Governor, Reserve Bank played a crucial guiding role. Shri A V Sardesai, Executive Director-In-Charge, Rural Credit, made himself available whenever requested by Committee. It benefited by his intimate knowledge of working of rural financial institutions. We owe a debt of gratitude to all the senior personnel of Reserve Bank.

The Committee generated and collected a vast amount of material in its deliberations and meetings with stakeholders and others. To collate this material and prepare background notes for the consideration of the Committee was not easy, given the comprehensive terms of reference and the short period of time. This task was performed in the most satisfactory manner by the Secretariat of the Committee, under the able leadership of Shri C S Murthy, Chief General Manager and in-charge of the Rural Planning and Credit Department in the Central Office of Reserve Bank. In spite of his other responsibilities, he effectively handled organisational matters and provided valuable inputs to the deliberations of the Committee. Contributions of Dr Amarendra Sahoo, Dr B N Kulkarni, Shri H R Dave, Shri R N Dash, Shri P K Nayak, Shri R Sudeep and Shri D G Nalawade, all members of the team working for the Committee, are gratefully acknowledged. Our editor, Dr Shreekant Sambrani, put his considerable subject matter skills and experience as well writing abilities at the Committee's disposal to strengthen our draft for its effective and focussed presentation. Dr Nachiket Mor of ICICI Bank made a very useful special presentation to the Committee.

The Committee also wishes to thank many others in Reserve Bank, NABARD and other organisations, too numerous to be mentioned by name, who contributed to various aspects of preparing this Report.

ABBREVIATIONS

ACRC	Agriculture Credit Review Committee
CDF	Co-operative Development Fund
DCCB	District Central Cooperative Bank
DLCC	District Level Coordination Committee
DRI	Differential Rate of Interest
ECRC	Expert Committee on Rural Credit
GLC	General Line of Credit
GOI	Government of India
JLG	Joint Liability Group
KCC	Kisan Credit Card
LNJPNF	Lok Nayak Jai Prakash Narayan Fund
MFIs	Micro Finance Institutions
MOU	Memorandum of Undertaking
NABARD	National Bank for Agriculture and Rural Development
NBC	Net Bank Credit
NBFC	Non-banking Financial Company
NCAER	National Council of Applied Economic Research
NMCE	National Level Multi Commodity Exchange
NPA	Non Performing Asset
PACS	Primary Agricultural Cooperative Societies
PLR	Prime Lending Rate
POS	Point of Sale
PRI	Panchayati Raj Institution
REC	Rural Electrification Corporation
RFAS	Rural Financial Access Survey
RFI	Rural Finance Institution
RIDF	Rural Infrastructure Development Fund
RRBs	Regional Rural Banks

RUDSETI	Rural Development and Self-Employment Training Institutes
SAA	Service Area Approach
SACP	Special Agricultural Credit Plans
SAMIS	Service Area Monitoring and Information System
SARFAESI Act	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act
SCARDB	State Co-operative Agriculture and Rural Development Bank
SCB	Scheduled Commercial Banks
SGSY	Swarnjayanti Gram Swarojgar Yojana
SHG	Self Help Group
SHPI	Self Help Group Promoting Institutions
SIDBI	Small Industries Development Bank o f India
SLBC	State Level Bankers' Committee
WTO	World Trade Organisation

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EXECUTIVE SUMMARY

Provision of Agriculture Credit and Committee's Tasks

0.1 **Changes in Agriculture**: Even though the current share of agriculture and allied activities in India's GDP at 22 per cent is less than half of what it was three decades ago, the agriculture sector continues to be the single largest occupation as it still provides livelihood to two-thirds of the population. While the production base continues to comprise predominantly small and marginal farmers, other changes indicate a greater commercial orientation of the sector. These include increasing importance of allied activities such as those based on livestock and fishery, greater importance of non-food and commercial crops and superior cereals among food crops and a higher share of purchased items in inputs used.

0.2 **Emerging Challenges**: These changes clearly point to a greater market orientation of the sector, for both inputs as well as outputs. Increasing commercialisation and globalisation also require expanded and improved infrastructure. The National Agricultural Policy not only envisages faster agricultural growth at 4 per cent a year, but also its equitable spread across regions and classes of farmers. At the same time, some important provisions of the WTO agreements have the potential of increasing India's share in world trade of agricultural commodities. All these translate into higher credit demand and acceleration in its growth, as well as cost-effective mechanisms for its delivery. Equity considerations also require that the cost of credit must be affordable by the vast majority of its potential users, agriculturists with a small resource base.

0.3 **Committee and its Mandate**: Reserve Bank of India set up an advisory committee on provision of credit to agriculture and allied activities under the chairmanship of Professor V S Vyas in December 2003. The Committee considered ways to expand flow of agricultural credit and its outreach including SAA, measures to reduce cost of credit, possible use of IT, definition of NPAs as relevant to the sector, impediments to the flow of credit to disadvantaged sections, micro finance, the role of RRBs, NABARD as apex developmental institution and RIDF as facilitator of credit absorption in rural areas, in fulfilment of its various terms of reference. It undertook field visits to 18 states and held discussions with numerous stakeholders in the rural credit system and other knowledgeable persons. Its overall brief as well as its recommendations were guided by the concern of attaining dynamic, vibrant agriculture contributing to resurgent rural India.

Mandatory Lending and Credit Flow

0.4 **Growth of Agriculture Credit, but Target Not Met**: Commercial banks' agriculture advances outstanding grew nearly fourfold, from under Rs 22,000 crore to Rs 85,000 crore over the last decade. Yet only five of the 27 public sector and two of the 29 private sector banks met the target of extending 18 per cent of the net credit outstanding to agriculture. The rest had to deposit amounts in accordance with their shortfall to RIDF established with NABARD. The nine annual tranches of RIDF have so far added up to Rs 34,000 crore.

0.5 **Means to Improve Performance**: The R V Gupta committee (1995) recommended preparation of special agriculture credit plans in which banks set for themselves targets for disbursements taking into account the annual increment in credit indicated by the Reserve Bank. The target of 18 per cent has not been met despite monitoring credit flow though SACP. ECRC, set up by NABARD in 2001, recommended a review of the targets after five years and a substantial reduction in the rate of interest on RIDF, to deter banks from using it as an easy way to fulfil their obligations. RIDF interest rates are now restructured and vary between Bank rate and Bank rate minus 3 percentage points depending on the extent of shortfall.

0.6 **Relevance and Continuation of Targets**: While considering alternatives ranging from no targets to GDP-linked targets, the Committee noted that all major participants in the financial system agreed on increasing rural credit. It concluded that the entire issue needed a comprehensive review, pending which the present target of 18 per cent of the net bank credit to agriculture should continue. The use of SACP should be continued and applied to private sector banks as well, with its framework restricted to direct lending. Banks may have their own review mechanisms for indirect lending. Since interest rates on RIDF deposits were reduced to levels possibly below the cost of funds in some cases, no further punitive measures would be needed to deal with shortfalls.

0.7 **Road Map to Meet Targets**: In view of the operational difficulties experienced by banks in achieving the target in respect of direct agricultural advances, they should increase their direct agricultural lending to 12 per cent of net bank credit in the next two years and 13.5 per cent in two years thereafter. Indirect lending may be reckoned at 6 per cent in the next two years and 4.5 per cent thereafter. Small and marginal farmers, who account for 80 per cent of the total number of holdings and 36 per cent of the total area, have only a 27 per cent share in disbursements under SACP. This should be progressively raised to 40 per cent by the end of the Tenth Plan period. Loans for storage facilities even outside producing or rural areas should be treated as indirect advances to agriculture, if they are used mainly for handling and storing agricultural commodities. Banks' investments in securitised assets comprising wholly direct advances to agriculture may be treated as part of their direct lending to agriculture. Similarly, if the securitised assets comprise wholly indirect advances to agriculture, the banks' investments in such securitised assets may be treated as their indirect lending to agriculture.

Expanding Outreach

0.8 **Impressive Network, Limited Reach**: Rural financial institutions have a large network of over 1,00,000 outlets of co-operatives and 47,000 branches of scheduled commercial banks. Yet the share of agricultural lending in total credit halved, from 21 per cent in 1970s to 11 per cent in 2001-02. The poor health of co-operatives in most states could be a contributing factor. Commercial banks' share in rural credit went up substantially from 2 per cent in 1970-71 to 45 per cent 20 years later, all at the expense of the co-operatives (whose absolute quantum of lending went up six-fold in this period). The pace of credit disbursed to agriculture is, however slowing, especially for term loans, regional imbalance seems to be widening and the share of small farmers in credit disbursed is declining.

0.9 **New Opportunities**: Credit disbursed would be considerably enhanced if investment and production credit were integrated and scales of finance used at the district level were reviewed and readjusted in line with requirements of modern, market-oriented capital-intensive agriculture using newer technologies and superior inputs. Linkages between production and marketing need to be strengthened by increasing pledge finance, credit for marketing and introduction of advances against warehouse receipts. Other avenues for increasing credit flow include finance for land reclamation, schemes of improved water management, dryland farming development, all of which are aimed at easing some of the present constraints on agriculture. Forward-looking schemes such as those meant for precision farming and hi-tech agriculture, processing and export-oriented farming merit consideration as they add value to agriculture and help meet emerging opportunities. New commodities exchange mechanisms provide an opportunity to hedge and mitigate risks. Select banks willing to participate in pilot trading projects should be allowed to do so in the interest of providing a hedging mechanism for farmers. They should be exempted from relevant provisions of the Banking Regulations Act.

0.10 **Supporting Measures**: Inadequate and undertrained human resources are the biggest handicap RFIs face in increasing their outreach. The ECRC recommendations on posting of technical staff at branches and controlling/head offices need to be implemented urgently. The most important task is the change of mindset. Banks and their staff must appreciate that there is hardly any better avenue of retail banking than agriculture in India. Outsourcing certain preliminary credit-related tasks to development agents such as SHGs, NGOs, members of panchayati raj institutions, village functionaries, farmers' clubs etc, or using rural agencies as franchisees for such tasks would help banks expand their outreach without adding proportionately to their costs. A hub and spokes model based on nodal branch and points of sale respectively would be useful, especially in conjunction with outsourcing. Village information kiosks could be used as an additional channel for dissemination of agricultural and credit information. A group of bank and state government officials together with experts from agriculture universities in each state should look into the scope of communication and information technologies in transforming agriculture.

0.11 **Legal and Other Provisions**: Recognising and noting tenants' and sharecroppers' rights in land records would help provide these groups access to bank credit. Revenue authorities and state officials also need to support RFIs in collecting their dues, since the institutions cannot attach lands for recoveries. Treating co-operatives and banks on par for the purpose of creating charges and stamp duties for this purpose, as recommended by ECRC, would help remove this anomaly. Training centres for various support functions to agriculture help create opportunities for self-employment in villages. Such facilities already set up by some banks should be adopted as examples by other banks.

0.12 **Procedural Issues**: Various procedures involved in provision of credit and paper-work related to it need to be simplified. Not all recommendations of the R V Gupta Committee and ECRC have been effectively implemented yet. These aspects, along with practice of some branches of demanding unreasonably high margins, need to be reviewed by controlling authorities of banks and rectified. Some other specific actions needed are waiver of margins/securities on agriculture loans up to Rs 50,000 and agri-business and agri-clinics up to Rs 5,00,000.

0.13 **Modifications to SAA**: The service area approach, introduced in 1989 for planned and orderly development of rural areas, has developed rigidities and is acting as a bottleneck, despite measures to provide it flexibility. Its merit is that it provides a mechanism for first tier approach to credit planning and monitoring and its integration into successively higher tiers. This feature needs to be preserved, but several modifications are needed to remove the rigidities. These include:

- SAA to be mandatory only for government-sponsored schemes;
- Format of village surveys to be changed in view of current realities;
- Service area monitoring and information system to be modified and strengthened to include information on new products introduced since its inception.

The Lead Bank Scheme also needs a review in terms of manpower and other support facilities provided and current requirements.

Reducing Cost of Agricultural Borrowings

0.14 **Basic Consideration**: Even as there is a need to make the interest rates on agricultural credit more affordable, a single mandatory rate of interest would affect various institutions differentially, mostly adversely, and is therefore not feasible at present. Timeliness and adequacy of credit as well as the concomitant costs of availing credit matter to the borrower in addition to the rate of interest. Measures to reduce costs of funds, transactions and risks, could lower the cost to borrowers without impairing viability of RFIs. Banks must also ensure that their systems and procedures lead to cost-effective lending. IBA has already advised all public sector banks to reduce their lending rate to not more than 9 per cent for crop loans up to Rs 50,000. NABARD has also issued appropriate instructions to co-operative banks and RRBs.

0.15 **Impact of Reduction**: Co-operatives and RRBs have not been able to reduce their rates appreciably, unlike commercial banks. A simulation exercise shows that commercial banks as a whole could absorb a 2-percentage point reduction in the rate of agriculture loan interest. Obviously, only profit-making RRBs could sustain such a reduction, if their accumulated losses were to be ignored, but 59 of them with already slim margins would incur losses. DCCBs as a whole appear to break even at present rates of interest, but would suffer on account of interest rate reduction.

0.16 **Costs of Funds**: Commercial banks now face lower costs of funds, as their costs of time and savings deposits are 5-6 per cent and 3.5 per cent respectively. RRBs get credit from sponsor banks and refinance from NABARD at rates of interest higher than the market rates. This limits their ability to reduce the rates they charge to their borrowers, although they are compelled to do so in competition with commercial banks. The multi-tier co-operative structure leads to each tier adding its own costs and margins aggregating 5 to 6 per cent to the basic cost of funds, which is higher than that of commercial banks to begin with. Thus, they charge between 12 and 14 per cent to their borrowers. When high cost deposits mature in the next couple of years, cost of funds may come down by 0.5 to 1.0 per cent, but 40 RRBs and 105 DCCBs will not be able to reduce their rates, as they face negative margins. States such as Andhra Pradesh have offered subsidies to make the ultimate rate 5 to 7 per cent, but such measures distort the interest rate structure and should be discouraged.

0.17 **Transaction Costs**: These will be reduced only when there is a higher volume of business per employee. This in turn requires introduction of new, innovative products (KCCs, ATM-enabled smart cards, among others), simplification of procedures, outsourcing of some functions (already done by some RRBs with telling results), for all banks. If the multi-tier co-operative structure simply adds to the cost of ultimate borrowers, there would be a case to eliminate one of the tiers. Good PACS, if hampered by weaker DCCBs, could seek synergies with commercial banks, even to the extent of credit support or guarantees for marketing inputs or outputs. Use of IT could help reduce transaction costs. Banks must formulate a time-bound programme to use IT and providing basic infrastructure facilities needed for it in rural branches.

0.18 **Risk Costs**: Banks may review and revise their appraisal procedures to overcome some supply-side risks and tighten post-disbursement supervision to help reduce possibilities of non-payment. They may also design incentives for timely repayment. Risks arising out of death or illness of the borrower could be covered partly through personal life insurance, but products suited to farmers' needs are not available except in case of KCC. Innovations in this regard are urgently needed. Minimum support prices and crop insurance schemes cover risks of market fluctuations and yield variations to an extent, but their working and coverage need to be improved. The present method of charging flat premia effectively increases the cost of borrowing, which is already high, to as much as 19 per cent in case of cash crops. Farmer-friendly, low-cost insurance products are needed. The pilot index-based rainfall insurance is one such. Helping farmers take forward positions through commodity exchanges could help cushion the adverse price impact of bumper harvests.

0.19 **Agri-Risk Fund**: Recurrent calamities such as droughts and floods need long-term remedies in addition to the short-term relief of loan restructuring. An *Agri-Risk Fund* with equal contribution from Central and state governments and participating banks would moderate the risk of lender banks as they could take recourse to the fund in the event of a genuine default; it would also relieve the farmer hardships.

Agriculture Finance and NPAs

0.20 **Current Norms**: Agriculture advances of commercial banks are treated as NPAs if interest or instalment of principal remains unpaid for two harvest seasons after the due date, but for a period not exceeding two half-years. Loans for allied activities are considered delinquent after a period of 90 days from due date. Co-operatives, which charge interest half-yearly, coinciding with harvests, have been directed to treat those loans on which interest is not paid for two seasons after the loan is overdue as NPAs.

0.21 **Need for Revision of Norms**: Crop seasons vary considerably, some lasting as long as 18 months. Therefore, prescription of a period for reckoning default common to all crops is not realistic. Farmers also tend to treat all their loan obligations as one and effect payment out of income pooled from all sources. Applying differential periods of delinquency to loans for farmers' main and allied activities is also not appropriate. The practice of rendering all accounts of a borrower as NPAs in the event of a default in any one of them affects adversely flow of production credit to those farmers who have also availed of term loans and have a default thereon.

0.22 **Proposed Revisions**: Revised norms would help resolve some of these difficulties:

- While the current NPA norm of default for two crop seasons after the due date could be retained with crop season meaning the maturity period of the concerned crop for harvesting, the provision of two half-years could be removed. Crop seasons could be determined by the technical committee appointed to fix scales of finance and ratified by DLCC/SLBC. For long duration crops, the period of default may be one crop season after the due date;

- Loans for allied activities may be classified as NPA after a default of 180 days, as was the case earlier;

- In case of farmers availing both crop loans and term finance, only the account with default may be treated as NPA and not the regular account.

0.23 **Other Provisions**: The state government declaration of *annawari* often takes a long time during which no relief is provided to the drought-affected farmers. A committee headed by the lead bank manager and consisting of NABARD district development manager, district agriculture officer and managers of a few major banks could decide on conversion/restructuring of loans in consultation with agricultural scientists and/or university. This should be noted in the proceedings of the SLBC meeting immediately following. All banks operating in the district may authorise their branches to take up conversion/restructuring based on the recommendations of the district committee. Banks may restructure loans if farmer-specific events beyond their control, such as major illness in the family, affect the repayment schedule, with approval of the controlling authority, after ensuring that this does not lead to ever greening. Such conversions should be at reasonable rates of interest, lower than those on the original loan.

Impediments to Credit Flow to the Disadvantaged

0.24 **Poor Access to Credit**: A recent World Bank/NCAER survey shows that only 24 per cent of the Andhra Pradesh and 19 per cent of the Uttar Pradesh households had access to formal credits, while 56 and 51 per cent of the households in two states respectively depended on private credit. The proportions of small and marginal farmers accessing formal credit were lower than those in the medium and large category in both the states. Thus access to formal credit was poor and skewed in favour of the larger holdings. Current guidelines provide 10 per cent of the net bank credit for the weaker sections comprising small and marginal farmers, landless labourers, artisans etc. Public sector banks had extended only 6.8 per cent of their credit to these weaker sections as of 2003. The number of weaker section borrowers fell from 1.76 crore in 2000 to 1.43 crore in 2003. Factors such as high transaction costs for both banks and borrowers in case of small loans, client-unfriendly procedures and mindsets, client inability to provide tangible securities, non-availability of relevant documents, distortions to banking principles caused by linking credit with subsidies and/or expectations of waivers, inadequate risk coverage, have all resulted in this restricted and skewed access to credit. Measures recommended earlier, such as a reduction of cost of borrowing, increasing outreach through outsourcing, simple procedures, bridging the information gap would help remove some impediments. Banks should provide a separate flexible revolving credit limit to small borrowers of production or investment loans to meet temporary shortfalls in cash flows. A branch advisory committee comprising some elected representatives and women leaders of local *panchayati raj* institutions may be established at every rural branch to oversee flow of credit to the disadvantaged.

0.25 **Other Measures**: Financing oral lessees is a problem area. Financing models based on joint liability groups/SHGs could be tried on a pilot basis. Contract farming has the potential for expanding credit outreach, especially to the small/marginal farmers and oral lessees. Banks may increasingly consider associating with contract farming, subject to availability of proper legal and regulatory framework in different states. The inadequate response of the banking system to SGSY and the feedback to the Committee indicate a need to look again into the design of the programme, especially with regard to moderating the timing and quantum of subsidies.

0.26 **Success of SHGs**: The NABARD-led SHG-bank linkage programme with a current base of 10 lakh SHGs and lending of over Rs 3,500 crore is considered the largest and fastest growing example of micro finance in the world. The repayment rate is over 95 per cent. Its performance in some states otherwise considered poor on developmental indices, such as Rajasthan, Orissa and Uttar Pradesh, has been noteworthy. Banks in states where the programme has not fared so well may evolve three-year action plans to scale it up. All banks may set up micro finance cells at their central offices and in each state of their operation. The quality of linkage reflected in client satisfaction continues to be uneven. Banks need to provide smooth and client-friendly access to credit. Older SHGs with sizeable resources need to be provided diversified savings and credit products tailored to their needs. Some of these groups may need escort or hand-holding services to take up higher level enterprises, which may be provided by banks, NABARD, NGOs and governments acting in concert. Specialised enterprise promoting agencies or corporate entities may also be involved in this effort, to be led by NABARD. SHG federations of the non-financial intermediary type emerging out of demands of SHGs need to be encouraged. More experimentation of the financial intermediary type federations is needed to determine their cost of promotion, capacity building, organisational and financial sustainability and above all, the quality of value-addition being achieved by them.

0.27 **NGO-MFIs**: About 800 NGO-MFIs are estimated to be undertaking financial intermediation in India. These also include a handful of commercial MFIs, which account for bulk of their outreach. While a few MFIs have reached significant scales of outreach, these institutions as a whole are still evolving. Further experimentation is needed to establish the MFI model, especially in areas where banks are still not able to meet credit demands of the rural poor adequately, such as North-eastern states and tribal dominated states such as Jharkhand, Chhattisgarh and Orissa. NGO-MFIs may not be permitted to accept public deposits unless they comply with the Reserve Bank regulatory framework to protect the interests of depositors. Since MFIs are known to charge high rates of interest to their borrowers, lenders to MFIs may ensure that these institutions determine the rates of interest they charge to their clients on a cost plus reasonable margin basis.

Regional Rural Banks

0.28 **Current Status**: The Government of India promoted regional rural banks through the RRB Act of 1976. Their equity is held by the Central Government, concerned state government and sponsor bank in the proportion of 50:15:35. There were 196 RRBs with over 14,000 branches by 2003. Their deposits rose from Rs 4,035 crore in 1990-91 to Rs 48,346 crore in 2003, while their credit disbursal went up only half as rapidly, from Rs 3,s378 crore to Rs 21,773 crore in the same period. Despite their strong rural branch structure, accounting for 30 per cent of all rural branches of SCBs, their share in the total agriculture credit at the national level has remained at 8 to 9 per cent right from their inception. Their asset quality has improved lately; their recovery rate has gone up from 60 per cent in 1999 to 73 per cent in 2003, and the ratio of NPAs halved from 28 per cent to 14 per cent in this period. Their involvement in promoting SHGs has helped them improve their outreach. There were 156 RRBs in profit in 2003, with 97 having wiped off their accumulated losses also and built up collective reserves of Rs 2,300 crore. They have collectively earned a relatively slim margin varying between 0.8 per cent and 1.4 per cent annually, by focussing on narrow banking: investing in relatively high yielding government securities to meet their somewhat higher financial, transaction and risk costs. This situation may not be tenable in a falling interest rate regime; therefore, they have to devise new products for their clients and diversify their lending portfolio.

0.29 **Concerns about RRBs**: The financial health of RRBs has been indifferent from their inception. This is caused by factors such as limited area of operation, narrow client base, high cost of servicing numerous small accounts, poor human resources of RRBs and their ineffective boards. Several committees have suggested various remedies: lending to non-target groups (Dantwalla Committee, 1978), recapitalisation and investment in high-yield government securities (Kelkar Committee, 1986) and possible merger with rural subsidiaries of sponsor banks (Narasimham Committee, 1995). The RRB stakeholders pumped in nearly Rs 2,200 crore as additional capital for 187 RRBs between 1995 and 1999.

0.30 **Continuation of RRBs**: The Tenth Plan target of 4 per cent growth of agriculture leads to a projected credit demand of over Rs 7,00,000 crore. Even if their share in it is 8 to 9 per cent, RRBs would have to deal with Rs 66,000 crore or more. Their role would be important because of their strong rural branch infrastructure and rural orientation of their staff. The RRB mandate has to continue, even as they need to be restructured into viable financial institutions, simultaneously retaining their regional character and rural focus.

0.31 **Reorganisation of RRBs**: Several suggested and considered alternatives for restructuring RRBs include:

- Merger with sponsor banks;
- All RRBs sponsored by a single sponsor bank to be amalgamated into a single, wholly-owned subsidiary of sponsor bank;
- Each RRB to be a wholly-owned subsidiary of its sponsor bank;
- Consolidation of all RRBs into a National Rural Bank;
- Continuation as of now;
- Privatisation of RRBs;
- Amalgamation of RRBs into zonal banks;
- Amalgamation of RRBs into state-level banks;
- State level amalgamation of RRBs of a sponsor bank.

Each of the above has certain merits and demerits and none could apply in isolation because of the prevailing diverse socio-economic conditions and region-specific problems. A hybrid model combining several options has to be evolved.

0.32 **Preferred Model I - Zonal Bank for North-East**: All RRBs in the North-eastern states should be merged into a zonal bank with equity from NABARD, State Bank of India and United Bank of India, in the ratio of 26:37:37, through a holding company. The holding company will return the share capital and additional share capital deposits contributed by the Central and state governments at a price based on the book value.

0.33 **Preferred Model II – State Level Regional Rural Banks**: A two-step reorganisation of RRBs for the rest of the country would involve all RRBs of a sponsor bank in a state amalgamating into a single unit in that state as a first step. Sponsor banks in each state may establish one holding company, with equity from sponsor banks and NABARD in the ratio of 74:26. The holding company would contribute to the equity of the various state-level RRBs of the sponsor bank. It will also return the share capital and additional share capital deposits contributed by the Central and state governments at a price based on the book value. This will reduce the number of RRBs to 74 from 196. Holding companies should harmonise staffing patterns, procedures and policies of amalgamated RRBs operating in a state in three to five years, as the second step of state-wise consolidation and formation of state level rural banks. Thus 20 state-level rural banks will emerge after the second stage.

0.34 **Advantages of Amalgamation**: This model has several advantages:

- Amalgamated boards could be strengthened by professionals and experts;
- Administrative expenses could be cut by closing redundant head offices;
- Unsatisfactory working of individual RRBs may not contaminate the balance sheets of sponsor banks, in view of the presence of the holding company;

- NABARD presence will ensure sponsor banks' concentrated attention on rural credit;
- The expanded structure would permit sanctioning of higher limits to single or group borrowers and still comply with the Reserve Bank prudential norms.

0.35 **Qualifying Note**: This preferred approach needs further detailing of all the procedural and formal requirements.

NABARD

0.36 **Rationale and Functions**: NABARD, set up in 1982 through an Act of Parliament, has a mandate of "providing and regulating credit and other facilities for the promotion and development of agriculture…and … allied … activities in rural areas with a view to promoting integrated rural development". Its three main functions are development, credit and supervision. Development includes activities which ultimately enhance credit absorption capacity, build awareness and allow policy advocacy for various causes. Credit primarily covers refinancing of co-operatives, RRBs and commercial banks and finance for rural infrastructure. Successful development initiatives translate into credit demand. Supervision, taken up primarily on behalf of Reserve Bank, includes on-site inspection and off-site surveillance of co-operatives and RRBs. It is thus a development financial institution.

0.37 **Achievements and Shortcomings**: Its disbursal of loans increasing from Rs 2,035 crore in 1982-83 to Rs 14,650 crore in 2003-04 has made an impact on private capital formation in agriculture. Its organisational development interventions in all RRBs and 50 SCBs/DCCBs contributed to their turnaround. Its other development projects in areas such as dryland and watershed development, credit extension, micro finance (discussed earlier) and promotion of self-employment are considered models of such activities. It has developed expertise in appraisal and monitoring of infrastructure projects through its funding of 1,73,000 such projects with loans of Rs 34,678 crore. It needs to pay more attention to supporting value-addition in agriculture, encouraging investments for diversification from subsistence to commercial agriculture, facilitating access to oral lessees and tenant farmers and increasingly using various funds at its disposal for institutional development. A renewed thrust to policy advocacy for various sub-sectors of the rural economy is also necessary.

0.38 **Key Issues**: The key issues are whether such a DFI is needed now for the rural economy, maintaining a synergy among its three functions, and constraints it faces in expanding its operations. The capital formation in agriculture fell from 1.6 per cent of GDP in 1995-96 to 1.3 per cent in 2000-01. This needs to be reversed for accelerated agricultural growth. A two-pronged strategy of providing additional resources and building a viable delivery system is necessary. Increased investment in rural infrastructure and greater credit flow for agricultural production are the other pre-requisites of increased production, productivity and employment generation envisaged in the Tenth Plan. These are the main functions of a DFI; hence the NABARD role in this direction needs strengthening. All three functions of NABARD continue to be of high relevance to the rural economy. In view of its predominant developmental and promotional roles, NABARD need not be driven by commercial considerations alone. Profit maximisation or a strong balance sheet cannot be the sole criterion for judging its performance. It has to strike a proper balance between developmental and commercial agenda.

0.39 **Strengthening NABARD Resource Base**: This is an urgent need to enable NABARD to influence ground-level credit flow. Its ability to provide cheaper refinance is constrained due to its cost of market borrowings and rate of interest on GLC. A judicious balance between market borrowings and Central Government funding out of profits transferred to it by Reserve Bank is needed to further expand the NABARD scale of operations. It needs permission under the automatic route to access external commercial borrowings at lower costs, for which the NABARD Act will have to be amended. Reserve Bank may arrange for a contingency credit line from the banking sector at a reasonable rate of interest for NABARD to draw funds if needed. Since NABARD development schemes are crucial for rural wellbeing and do not generate income for it, imposition of corporate income tax may be deferred until a review in 2007. This exemption should not apply to its commercial business.

0.40 **Development Function**: Some specific actions recommended are:

- NABARD should reorient its development interventions to PACS for skill-building etc, using CDF, even as it continues with its focus on DCCBs and SCBs;
- Recommendations of earlier committees on linking release of credit to timely submission of progress reports, duality of control, recapitalisation etc, need to be speedily implemented;
- More DCCBs should be associated with SHG-bank linkage programme;
- State governments need to support NABARD efforts of revitalising long-term credit co-operative structures. Using SCARDBs for short-term finance in areas where PACSs are non-functional should be explored;
- NABARD strategic partnerships with and stakes in RRBs should be further strengthened in areas such as HRD, systems and computerisation and micro finance;
- Its various promotional initiatives and projects aimed at improving rural credit absorption should lead to replicable models. Use of specific funds for this purpose should be enhanced;
- NABARD needs to be represented in state and national planning mechanisms to dovetail its activities with overall plans;
- NABARD should monitor the entire rural credit situation and convey its views to the Reserve Bank's Annual Policy Statement and devise its own action plan based on it.

0.41 **Credit Function**: NABARD may review its refinance products in line with market expectations and explore other areas such as making available its expertise on project monitoring etc to other RFIs, setting up a venture capital fund to promote agriculture growth projects, partnerships with private sector for infrastructure creation. It could also explore the area of micro insurance for entry by leveraging its vast base of clients from banking sector and NGOs.

0.42 **Supervision Function**: NABARD should continue with this to safeguard its interests and to strengthen the economic viability of co-operatives and RRBs. Periodic exchange of experiences between Reserve Bank and NABARD would help achieve their common goals. NABARD operating systems may be reviewed, especially at the regional level, to help build up synergy in all of its functions.

0.43 **Autonomy, HRD**: NABARD should have full operational autonomy in the areas of credit and developmental interventions, by amending the Act if necessary. It may review and suitably adjust its human resource management and development policies to meet client expectations. A client satisfaction survey and linkage with systems such as agriculture universities could help redraw its operational policies.

RIDF, Lok Nayak Jai Prakash Narayan Fund

0.44 **RIDF Genesis**: The Rural Infrastructure Development Fund was set up in NABARD in 1995-96 with contributions from banks which had shortfalls in their agricultural lending as compared to the 18 per cent target. This was continued on a year-to-year basis. Its nine tranches so far have raised Rs 34,000 crore as deposits. These funds were to be used to finance state government sponsored rural infrastructure projects. Cumulative sanctions and disbursals under RIDF so far amount to Rs 34,648 crore and Rs 21,067 crore. Rural connectivity and irrigation accounted for the bulk of sanctions so far.

0.45 **Interest Rate Structure**: Following ECRC recommendations, interest rates on RIDF deposits were reduced to Bank Rate minus 1 to 3 percentage points depending on the shortfall (presently between 6 and 3 per cent). Interest on borrowings is currently pegged at Bank Rate plus 0.5 percentage points (6.5 per cent).

0.46 **LNJPNF**: The setting up of this fund, with a corpus of Rs 50,000 crore and a simultaneous discontinuation of RIDF was announced in the Interim Budget Speech for 2004-05. It was meant to efficiently collect resources from providers of long-term finance and markets for development in rural infrastructure and diversification, export and value-addition projects in agriculture.

0.47 **Component Activities**: Rs 30,000 crore was earmarked for infrastructure through state governments, state-owned enterprises, local bodies etc. Irrigation, watershed development, land development projects, marketing infrastructure, livestock project infrastructure, etc are among the eligible activities. Rs 18,000 crore are provided for refinance for investments in agriculture and commercial infrastructure for similar projects to be taken up by corporates, NGOs, individuals and other agencies. NABARD Board can alter the list of eligible activities in both these areas. The remaining Rs 2,000 crore are meant for various development and risk management measures planned by NABARD to encourage diversification of agriculture and encourage demand for credit. A highly competitive rate of interest, expected to be 2 percentage points below PLR, was indicated.

0.48 **Sources of Funds**: Funds for the first year (2004-05) would be from banks making deposits under RIDF, but in a phased manner, as and when demanded by NABARD for investment. The Central Government assured to meet any shortfalls through other measures including market borrowings, if needed, and promised NABARD risk mitigation support including partial guarantees.

0.49 **Use of Funds**: Resources mobilised from commercial banks out of their shortfall in agricultural lending should be used only for infrastructure through the state government component of the fund (Rs 7,800 crore in the first year) and not for the investment credit component, for which NABARD may find alternative sources. The list of eligible projects does not include rural connectivity, which has so far used a predominantly high share of RIDF finances, and medium irrigation projects. Some states have requested their inclusion again. Assistance under LNJPNF should be for projects with capacity to generate some resources in future to help repay the loans. Private sector rural infrastructure projects should be financed directly by banks.

0.50 **Areas of Concern**: State governments may find it difficult to absorb the scaled-up corpus in the next two years. Therefore, Government of India/NABARD may make a realistic assessment of such needs and the corpus of the fund meant for infrastructure development through state governments may be suitably readjusted. State governments should limit their contingent liabilities and the automatic debit mechanism under RIDF/LNJPNF should be phased out. Instead, state governments should make budgetary allocations for payment of interest and repayment of principal. They may also consider establishing a sinking fund for this purpose.

0.51 **Carry-forward Areas from RIDF**: The interest rate structure of RIDF IX may be continued for deposits/advances under LNJPNF. RIDF deposits were reckoned as banks' indirect lending to agriculture, which may be continued under the new fund also. Since a large number of projects have been sanctioned under RIDF and there is a gap between sanction and actual utilisation of assistance so far, the scheme should be reviewed after three years. Some states, such as Bihar, Jharkhand, Uttaranchal, and those in the North-East showed low use of RIDF assistance. Government of India and NABARD need to take steps in consultation with state governments concerned to ensure their greater participation in the new activities.

PROLOGUE

The pace of development of agriculture and allied activities in India needs to be accelerated to achieve the overriding national objective of faster and equitable growth. Dynamic and vibrant agriculture alone will effectively address problems of rural poverty. This in turn calls for strengthening the rural production base, well supported by all the facilitating agents. Credit is among the critical support areas.

The key task is to ensure a convergence among credit availability, effective credit delivery systems and adequate credit absorptive capacity of the rural populace. The Committee's deliberations continued to revolve around this point, as did the various submissions to it from knowledgeable persons. In essence, the Committee was enjoined to examine this concern, although the supply side was emphasised.

A simple match between a technical assessment of credit required to maintain a level of production and its growth, and availability of credit does not become a sufficient condition for equitable growth, since the mere availability of credit does not ensure its actual use. Thus we are confronted with the problem of converting credit requirement into an effective demand for credit. Not only do we need to understand the extent of availability of productive resources, their distribution, laws and social structures governing their use, but also cropping patterns, current and emerging technologies, markets and their stipulations, among others, to get an idea of credit requirements. Factors such as infrastructure and institutions supporting agriculture, along with risk perceptions and risk-bearing abilities of the various categories of farmers would largely determine credit absorption capacity.

Credit must also reach all its users effectively; it must be on time, in required quantities and addressed to the right activity mix. Raising agriculture to higher thresholds to usher in value-added, hi-tech enterprises requires strengthening the delivery systems. These tasks begin at home for the rural financial institutions: co-operatives, regional rural banks and rural branches of commercial banks. Their organisation must allow flexibility of approach, innovation to meet new needs, empathetic treatment of the clientele and responsiveness. All these call for changes in organisational structures, procedures, and above all, the mindsets of those who manage the system.

Since credit provision is not a one-time task, its recovery also becomes a concern. Procedures that lead to prudence in lending, yet do not choke off the flow of credit at the slightest hint of trouble in recovery are the need of the day. While emphasising timely and sufficient recoveries, lenders must also be prepared to face problems of risks inherent in agriculture and allied activities. Vagaries of weather, adverse conditions of pests and diseases and other calamitous factors could seriously affect farm incomes, and severely constrain the repayment capacity.

Costs of risk alleviation mechanisms, such as traditional as well as novel insurance schemes, stabilisation or balancing funds, etc, are too large to be passed on in their entirety to an agrarian milieu comprising mostly of subsistence farmers, as is the case in India. Nor could the rural financial institutions shoulder the whole burden. A part of it must be reckoned as a social developmental cost and borne by the society at large, namely the central and state governments. States have a vital role to play, in the sense that they have the largest interface with the rural community and have its best interests at heart. Their concerns need to be translated into effective contributions to measures that build and improve farmers' capacity to take risks and progress along a higher growth path.

States also have a vital developmental role to play, not merely because agriculture is a state subject, but because most strategies for new developments and corrective measures have to be location-specific. Therefore, state administrations have to become even more pro-active, in the sense of anticipating peasant concerns and putting in place activities in the right direction. A large part of the credit delivery system, the co-operative structure, is in the purview of state governments. They must act effectively to give it the required strength.

The Committee has addressed a number of related issues and processes, as per its mandate. Its overall brief as well as its recommendations, however, have all been guided by one overwhelming concern: the attainment of a dynamic, vibrant agriculture contributing to resurgent rural India. Obviously, its brief was limited to one specific set of inputs and organisations, yet the spirit that pervaded all of the Committee's deliberations and recommendations stems from overarching objective.

1

STRUCTURAL AND ORGANISATIONAL CHANGES IN AGRICULTURE

Changing Setting of Agriculture Sector

1.1 Most available indicators suggest that India is poised to attain a high rate of growth. Sustaining the momentum of growth, however, would critically depend on sustaining agricultural growth. Although the share of agriculture in the gross domestic product declined from 46.3 per cent in 1970-71 to 22.2 per cent in 2003-04, the proportion of workforce depending on it has remained unchanged. It still provides livelihood to about two-thirds of the country's population and is the single largest occupation. It also contributes about 14.7 per cent of the export earnings and provides raw material to a large number of industries.

1.2 Agriculture also includes allied activities such as horticulture, animal husbandry, dairy and fisheries, which have an important bearing on the overall economic growth as well as the health and nutrition of the masses. Agriculture is the largest user of land and water. Therefore, sustainable and balanced development of agriculture is a pre-condition for ecological conservation.

Ongoing Changes in Agriculture Sector

1.3 The important changes that have occurred in Indian agriculture include, among others:

i. *Greater Share of Allied Activities*: The share of allied activities in agriculture, mainly dairying, fisheries and poultry, has been increasing. The share of livestock in gross value of agriculture (crop *and* livestock production) increased from under 16 per cent in 1970-71 to 26 per cent in 1995-96, while that of fisheries went up from 1.7 per cent to 3.1 per cent in the same period. This growth could be attributed to the increase in per capita income and consequent changes in the composition of food intake;

ii. *Shift in Crop Composition*: First, the share of non-food crops in the cropped area has increased. It was 25.7 per cent in the triennium ending 1971-72 and went up to 35.1 per cent by 1999-2000. Second, commercial food crops such as sugarcane, oilseeds, spices and condiments, fruits and vegetables, have become more important. Third, the share of superior cereals (rice, wheat) in foodgrains has been increasing. Thus, the trend is clearly towards cultivating higher value crops, indicating the growing market orientation of agriculture;

iii. *Increasing Importance of Non-land Inputs*: The share of purchased items in inputs used has increased significantly, indicating modernisation of Indian agriculture. This has strengthened its backward linkage to industry, through the higher demand for manufactured inputs;

iv. *Marginal and Small-holding Dominance*: The latest figures show that nearly 36 per cent of agricultural land is now owned by small (19 per cent) and marginal (17 per cent) farmers. Further, the land cultivated in the small and marginal holdings is progressively increasing. While land owned and cultivated by medium holdings has remained stable, land owned and cultivated by larger owners has progressively declined. Institutional, technological and demographic factors are responsible for this change in the agrarian structure;

v. *Challenge of Marketing*: Increasing commercialisation and globalisation of agriculture requires efficient and cost-effective channels to transport produce, adequate physical infrastructure such as warehousing and market complexes, and credit support to producers. Credit needs will further increase for the development of market infrastructure.

Future Directions and Challenges

1.4 The future of Indian agriculture depends on both domestic agriculture policy as well as the changing course of globalisation. The National Agriculture Policy (NAP, 2002) seeks to actualise the vast untapped growth potential of Indian agriculture, strengthen rural infrastructure to support faster agricultural development, promote value addition, accelerate growth of agro-business, create employment in rural areas, secure a fair standard of living for farmers and agricultural workers, discourage migration to urban areas and face the challenges arising out of economic liberalisation and globalisation. Over the next two decades, it envisages attaining:

- Agriculture growth rate of over 4 per cent per annum;
- Growth based on efficient use of resources and simultaneous conservation of soil, water and bio-diversity;
- Equitable spread of growth across regions and classes of farmers;
- Domestic/export market-driven growth, meeting challenges from economic liberalisation and globalisation and deriving benefits from them.
- Growth that is sustainable technologically, environmentally and commercially.

1.5 Three important provisions of the WTO agreements, i e lower trade barriers, increased market access, and reduction in aggregate measure of support (AMS) have major implications for Indian agriculture. India could increase its share in world trade by directing its agricultural production towards high value and hi-tech crops. This acceleration in agriculture exports depends on identifying products in which India has a comparative advantage. Institutional credit will also play an important role.

Evolution of Rural Credit Delivery System

1.6 Credit has been considered not only as one of the critical inputs to agriculture, but also an effective means of economic transformation. A large number of agencies, including co-operatives, regional rural banks (RRBs), commercial banks, non-banking financial institutions, self-help groups and widespread informal credit outlets together comprise the Indian rural credit delivery system. They act not merely as financial intermediaries but also play a key developmental role. The Rural Credit Survey Committee Report (1954) and acceptance of its recommendations, nationalisation of major commercial banks (1969 and 1980), establishment of RRBs (1975), establishment of National Bank for Agriculture and Rural Development (NABARD) in 1982 and the on-going financial sector reforms since 1991 are the milestones in the evolution of the rural credit system. Several initiatives, such as the Kisan Credit Card (KCC), Special Agricultural Credit Plans, Rural Infrastructure Development Fund (RIDF), etc have been taken up to increase the flow of credit to agriculture. The phenomenal growth of Self-Help Groups (SHGs) since the 1990s is a major development.

Present Status

a. Quantitative Aspects

1.7 The Tenth Five-year Plan projects a credit flow of Rs 7,36,570 crore to agriculture and allied activities. The estimated actual flow of credit to agriculture from formal rural financial institutions (RFI) during the first year of the Tenth Plan (2002-03) was, however, Rs 69,560 crore or 84.8 per cent of the projected Rs 82,073 crore (Table-1.1). This was despite the extensive outreach of rural and semi-urban branch network of commercial banks (about 33,000), co-operative banks (about 1 lakh) and RRBs (about 14,000). Therefore, there is an urgent need to accelerate the flow of credit to agriculture. This is a formidable challenge.

Table 1.1: Agency-wise Ground Level Credit Flow for Agriculture and Allied Activities

Rs crore

Agency/Year	1997-98	1998-99	1999-2000	2000-01	2001-02*	2002-03*
Co-operative Banks	14,085	15,957	18,260	20,718	23,524	23,636
Regional Rural Banks	2,040	2,460	3,172	4,220	4,854	6,070
Commercial Banks	15,831	18,443	24,733	27,807	33,587	39,774
Other Agencies	-	-	103	82	80	80
Total	**31,956**	**36,860**	**46,268**	**52,827**	**62,045**	**69,560**

Source: **NABARD Annual Report, 2002-03**; * NABARD data

b. Qualitative Aspects

1.8 Globalisation and deregulation of financial institutions have thrown up new challenges and opportunities. Indian agriculture must possess greater export orientation and aim at higher value addition to thrive in the globalised situation. This in turn calls for augmenting primary resources of land and water with appropriate farm machinery and structures, additional and better quality purchased inputs and more efficient post-harvest facilities. All these will require a higher credit flow, and equally importantly, changes in qualitative dimensions of credit delivery. Capabilities of the institutional credit delivery channel will be severely tested in funding farmers at the extremes of the spectrum, the small and marginal holdings accounting for over a third of the production base, and the large and enterprising ones. Credit requirements of the various segments of producers have specific characteristics of content, scale, timing, mode of payment and back-up services. Therefore, meeting them effectively, which depends on the quality of credit delivery systems of the various institutions, will determine their competitiveness under a deregulated financial regime.

The Present Committee

1.9 Reserve Bank of India has now constituted an Advisory Committee on flow of credit to agriculture and allied activities in an accelerated manner under the chairmanship of Professor V S Vyas, with the following Terms of Reference:

- To assess the progress made in implementation of the recommendations of the Expert Committee on Rural Credit (Vyas Committee) appointed by NABARD in August 2000;

- To suggest measures to reduce the rate of interest on agriculture credit given by Commercial, Co-operative and Regional Rural Banks;

- To examine the role of NABARD as the apex institution for providing and regulating credit for the promotion and development of agriculture and the role of Regional Rural Banks (RRBs) in purveying agricultural credit and suggest measures for improving the same without sacrificing overall viability considerations;

- To study the role and effectiveness of the RIDF mechanism and suggest ways to improve the same, or to suggest alternatives, with a view to increase direct agriculture lending;

- To identify the impediments in the flow of credit to the disadvantaged sections such as small and marginal farmers, tenant farmers, oral lessees and landless labourers and suggest measures to be taken by banks for providing financial assistance to them;

- To suggest short-term and medium-term measures to improve the flow of credit to agriculture, with particular emphasis on:

- ♦ Direct financing of farmers based on linkages for supply of inputs and sale of outputs and institutional and procedural arrangements required therefor;

- ♦ Scope for involving innovative location-specific catalytic agents to bridge the gap between the demand and supply of timely credit in rural areas;

- ♦ The problems faced by banks in extending their outreach;

- ♦ The need to modify the Service Area Approach; and

- ♦ Feasibility for harnessing new technological developments in smoothening the process of credit delivery to the rural and agricultural sector.

- ➢ To study the role of micro finance in poverty alleviation and adoption of the Self-Help Group (SHG) approach in extending banks' outreach to the disadvantaged sectors;

- ➢ To examine the need to regulate micro finance institutions and to suggest appropriate regulatory model;

- ➢ To examine the norms relating to NPAs in cases of crop failure where seasonality and uncertainty are not captured.

1.10 The Committee comprised the following:

Chairman
Professor V S Vyas, Professor Emeritus, Institute of Development Studies, Jaipur

Members:
Shri J N L Srivastava, IAS (Retd), Former Secretary, Agriculture, GoI
Dr N Mohan Kumaran, Former Director of Research, Kerala Agriculture University
Dr Sardar Singh Johl, Former Vice Chancellor, Punjab Agriculture University
Shri P S Shenoy, Chairman and Managing Director, Bank of Baroda
Shri K R Ramamoorthy, Former Chairman and Managing Director, Corporation Bank
Dr B Samal, Former Chairman and Managing Director, Allahabad Bank

Permanent Invitees:
Smt Ranjana Kumar, Chairperson, NABARD,
Shri Vepa Kamesam, former Deputy Governor, Reserve Bank of India

1.11 Rural Planning and Credit Department (RPCD), Reserve Bank of India, provided the Secretariat to the Committee. NABARD also contributed senior personnel to the Committee Secretariat. Dr Amarendra Sahoo, Shri R N Dash, Shri P K Nayak, Shri R Sudeep and Shri D G Nalawade from the Reserve Bank and Dr B N Kulkarni and Shri H R Dave from NABARD were the members of the Secretariat.

1.12 The Committee in its second meeting held on February 24, 2004 clubbed various terms of reference in the following five broad categories:

- Revisiting the definition of NPAs in agriculture and priority sector norms;
- Expanding flow of agricultural credit and outreach, and the Service Area Approach;
- Recommending measures to reduce rates of interest on agricultural credit and possible use of information technology;
- Identifying impediments in the flow of credit to disadvantaged sections, micro finance, etc;
- Defining roles of NABARD as apex development bank, RIDF and RRBs.

1.13 The Committee called for written views from various stakeholders of the credit system through press releases and also through the websites of the Reserve Bank and NABARD. It requested inputs from various organisations and persons including federations of commercial banks, state co-operative banks, state agriculture and rural development banks and NBFCs, Federation of Sugar Co-operatives, micro-finance networks and office bearers of RRB staff associations. It also held in-depth interactions with officials of Ministries of Finance, Agriculture and Co-operation, Rural Development and Food Processing, Government of India. Discussions with some of the past heads of NABARD also contributed greatly to the Committee's deliberations.

1.14 The Committee made specific visits for consultations with stakeholders of 18 states (Andhra Pradesh, Assam, Bihar, Chhattisgarh, Delhi, Gujarat, Haryana, Himachal Pradesh, Jharkhand, Karnataka, Kerala, Maharashtra, Meghalaya, Orissa, Punjab, Rajasthan, Uttar Pradesh, and West Bengal). Committee members interacted with the chief secretaries and senior officials of state governments, SLBCs, major commercial banks, co-operative banks, RRBs, NGOs and micro-finance institutions, members of SHGs, prominent economists and opinion leaders during these visits on various matters arising from its terms of reference.

Organisation of the Report

1.15 This Report comprises nine sections. Issues arising from mandated levels of lending to agriculture are discussed in the immediately following section. The outreach of rural financial institutions and measures to expand it are discussed in Section 3. Cost of credit to rural borrowers and ways of reducing it are presented next. The impact of prudential norms of banking, specifically concerning NPAs, is discussed in the next section. Analysis of issues involved in the reach of credit to the disadvantaged and vulnerable sections of the society and recommendations in this regard follow. The position of the regional rural banks and ways of strengthening them form the subject of Section 7. The role and contribution of NABARD to the entire rural credit system is the focus of the next section. The concluding section is devoted to the subject of Rural Infrastructure Development Fund (now renamed Lok Nayak Jai Prakash Narayan Fund).

1.16 The Committee and its Secretariat examined and analysed voluminous data. This Report contains only the most relevant of these and presents them in a concise manner. Longer tables are presented as annexures. The Committee's inferences, conclusions and recommendations are presented in bold face.

2

INCREASING FLOW OF CREDIT TO AGRICULTURE: MANDATORY LENDING BY SCHEDULED COMMERCIAL BANKS

Targets, Shortfalls and RIDF

2.1 Domestic scheduled commercial banks are required to meet a target of 18 per cent of net bank credit for lending to agriculture under the system of directed lending. There is a further stipulation that indirect lending should not exceed 4.5 per cent of net bank credit or one-fourth of credit target of 18 per cent, to ensure that banks concentrate on the direct advances to agriculture. Indirect finance to agriculture in excess of 4.5 per cent of net bank credit is, however, taken into account while reckoning banks' total priority sector lending.

2.2 Although most public and private sector banks did not meet this target, advances to agriculture in absolute terms have steadily increased over the years:

Table 2.1: Outstanding Credit to Agriculture by Public and Private Sector Banks

Rs crore

	March 1994	March 2003	Annual Compounded Growth Rate (%)
Public sector banks			
Net bank credit	1,40,914	4,77,899	14.5
Total agri advances outstanding	21,204	73,507	14.8
Direct agri advances	19,256	51,799	11.6
Indirect agri advances	1,949	21,708	30.7
Private sector banks			
Net bank credit	9,545	71,761	25.1
Total agri advances outstanding	591	11,873	39.6
Direct agri advances	515	5,201	29.3
Indirect agri advances	76	6,671	64.4

Source: RPCD, RBI

2.3 Banks which failed to meet the target for advances to priority sector / agriculture have contributed an amount based on their shortfall to the Rural Infrastructure Development Fund (RIDF) established with NABARD since 1995-96. The nine tranches of RIDF to date have generated an aggregate corpus of Rs 34,000 crore. RIDF is used to assist state governments in quick completion of ongoing rural infrastructure projects. Cumulative sanctions and disbursements under RIDF amounted to Rs 34,678 crore and Rs 21,067 crore respectively till the end of March 2004. Completion of projects under RIDF is expected to improve the credit absorption capacity in the areas concerned and provide infrastructure support for agricultural production and development. The Committee's observations relating to RIDF/Lok Nayak Jai Prakash Narayan Fund are placed in Section 9 of this Report.

2.4 The target of 18 per cent of net bank credit for lending to agriculture was introduced in 1989 and banks were required to meet it by March 1990. Agricultural credit of the entire banking system, however, has not so far reached the level of 18 per cent. Private sector banks were also asked to meet the target of 18 per cent of net bank credit for lending to agriculture in 2001 within the next two years. The time frame was extended subsequently to public sector banks. Reserve Bank advised banks to step up their priority sector lending (including agriculture) so as to reach the stipulated targets by March 2003. Table 2.2 shows that many banks were yet to reach the required level by March 2003.

Table 2.2: Number of Banks Achieving Target for Agricultural Credit

As of last reporting Friday	**Public Sector Banks**		**Private Sector Banks**	
	On target	*Off target*	*On target*	*Off target*
March 2001	4	23	1	30
March 2002	6	21	2	29
March 2003	5	22	2	27

Source: RPCD, RBI

2.5 Agriculture received indirect finance from public and private sector banks to the extent of 4.5 per cent and 8.6 per cent of their net bank credit respectively. New private sector banks have lent more (12.1 per cent) than the older ones (4.5 per cent), raising the figure for *all* private sector banks (all figures as on the last reporting Friday of March 2003).

Special Agricultural Credit Plans (SACP)

2.6 As instructed by Reserve Bank, Public sector banks have been formulating Special Agricultural Credit Plans (SACP) since 1994-95 as a means of achieving marked improvement in the flow of credit to agriculture. Under SACP, banks are required to fix for themselves targets for disbursement during a year (April-March). Reserve Bank has advised banks to fix targets that are about 20 to 25 per cent higher than the disbursement of the previous year. Under SACP, the credit to agricultural sector by public sector banks increased from Rs 10,172 crore in 1995-96 to Rs 33,921 crore in 2002-03.

Table 2.3: Disbursement of Credit to Agriculture under SACP

Rs crore

Year	Production Credit	Investment Credit	Total Direct Lending	Indirect Lending	Total Disbursement
1995-96	4,951	4,040	8,991	1,182	10,172
1996-97	6164 (24.5)	4,896 (21.2)	11,061 (23.0)	1,721 (45.7)	12,782 (25.6)
1997-98	7,299 (18.4)	5,373 (9.7)	12,672 (14.6)	2,136 (24.1)	14,808 (15.8)
1998-99	8,204 (12.4)	6,063 (12.9)	14,267 (12.6)	3,521 (64.8)	17,787 (20.1)
1999-2000	9,903 (20.7)	6,120 (1.0)	16,023 (12.1)	5,890 (67.3)	21,913 (23.2)
2000-01	11,615 (17.3)	6,818 (1.1)	18,433 (15.0)	6,221 (5.6)	24,654 (12.5)
2001-02	15,385 (32.5	7,288 (6.9)	22,673 (23.0)	6,659 (7.0)	29,332 (18.0)
2002-03	18,319 (19.1)	7,831 (7.5)	26,150 (15.3)	7,771 (16.7)	33,921 (15.6)

Figures in brackets indicate year-on-year growth rates.

Source: *RPCD, RBI*

Recommendations of Earlier Committees

a. *High Level Committee on Agricultural Credit through Commercial Banks (R V Gupta Committee)*

2.7 The committee noted that the target of 18 per cent for lending to agriculture was fixed when the reserve requirements were 63 per cent. Due to the progressive reduction of the reserve requirements over the years, the total lendable resources of banks have increased substantially. The committee estimated that the base on which the target of 18 per cent was calculated had doubled; thus, the banks would have to double their lendings to agriculture just to maintain the same share in conditions where agricultural production itself was growing at 2.1 per cent per annum.

2.8 The committee also noted that the system of fixing targets on outstandings had its drawbacks; outstandings decrease with improved recoveries, as was the case between 1991 and 1995, when recoveries went up from 48.8 per cent to 59.5 per cent. The combined effect of improved recovery and write-offs was to reduce the share of net lending to agriculture without actually slowing the pace of lending to the sector.

2.9 Hence, the committee suggested that banks should set targets for themselves for agricultural lending based on the flow of credit. They needed to prepare Special Agricultural Credit Plans (SACP), with Reserve Bank indicating every year the expected increase in the flow of credit over the previous year. The committee felt that once such special plans were in place, the 18 per cent target based on outstandings would cease to have much relevance.

2.10 Despite monitoring of credit through SACP, the target of 18 per cent has not been reached. Various parliamentary committees have time and again criticised banks for not achieving the target and demanded punitive actions against banks that fail to reach the stipulated level.

b. *Expert Committee on Rural Credit (Vyas Committee)*

2.11 The committee appointed by NABARD recommended in July 2001 that the mandated rates of 18 per cent of credit outstanding for agricultural loans and 40 per cent for priority sector loans should be reviewed after five years. It projected Indian agriculture to undergo substantial structural and other changes in this period; these experiences would be the base for a more realistic reappraisal of credit requirements.

2.12 It also recommended a substantial reduction in RIDF interest rates to levels just enough to cover the interest cost of deposits. This would make RIDF deposits economically unattractive to banks and spur them to achieve agricultural lending targets, with higher margins to cover transaction costs and provide reasonable profits.

2.13 The committee suggested retaining the upper limit of 4.5 per cent on indirect credit while reckoning the achievement of 18 per cent target for agricultural lending. The entire indirect credit, however, may be taken into account for meeting priority sector lending obligations, in view of the importance of components of indirect advances.

2.14 Although Reserve Bank has not formally reviewed agriculture credit targets in the intervening period, it has regularly advised banks to take steps to achieve the level of 18 per cent in a time-bound manner. RIDF interest rates have been restructured; the interest rates on deposits of RIDF-IX operationalised in 2003-04 vary between Bank Rate and Bank Rate minus 3 percentage points (i e 6 per cent and 3 per cent, on the basis of the current Bank Rate of 6 per cent). The 4.5 per cent ceiling on indirect credit remains in force.

Assessment of Mandatory Lending

2.15 The Committee members received several suggestions regarding mandatory lending during their field visits to various States. Banks and other agencies also sent their views on the issue to the Committee. The suggestions range between having *no* target at all to linking the target to the share of agriculture in the GDP. The Committee has examined all of them. It notes that the stipulation of *any* target imposes an obligation on banks to lend a part of their total credit to the agriculture sector. The Committee also notes and addresses in the following sections difficulties faced by banks in achieving the target of 18 per cent, particularly in the context of a faster growth in the quantum of net bank credit, the demand constraints and the cap on indirect finance to agriculture for reckoning banks' performance against the stipulated target.

2.16 Certain quarters have suggested linking the target to disbursements rather than outstanding advances. Some have even advocated that moving forward, the banking system's support to overall rural development must be evaluated and in that context all lending by a rural branch of banking system must be captured rather than a limited segment of the economic activity. The Committee is heartened to note that all major actors in the financial system concur that they have to play a pro-active role in stepping up the flow of credit to rural masses in a cost-effective manner, lest the rural-urban divide further widens. **The Committee observes that fixing targets on the basis of disbursements would not establish a link between the total advances of a bank and its lending to agriculture. The Committee also feels that the entire issue of fixation of targets for lending to the priority sector including agriculture needs a comprehensive review. Pending such a review, the existing target of 18 per cent of net bank credit for lending to agriculture should continue.**

2.17 SACP provides an additional mechanism for credit planning and monitoring at the bank level. This being based on disbursements during a year rather than on outstanding, is a good supplementary indicator of the bank's lending to agriculture. **This system may be continued**

and may also be made applicable to private sector banks, which are treated on par with public sector banks in matters relating to priority sector lending.

2.18 **Reserve Bank may continue to monitor performance of banks under SACP and indicate the expected growth rate in disbursements over the previous year. The Committee feels that the efficacy of these plans can be better evaluated in the context of direct lending to agriculture and recommends that the framework of SACP may be restricted to direct lending to the agriculture sector, comprising both production as well as investment credit, while banks could have their own separate review mechanism for indirect lending to agriculture.**

2.19 Indirect finance to agriculture includes lending to various intermediary agencies assisting the farmers, as also investment in special bonds issued by NABARD and the Rural Electrification Corporation (REC). It also includes deposits placed by banks in RIDF. The annual growth rate of indirect lending as reported under SACP by public sector banks has ranged between 5.6 and 67.3 per cent. For the last three years, however, the growth of this segment has also slowed, with the 2002-03 growth being 16.7 per cent.

2.20 **The Committee is of the view that the existing system of relating interest rates on deposits placed in RIDF (now renamed Lok Nayak Jai Prakash Narayan Fund) inversely to the shortfall in agricultural lending is adequately punitive. Banks with higher shortfalls earn lower rates of interest, which could be less than their cost of funds.**

2.21 The Committee has examined various issues relating to direct lending to agriculture by the scheduled commercial banks. It feels that both direct as well as indirect lending to the sector need to increase for agricultural production to improve substantially. Indirect lending is important for improving current credit absorption capacity, adding to it and expanding the outreach of banks. The Committee also, however, recognises that indirect lending needs to be subject to certain limitations, lest banks neglect direct finance for agricultural production, which may jeopardise the goal of achieving annual growth of 4 per cent in agricultural production. **In view of the operational difficulties experienced by banks in expanding direct credit to agriculture, and the time required for their resolution,** t**he Committee would like to provide road maps for public and private sector banks which would enable them to reach the required level of direct lending within four years.**

2.22 **All public and private sector banks should increase their direct lending to agriculture to 12 per cent of net bank credit in the next two years and to 13.5 per cent in the two years thereafter. Banks that have already reached this level may at least continue to maintain the position; it would be best if they would further improve their direct**

lending. While planning to achieve the target for credit to agriculture, banks should also take into account the likely spurt in credit towards the end of the financial year.

2.23 **Indirect lending to agriculture may be reckoned to the extent of 6 per cent in the first two years for assessing banks' performance against the 18 per cent target. Thereafter, the ceiling of 4.5 per cent should apply.**

2.24 The Committee would, however, like to make it clear that banks have the option - and some of them are already exercising this - to lend indirectly to agriculture in excess of the proposed ceiling. Lending in excess of this ceiling may continue to qualify for meeting the overall priority sector lending target of 40 per cent.

2.25 Small and marginal farmers are among the weaker sections in the scheme of priority sector lending. They account for about 80 per cent of the total number of holdings and 36 per cent of the total area. Small and marginal farmers need additional credit support for intensive cultivation, introduction of high value crops and allied activities. Actual disbursements to small and marginal farmers were 26.7 per cent of total disbursements under SACP in 2002-03. **The Committee feels that the share of small and marginal farmers in agricultural credit should be commensurate with their holdings and credit needs. It therefore recommends that credit to small and marginal farmers should be progressively raised to 40 per cent of disbursements under SACP by the end of the Tenth Plan period.** Under SACP, Reserve Bank already collects from banks data on disbursement to small and marginal farmers; hence, there would be no added data reporting requirement.

2.26 At present, loans for construction and running of storage facilities (warehouse, market yards, godowns, silos and cold storages) in producing areas are treated as indirect finance to agriculture. Further, loans to cold storage units which are mainly used for hiring out are treated as indirect agricultural advances, provided they are in rural areas and not registered as SSI units. **The Committee feels that reckoning units only in the producing areas/rural areas for bank finance under priority sector restricts the flow of credit for building up such facilities. It recommends that the stipulation regarding location of the storage units be removed, subject to these units storing mainly agricultural products.**

2.27 With increasing emphasis on securitisation of assets, banks have the option of purchasing securitised loans from other banks/companies. At present, such investments by banks are not reckoned for the purpose of computing their priority sector lending. **The Committee feels that banks' investments in securitised assets comprising wholly of direct advances to agriculture may be treated as their direct lending to agriculture under the priority sector. Similarly, if the securitised assets represent indirect finance to agriculture, the investment in such assets may be treated as indirect finance to agriculture.**

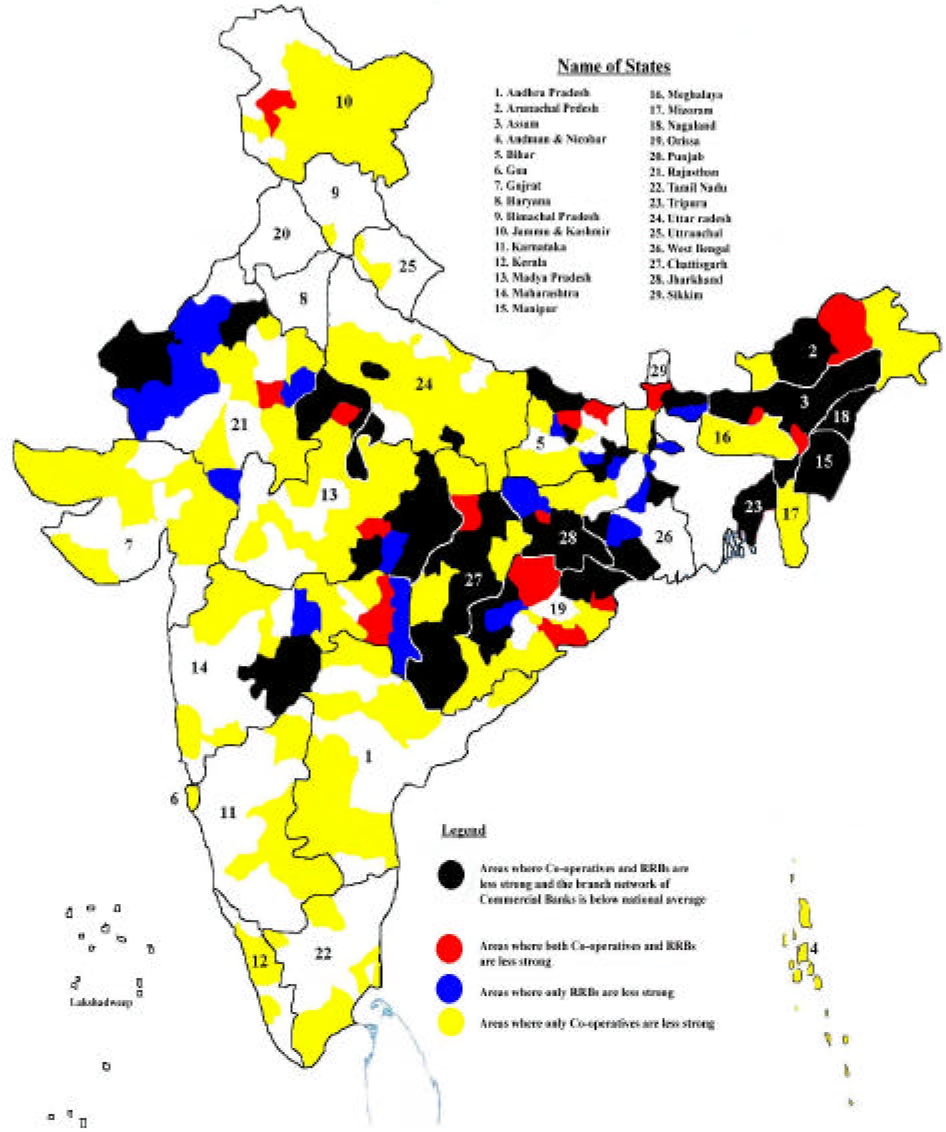
3

EXPANDING RURAL OUTREACH OF BANKS

3.1 Despite its declining share in GDP, agriculture continues to be an important sector of the Indian economy. The National Agriculture Policy 2002 envisages that agriculture growth has to exceed 4 per cent a year to attain a 7 per cent overall growth rate. Both production credit and capital formation in agriculture have to be accelerated to achieve this growth rate.

3.2 Commercial banks, co-operative banks and regional rural banks (RRBs) are the main providers of agriculture credit at present under the multi-agency approach. They have established an impressive branch network over time: about 47,000 branches of scheduled commercial banks (including RRBs) and over 1,00,000 co-operative outlets in rural and semi-urban areas. Even so, the outreach of banks has remained restricted for various reasons which is caused by a weak credit delivery structure. Large parts of states such as Orissa, Chhattisgarh, Jharkhand, Bihar, West Bengal, most of the North-east and parts of Maharashtra are handicapped by weak RRBs and co-operatives in addition to branch network of commercial banks that is below the national average. The co-operative credit structure shows weaknesses in most other states except Punjab, Haryana, Himachal Pradesh and Uttaranchal see Fig

3.1).



Presence of less strong rural financial institutions in various states of India

3.3 Though the ratio of agricultural credit to agricultural GDP increased from 5.4 per cent in the 1970s to 8.7 per cent in 2001-02, the share of agricultural credit in total credit declined from 20.5 per cent to 10.5 per cent in the period (Table 3.1). This trend seems to be going counter to the changes in agriculture mentioned earlier, which would normally be more capital and credit intensive.

Table 3.1: Ratio of Agricultural Credit to Agricultural GDP and Total Credit

Period	Agricultural Credit as % of Agricultural GDP	Agricultural Credit as % of Total Credit
1970s	5.4	20.5
1980s	8.3	20.1
1990s	7.4	14.4
2001-02	8.7	10.5

Source: **Handbook of Statistics on Indian Economy, 2002-03,** RBI

Trends in Institutional Credit to Agriculture

3.4 The following paragraphs summarise important changes in the provision of credit to agriculture that have occurred in the last three decades:

i. *Increasing Share of Commercial Banks*: The flow of direct institutional credit to agriculture and allied activities increased sharply from Rs 744 crore in 1970-71 to Rs 9,829 crore in 1990-91, at a growth rate of 7.6 per cent a year, mainly due to the increased participation of scheduled commercial banks (SCBs) in agriculture credit after the bank nationalisation of 1969. It further increased to Rs 41,385 crore in 2001-02. The share of co-operatives dropped to 44 per cent in 2001-02 from 98 per cent in 1971-72, although their lending increased six-fold in absolute terms, while that of SCBs rose considerably from 2 per cent to 45 per cent in this period. RRBs, in existence since 1975-76, account for 11 per cent.

ii. *Differential Growth of Crop Loans and Investment Credit*: Banks provide two types of credit, short-term for seasonal agricultural operations and long-term for creation of assets. The decadal growth rate of short-term credit by all agencies together remained nearly unchanged at about 14 per cent through the last three decades, while the growth of long-term credit slowed down from about 20 per cent in the 1970s to about 12 per cent in the 1990s (Table 3.2). This deceleration of growth of investment credit, more pronounced in case of commercial banks, impairs agricultural borrowers' credit absorption capacity. It would eventually affect the growth of crop loans as well.

Table 3.2: Decadal Average Growth Rates of Direct Institutional Credit to Agriculture

Period	Co-operatives		RRBs		Commercial Banks		Total	
	Short-term	Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	Long-term
1970s	10.6	13.9	334.8	426.8	28.2	29.9	14.5	20.2
1980s	12.5	11.0	19.8	18.5	16.3	18.6	13.9	14.8
1990s	11.9	13.1	32.7	10.6	17.8	12.1	14.6	11.9

Source: **Handbook of Statistics on Indian Economy, 2002-03**, RBI

iii. *Regional Disparities in Credit Disbursement*: There are also significant regional disparities in the disbursement of agriculture credit**.** The southern region continues to account for the bulk of agriculture credit disbursed, followed by the northern, western and central regions. The share of the North-east continues to remain abysmally low (See Appendix Table).

iv. *Declining Share of Small Farmers*: Although small farmers with landholdings up to 1 ha held the bulk of the accounts with SCBs (excluding RRBs), their share of the total disbursement was only one quarter between 1980-81 and 2000-01. Larger farmers, on the other hand, accounted for a fourth of the total number of accounts and nearly half the total amount disbursed. Both the number of accounts of small farmers and credit disbursed to them declined. Banks appear to have reduced their exposure to such accounts to improve their profitability, since large numbers of small borrowing accounts tend to increase their transaction costs.

New Opportunities

3.5 To sum up, the pace of credit disbursement to agriculture is slowing, regional imbalance seems to be widening and the share of small farmers is declining. The new and emerging opportunities for increasing the flow of credit to agriculture, some of which are listed below, must be seen against this backdrop.

i. *Integrating Investment and Production Credit***:** Farmers use credit for various activities, such as crop cultivation, purchase or replacement of tractors and farm equipment, digging/deepening wells, installing diesel pump sets or electric motors, laying cement pipelines/field channels and drip/sprinkler irrigation system, construction of farm sheds, purchase of produce transport vehicles, dairy animals and so on. **Banks can expand the flow of farm credit significantly if they were to consider total credit needs of cultivators**. **There is, therefore, a need to integrate investment and production credit.**

ii. *Raising Scale of Finance*: Banks presently use the scale of finance suggested by the district level technical committees as the criterion, although it is meant only to be indicative. **Scales of finance, therefore, need to be reviewed and revised to meet credit needs of more capital intensive agriculture, using newer technologies and superior inputs.**

iii. *Strengthening Linkages between Production, Marketing, Post-harvest activities*: ECRC had noted in 2001 an imbalance between financing production and post-harvest operations, as also poor linkages between credit and marketing, leading to insufficient business development for rural financial institutions (RFIs). The situation has not improved since then. A more balanced approach to crop production and post-harvest operations will open up new opportunities. The Expert Committee on Strengthening and Developing Agricultural Marketing and Marketing Reforms (Shankar Lal Guru Committee) and the Inter-ministerial Task Force have identified areas such as contract farming, private market yards, public-private partnership etc, for integration of farmers' production with domestic and global markets. These measures would enable farmers to access markets beyond local *mandi*s and help promote competitive private and co-operative agricultural markets. **There is also a need for stepping up pledge financing, credit for marketing and introduction of negotiable warehousing receipt system.**

iv. *Strengthening Production Bases of Land and Water*: Land productivity needs to be raised and water resources for agricultural development enhance through increased public investment in land rejuvenation, irrigation and water management. In these activities, the importance of private capital formation is progressively increasing. **They offer banks immense scope to step up their credit disbursement.**

v. *Reclamation of Waste/fallow Lands*: India has about 24.5 million ha of wasteland and 16.6 million ha of fallow land. Sizeable parts of these could be converted into cultivable land through appropriate crop selection, improved water-use efficiency, adoption of watershed approach and development of irrigation potential. **State governments and the banking sector could prepare a long-term plan to develop these resources to make them productive for strengthening the rural economy. Investments in such resource development may be treated as an integral part of agriculture lending.**

vi. *Credit Expansion in Drought-prone Areas*: Recurrence of droughts in one or the other regions hinders progress of rural areas and flow of credit to them. Schemes such as i. micro irrigation, ii. sprinkler irrigation, iii. watershed management, iv. village ponds development, v. farm ponds promotion, vi. dry land farming, which could be jointly implemented by the states and the banking sector, offer scope for softening the impact of drought, if not allow a degree of drought-proofing.

vii. *Hi-tech Agriculture and Precision Farming*: Only a few commercial banks have lent to high technology, capital-intensive, export-oriented agricultural projects in the recent past. Some banks have also opened a few specialised hi-tech agriculture branches for financing such projects/schemes. Their experience in this respect is not particularly encouraging as projects, especially aquaculture and floriculture ones, have failed. Nevertheless, several small and medium sized hi-tech projects are proving good business for banks. Therefore, the reported failures in this area need to be analysed in depth to overcome possible weaknesses. With proper credit appraisal and introduction of appropriate management systems, such projects/schemes could provide significant financing opportunities for RFIs.

viii *Credit for Farm Mechanisation*: Machinery is becoming increasingly important as an instrument of transformation of agriculture into a diversified and commercial enterprise. **A few banks have entered into tie-ups with major tractor and farm machinery manufacturers for financing them in a cost-effective manner. Other banks could explore such possibilities as well.**

ix. *Value Addition through Processing*: Although India is a leading producer of foodgrains, vegetables and fruits in the world, its performance in the area of processing is abysmal. Only 2 per cent of annual fresh production gets processed for value addition at present. Processing activities need to be expanded and improved to reduce wastage, help producers realise better value for their produce, and improve nutrition of consumers.

x. *Expanding Agricultural Exports*: Under the WTO regime, fresh and processed Indian agricultural commodities could enjoy a more competitive position in international markets, provided they meet accepted international standards. This calls for improved cultivation, post-harvest and processing technologies and consequent investments of higher order. Since some corporate bodies are entering this area, their demand for credit is likely to increase. Banks should exploit this emerging opportunity fully to enhance their credit for agriculture.

Suggested Measures

3.6 Banks need to take up some developmental measures to be able to avail of the new and emerging opportunities:

i. ***Development of Human Resources*****: Staff related issues are the severest impediment in the expansion of the outreach of commercial banks. Rural bank branches are inadequately staffed and the officers frequently transferred. Technical officers conversant with areas such as agriculture, animal husbandry, fishery etc, need to be posted to such branches. ECRC had suggested that commercial banks should post technical staff at their head/controlling offices to interface with concerned government departments, place top level executives in charge of rural credit and effect rural**

posting of officers for a minimum of three to five years. The Committee endorses all these measures. It would also like to emphasise the need for absorbing more agricultural graduates for staffing rural branches of commercial banks. The most important task, however, is to change the mindset of bankers. It needs to be emphasised here that all over the world, retail banking is emerging as a more profitable and less risky proposition. In the Indian context, there is hardly any better avenue for retail lending than agriculture.

ii. *Outsourcing for Greater Outreach*: Approaching a large number of small borrowers spread over an extensive geographical area is always a cost-intensive proposition for the profit-oriented and cost-conscious banking sector. Routine functions such as accepting and scrutinising applications, appraisal, supervision and monitoring of loans, etc are cost intensive. **Financing institutions could outsource some of these functions to other agencies operating at the village level, such as local SHGs, input suppliers, tractor manufacturers, agriculture extension departments of corporate bodies such as HLL, ITC and Mahindra & Mahindra, farmers' clubs, and *panchayati raj* institutions**. Many private and some public sector banks have already adopted this approach for retail lending, especially consumer and housing finance. This has enabled them to attain a greater outreach without increasing the cost in the same proportion.

Organisational Innovations

3.7 Banks should also consider adopting certain innovative ways of functioning:

i. *Hub and Spokes Model*: A nodal branch could act as the hub and points of sale (POS) as spokes. Branch personnel could visit POS for a few hours on two or three days a week to sanction loans. A resource person such as a *sarpanch* or a *panchayat* member could pool and verify applications and present them to bank personnel. Several POS could be affiliated to one nodal branch. Loans would be disbursed at the nodal branch.

ii. *New Channels of Disbursement*: Village school teachers, postmasters and others familiar with borrowers could be used for purveying credit without much paperwork. They would also be well placed to recover dues on time. **Franchising village post offices to route bank credit, as announced in the Budget Speech 2003, would also go a long way towards associating these agencies. NABARD, SBI, etc have taken up such pilot projects in Tamil Nadu. Other commercial banks may like to examine this avenue for credit disbursal.**

iii. *Risk Mitigation through Hedging*: The setting up of National Level Multi Commodity Exchanges (NMCE) is a step towards minimising farmers' market and yield fluctuation risks. Some NMCEs are currently working on pilot projects involving cotton farmers in Punjab, Gujarat, Tamil Nadu and Andhra Pradesh. Participation of commercial banks would facilitate this development. Banks, however, cannot be involved in trading in

commodities under existing regulations. The Committee, therefore, recommends that in view of the urgent need for offering hedging mechanism to farmers, select banks willing to participate in such pilot projects may be exempted from the relevant provisions of Sections 6 and 8 of the Banking Regulation Act, either through an amendment to the Act or by issue of a notification.

Need for Re-examining Legal Provisions

3.8 Certain existing legal provisions and practices need to be recast to help improve credit disbursement as well as recoveries:

i. *Revenue Administration and Records*: Under Securitisation and Asset Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, taking possession of agricultural land for recovery of bank loans is not permitted. **Therefore, revenue authorities and state officials may have to extend their support in collecting dues.** A few states, such as Karnataka, have computerised their land records to help both borrowers and banks. **State governments may also have to legally recognise rights of tenant farmers and sharecroppers, and enter them in official records, which would provide them an access to credit.**

ii. *Changes in Stamp Duties*: In some states, borrowers have to pay a heavy stamp duty to execute documents for availing credit from non-co-operative channels. **Concerned states may consider reducing the stamp duty to bring it on par with that charged on borrowings from co-operative banks**. Co-operatives create a charge on land by filling a simple form without any legal fees. Commercial banks, however, create charge through mortgage of lands, which involves a considerable cost. The notification of mortgage is also at only a few specified centres, which the farmer has to visit on a given date, incurring additional cost. **Governments may consider providing facilities for mortgaging to commercial banks similar to those applicable to co-operatives to reduce or avoid these costs.**

iii. *Capacity Building of Borrowers*: Training some of the unemployed to prepare project profiles, product design, product promotion, pricing, marketing, accounting and acquainting them with bank procedures and formalities, etc could provide them excellent opportunities for profitable self-employment or successful micro enterprises. This would also enlarge the number of potential bank borrowers (see para 3.6 ii. above). Some banks have set up Rural Development and Self-Employment Training Institutes (RUDSETI) in some states for imparting training exclusively to the rural unemployed. Some banks, notably Punjab National Bank, have set up training centres for agricultural producers. The Committee has heard that such measures evoke very good response from farmers and enlarge bank clientele. **Other banks may consider setting up similar institutes in different regions.**

Use of Information Technology

3.9 Developments in information and communications technology could help extend the reach of the banking system. The village information and communications kiosk as a distribution channel has distinct advantage. It could provide information on sources of inputs as also outlets for produce marketing. Communication and information technologies have a major role to play in disseminating information on several aspects of farming, such as organic farming, precision farming, tissue culture, usage of bio-technology, as well as information on market and weather conditions. **A core group of bank and state government officials (with representation from departments of horticulture, agriculture, animal husbandry, etc), together with experts from agriculture universities may be constituted in each state to look into the scope of communication and information technologies in transforming agriculture.**

Procedural Issues

3.10 Procedural modifications in regard to agricultural advances, including simplification of procedures/forms for applications, agreements etc; rationalisation of internal returns of banks; delegation of more powers to branch managers; introduction of composite cash credit limits to agriculturists; introduction of new loan products with savings components; cash disbursement of loans; dispensing with the 'No Dues Certificate'; discretion to banks on matters relating to margin/security requirements for agricultural loans above Rs 10,000 etc were introduced following the R V Gupta Committee recommendations. The Committee observed in its field visits, however, that few banks have complied with these directives and cumbersome procedures persist. Further, several branches of commercial banks insist on unreasonably high margin money or fixed deposits for sanction of loans, sometimes not commensurate with the quantum of loans. Such insistence results in denial of loans even to worthy borrowers who may not have adequate cash/collateral on hand. **Controlling authorities of banks may review these lapses and take steps to rectify the situation.**

3.11 **The Committee suggests that Reserve Bank may advise banks to waive margin/security requirements for agricultural loans up to Rs 50,000 and agri-business and agri-clinics up to Rs 5 lakh**. Present ceilings on lending under priority sector to dealers of agriculture machinery, cattle and poultry feeds and inputs of production may be reviewed in view of the need to enhance the availability of agricultural machinery, implements, inputs etc.

3.12 At present, banks adopt scales of finance based on the use of traditional inputs. They need to be raised to facilitate adoption of new technologies and improved varieties of inputs**. State Level Bankers' Committees may, therefore, review the scales, taking into account current costs of inputs, nature of soils, types of crops raised etc in the respective states and suggest modifications as may be needed.**

Modification of Service Area Approach

3.13 The Committee was asked to comment on the need to modify the service area approach (SAA) in purveying credit in rural areas. The following paragraphs summarise the Committee's views on this subject:

3.14 SAA was introduced in 1989 to help achieve planned and orderly development of rural areas. Several relaxations have been made subsequently to make the system more flexible. Yet the mismatch between credit potential and deployment of credit remains, primarily due to absence of effective local level planning, infrastructure and forward and backward linkages.

3.15 The R V Gupta Committee had recommended significant modifications to SAA, to provide freedom to borrowers and rural bank branches. Some limitations of SAA noted by bankers and other knowledgeable persons are:

i. Borrowers are forced to approach only the service area branch, even if they are not satisfied with quality of its service.

ii. Private sector banks are also required to comply with the target for lending to agriculture. They are not in a position to do so due to both a limited branch network (or even its absence) as well as SAA restrictions.

iii. Some public sector banks have also represented to the Committee that they cannot comply with the target for agricultural lending due to SAA limitations.

iv. Despite Reserve Bank instructions to the contrary, non-service area branches wait for no-objection certificate from the service area branch even beyond 15 days, thereby inordinately delaying provision of finance to agriculturists.

v. In some states, a few branches have been allotted unmanageably large numbers of villages, with the result that branch resources are spread thin and credit needs of certain villages are not adequately served.

3.16 A strong point of SAA is the planning and monitoring mechanism put in place over a period of time. Under the 'bottom-up' approach to credit planning, branch credit plans are aggregated into block-level plans and subsequently into district-level plans. The block level bankers' committees established under the scheme provide a first tier monitoring mechanism, not only for reviewing performance of banks, but also for co-ordinating with local development administration. **These positive features need to be maintained in the modified version, even as there is a case for reviewing SAA.**

3.17 *SAA to be Mandated Only for Government-sponsored Programmes*: In view of the drawbacks listed above, SAA may be dispensed with for lendings outside government-sponsored schemes. This will ensure competition among banks and improve customer service.

3.18 *Format of Village Surveys to be Changed*: The format introduced in 1989 is still in use, even though ground realities have changed over the last 15 years. It needs to be revised to collect information about linkages between credit deployment by banks and non-credit support services required for its proper utilisation.

3.19 *Credit Monitoring and Information System to be Strengthened*: The Committee concurs with the ECRC recommendations of strengthening and wherever necessary, modifying the monitoring mechanism through Service Area Monitoring and Information System (SAMIS). Banks have introduced various new loan products and schemes after the service area approach. **Reserve Bank may factor these in while modifying SAMIS to help monitor credit disbursement under the annual credit plan in a more focused and effective manner.**

3.20 *Lead Bank Scheme to be Reviewed*: The organisational innovation of lead banks at district and state levels was considered the key to planned, orderly all-round development of the rural economy. As such, the lead bank will continue to co-ordinate credit plan preparation, implement poverty alleviation programmes, submit returns under SAMIS etc. The Committee heard from several knowledgeable persons that the current lead bank set up is not adequately equipped in terms of technical and non-technical manpower and other support facilities to be an effective instrument of change. **There is, therefore, a need to review the scheme.**

Annex 3.1

Percentage Share of States in Disbursement of Short- and Long-term Credit for Agriculture and Allied Activities

Region/State	1990-91	1995-96	2001-02
Northern Region	**12.9**	**11.6**	**19.9**
Haryana	2.8	2.2	4.4
Himachal Pradesh	0.2	0.4	0.6
Jammu and Kashmir	0.2	0.1	0.2
Punjab	6.3	5.7	10.4
Rajasthan	3.2	2.5	3.6
Chandigarh	0.1	0.6	0.5
Delhi	0.1	0.1	0.1
North-Eastern Region	**0.4**	**0.4**	**0.5**
Assam	0.2	0.3	0.3
Manipur	0.0	0.0	0.0
Meghalaya	0.0	0.0	0.0
Nagaland	0.0	0.0	0.0
Tripura	0.0	0.0	0.1
Arunachal Pradesh	0.0	0.0	0.0
Mizoram	0.0	0.0	0.0
Eastern Region	**8.3**	**6.4**	**7.4**
Bihar	2.4	2.0	2.2
Jharkhand	0.0	0.0	0.4
Orissa	3.0	1.5	1.0
Sikkim	0.0	0.0	0.0
West Bengal	2.8	2.9	3.8
Andaman & Nicobar Islands	0.0	0.0	0.0
Central Region	**16.9**	**16.4**	**14.1**
Madhya Pradesh	7.5	9.0	3.9

Chhattisgarh	0.0	0.0	0.5
Uttar Pradesh	9.4	7.5	9.3
Uttaranchal	0.0	0.0	0.5
Western Region	**13.6**	**17.1**	**14.4**
Gujarat	5.1	9.8	7.2
Maharashtra	8.3	7.0	7.1
Daman & Diu	0.0	0.0	0.0
Goa	0.1	0.3	0.1
Dadra & Nagar Haveli	0.0	0.0	0.0
Southern Region	**47.9**	**48.0**	**43.8**
Andhra Pradesh	14.5	15.5	13.5
Karnataka	6.3	8.8	9.7
Kerala	8.2	6.2	5.5
Tamil Nadu	18.6	17.1	14.9
Pondicherry	0.3	0.3	0.3
Lakshadweep	0.0	0.0	0.0
All-India	**100.0**	**100.0**	**100.0**

Source RPCD, RBI

4

REDUCING COST OF CREDIT TO AGRICULTURAL BORROWERS

Introduction

4.1 Interest rate is an important determinant of cost to agricultural producers; it will become even more important as backward and forward linkages are strengthened. The Committee has, however, come to the conclusion that in the present circumstances, a mandated rate of interest will affect different RFIs in dissimilar ways, most of them adverse. At the same time, the Committee feels that several measures to reduce costs of funds, transactions and risks, could lower the cost to borrowers without impairing viability of RFIs, if properly implemented.

4.2 Commercial banks' interest rates on agricultural loans are linked to the size of the loan. As per current Reserve Bank interest rate policy, interest rate on loans up to Rs 2 lakh should not exceed the prime lending rate (PLR) of the banks; commercial banks are, however, free to determine rates on loans above Rs 2 lakh. Banks generally arrive at PLR by adding together costs of funds, transactions and risks and a profit margin. Commercial bank's PLR ranged between 9.00 and 12.25 per cent per annum in 2002-03. Interest rates of RRBs and co-operative banks are totally deregulated and the concept of PLR does not apply to them.

4.3 The Union Finance Minister announced a reduction in lending rate for agriculture in July 2003 to pass on the benefit of declining interest rates to agriculture sector in general and small and marginal farmers in particular. The Indian Banks' Association has since advised all public sector banks to reduce their lending rate to a single digit rate of not more than 9 per cent per annum on crop loans up to a ceiling of Rs 50,000. NABARD has also issued appropriate instructions to co-operative banks and RRBs.

Recommendations of Earlier Committees

4.4 Earlier committees addressed issues related to rates of interest. Some of their recommendations are summarised below.

a. High Level Committee on Agricultural Credit through Commercial Banks (R V Gupta Committee)

This committee noted that viability of agricultural lending depended on a number factors, such as appropriate volumes, acceptable levels of recovery and a margin to cover cost of funds as well as expenses in sanctioning, supervising and recovery of loans. It observed that commercial banks were offering lower rates of interest on loans up to Rs 2 lakh through a cross subsidisation of interest rates, with an extra loading of interest on loans above Rs 2 lakh. The committee viewed this as an inefficient form of fixing interest rates and recommended that commercial banks should be free to fix their rates for small loans as was the case of co-operative banks and RRBs.

b. Expert Committee on Rural Credit (Vyas Committee)

The committee observed that co-operatives were free to fix their rates of interest on deposits as well as loans and advances. Co-operatives in most states had taken advantage of this relaxation and increased interest rates by as much as 3 percentage points as compared to commercial banks. The higher interest cost to borrowers, however, did not normally translate into higher net profits for these institutions, because of their own payment of higher interest on deposits, high transaction costs and higher credit risks in many states. The committee also observed that if commercial banks were free to choose rates of interest even on loans up to Rs 2 lakh, they would have possibly made such loans at 2 or 3 percentage points higher than their PLR. This would have improved their earnings substantially.

c. The IBA Working Group on Agriculture Credit (Samal Committee)

The committee had examined the need for a change in the regulatory guidelines regarding interest on small loans up to Rs 2 lakh and had felt that the then existing guidelines were flexible enough and enabled banks to charge interest below PLR. Some banks were already offering interest at PLR on agricultural loans up to Rs 5 lakh and had also introduced sub-PLR lending under this segment. The committee expected that market competition would lower farm credit interest rates. It suggested banks review their interest rates structure for agriculture credit to make their lending more attractive.

Costs and Margins of Banks

4.5 While commercial banks have reduced their interest rates on crop loans up to Rs 50,000 to 9 per cent and below, RRBs and co-operative banks, for various reasons, have not been able to reduce their rates to any appreciable extent, putting them at a disadvantage.

4.6 In the three-tier co-operative credit structure, each tier adds its costs and margins to interest rates, leading to a relatively higher rate of interest to the borrower. The interest rate structure also varies from state to state. In several states, the margin charged by District Central Co-operative Banks (DCCB) is around 2.0 - 2.5-percentage points, while State Co-operative Banks (SCB) charge around 0.50 to 0.75 percentage point. With Primary Agricultural Co-operative Societies (PACS) adding another 2.0 – 2.5 percentage points, the cumulative result is a much higher cost to the ultimate borrower. The NABARD Act, 1981 was amended in 2003 to ameliorate this problem by allowing NABARD to refinance DCCBs directly, provided these banks and their respective state governments adhere to certain stipulated conditions. This may enable the co-operatives to lower the rate charged to the ultimate borrowers to some extent.

4.7 An aggregate level analysis of margins, and banks' costs of funds, transactions and risk was attempted to see if banks enjoy a positive margin on agricultural lending, and if so, the extent of such margin, its sustenance and impact on economic viability. The exercise also simulated the impact of a further reduction of 2 percentage points in the interest rate at the end of the reference year. Annexure 4.1 presents the findings.

4.8 The analysis showed that the impact on profitability of different categories of banks would vary, as their costs and revenue streams differed very widely. Sustenance of profitability depends on magnitude of profits earned in the pre-reduction situation, relative weight of agriculture portfolio in the total loans and advances and other associated factors. While commercial banks as a whole could absorb a 2-per cent reduction of rates on their agriculture lending, only profit-making RRBs could sustain such a reduction, provided their accumulated losses are ignored. The reduction would cause 59 RRBs with slender net margin of 1 per cent or less to slide into losses. The position of loss-making RRBs would further deteriorate following *any* reduction in rates. All DCCBs taken together seem to break even at the existing rates of interest. A reduction in interest rates on their agriculture loan portfolio may lead to worsening of their financial position.

4.9 The Committee feels that the interest rate is an important aspect of credit. It takes cognisance of the growing borrower expectations of uniformly lower interest rates on loans by different agencies extending credit to agriculture. A single mandatory rate for all banks is, however, not feasible at present, as capacity of the various agencies to deliver agricultural loans at lower rates of interest varies due to their differential cost structure. What ultimately matters to the borrower in addition to the rate of interest is the timeliness and adequacy of credit as well as the concomitant costs he may have to incur to avail credit. **Therefore, banks need to pay attention to their systems and procedures to make their lending cost-effective. They have to consider also measures to save the borrower avoidable expenses for getting a loan sanctioned.**

Cost of Funds

4.10 The Committee has examined the cost of deposits, as they are the predominant source of working funds of banks. With lower rates of interest on deposits, commercial banks' cost of funds is on the decline. Their current rates of interest on term deposits range from 5 per cent to 6 per cent per annum while their savings deposit rate is 3.5 per cent.

4.11 Cost of funds to RRBs is somewhat higher, as they had accepted in the past long-term deposits at higher rates of interest, which are yet to mature. Sponsor banks provide credit at reportedly higher rates of interest than the prevailing market rates. NABARD refinance is also reported to be comparable with their term deposit rates. All these limit their ability to reduce their lending rates. RRBs, too, however, have to reduce their lending rates in line with those of commercial banks to compete successfully.

4.12 Co-operatives' rates of interest to the ultimate borrowers have been in the range of 12 to 14 per cent. Even in the north-eastern states, where only a two-tier co-operative structure exists, interest rates are in the range of 11 to 13 per cent, comparable to rates prevailing in some states with a three-tier system. Only in a few states, notably Andhra Pradesh, where the state government subsidises interest to the extent of 5 per cent, the rate charged to the final borrower is 7 per cent. **The Committee does not favour states subsidising interest rates and distorting the interest rate structure unless there are some extraordinary and compelling reasons.**

4.13 The higher rate of interest charged by co-operatives is partly due to the cumulative impact of margins retained by different tiers of the structure, and partly due to their higher cost of funds. The co-operative working funds comprise deposits (80 per cent) and refinance from NABARD (20 per cent). Co-operatives normally offer a slightly higher rate of interest on their deposit as compared to commercial banks to attract depositors. Their cost of deposits is also affected by a higher proportion of term deposits with higher rates of interest. Low cost funds, i e refinance, form only 20 per cent of the total, which does not provide them much room to dispense cheaper credit.

4.14 Co-operatives also apprehend paucity of funds in the near future as their depositors are shifting to other saving channels such as post offices, since some urban co-operative scandals seem to have tarnished their image. Their scale economies are also limited due to the limited operational area of one or two villages in case of PACS and one or two districts in case of DCCBs and do not provide any scope for reducing interest rates.

4.15 Since the old high cost deposits will be retired in a couple of years, there appears a possibility of cost of funds being brought down by 0.5 per cent to 1.0 per cent across the banks. This decline would be more pronounced in case of DCCBs and RRBs, given their large share of high cost deposits. As 40 RRBs and 105 DCCBs have negative net margins, however, even such a decline in the cost of fund may not immediately translate into reduced agricultural interest rates. **For a large number of DCCBs and RRBs, however, availability of funds at a reasonable cost may lead to proportionate cost reduction.**

4.16 **The costs of SCARDBs (LDBs) will continue to be influenced by the extent and rate of refinance, until such time as they can mobilise low cost deposits.**

Transaction Cost

4.17 Transaction costs include cost of management/manpower and establishment cost. Therefore, reduction in transaction cost could result from either an increase in volume of business per employee or a reduction in establishment and manpower expenditure. While some commercial banks have introduced innovative loan products for expanding their portfolio, most RRBs and DCCBs are yet to do so. Further simplification of loaning procedures, documentation, use of KCC, single window approach for meeting all the credit requirements, including consumption credit, village level planning, project formulations, etc could contribute to an expansion of credit business and bringing down transaction cost.

4.18 Rural credit is characterised by a wide territorial spread, large number of clients, small loan requirements, difficulties in asset verification and absence of social pressure for timely repayments, which makes it difficult to reduce transaction costs. Some banks (e g Prathama and Avadh Gramin, both in Uttar Pradesh) have, however, successfully tried approaches such as associating Farmers' Clubs, NGOs and even individual rural volunteers to reach out to their clients. They have demonstrated that such approaches can yield significant savings in transaction costs and be cost-effective, since they help expand business with the same number of staff. The Koraput RRB in Orissa, faced with limited credit expansion possibilities in a backward area of operation, has successfully engaged rural volunteers to promote SHGs. Despite such successes in different parts of the country, banks have not extensively adopted the idea of outsourcing some rural credit functions, except a few private sector commercial ones which have been using NGOs on a payment basis as business development agents. **The Committee, therefore, recommends that banks seek innovative ways to use such facilitating agents as links between the branch and rural clients.** The earlier section on outreach also addresses some of these concerns.

4.19 Reforms of the co-operative credit structure have focussed on revitalisation of weak district and state co-operatives. Many of the good working PACS are experiencing inadequate access to credit and/or delayed access to DCCBs in the wake of increasing number of weak DCCBs. Thus, weakening of the higher structure also causes lower tiers to weaken. **In this context, possibilities of building synergy between good working PACS and commercial banks need to be explored. Commercial banks could even extend credit support/guarantees for marketing of inputs/outputs to the identified PACS.**

4.20 The rigidity of the three-tier co-operative system results in additional cost of credit to the ultimate borrower. **The Committee feels that if the three tiers do not contribute to the improvement in efficiency and ultimate reduction in cost of credit to the borrower, there would be a case for elimination of one of the tiers.**

4.21 The Committee's review of RRBs and recommendations on various aspects of their working, including cost of credit provided by them, are in Section 7 of this Report.

4.22 Kisan Credit Cards (KCC) are among RFI's recent product innovations. The scheme would cover all eligible farmers by the end of this year. Different commercial banks have introduced variants of KCCs with value-added services, such as SBI's Gold Card, Bank of India's Suvidha card, etc. **These cards could be made ATM-enabled and converted into smart cards to reduce transaction costs as also to provide better customer service.**

Information Technology (IT)

4.23 IT holds the key to reducing transaction cost and increasing business volumes of banks. IT impacts both internal management and accounting/record-keeping/MIS in the banks and its reach to the clients outside. The first would include computerisation of bank branch operations and connectivity through networking. The latter includes setting up of information kiosks etc in rural/semi-urban areas to help banks reach out to a larger number of existing/potential customers and provide them with access to information at various levels. ITC's *e-choupal* experiment is an example of this outreach.

4.24 Banks have been motivated to provide "any time and anywhere" banking facilities in cities and metropolises to reduce transaction costs through IT. The experiment has reduced manpower cost of to a large extent. The pace of adoption of this technology in rural areas, however, seems to be very slow, partly because of its cost-intensive nature and partly because of non-availability of basic infrastructure facilities including electricity. **Low cost ATMs running on diesel generator sets could be used in rural areas for cash dispensation. Wherever volume of business justifies it, computers in rural bank branches may be networked for a free flow of intra-branch and inter-bank information. This could avoid physical movement of staff between various offices allowing them more time for servicing the clientele instead.** Some prerequisites, such as reliable power supply and connectivity, availability of bandwidth, proper facility management and maintenance in rural areas, however, need to be met. **Banks must formulate a time-bound programme for using IT in rural branches.**

Risk Cost

4.25 Risk costs play a decisive role in determining interest rate banks charge borrowers. Risks arise from a host of factors such as investment failure, weather aberrations, improper appraisal of loans, inadequate follow-up, diversion of funds, wilful defaults, and inability to realise the available securities. Disaggregation of credit risks would help the coverage of those arising from failure of rainfall, price fluctuations, poor health or death of the borrower, etc through non-credit financial products including insurance and derivatives. This could help banks provide credit at a lower rate.

4.26 Prompt repayments would not only enable banks to recycle funds quicker, but also help reduce their transaction costs. Various supply and demand factors such as inadequate loan amount, lack of timeliness, problem of multiple borrowings and weather aberrations seem to adversely affect loan repayment to varying extent; periodic loan/interest waivers by Central and state governments have also affected repayments. Such polices have to be desisted to inculcate prompt repayment culture among borrowers. At the same time, a proper incentive structure for prompt repayment of loans also needs to be put in place. **The Committee, therefore, recommends that banks may design, with the approval of their Boards, an appropriate incentive structure for prompt repayment. Further, banks may review and revise their project appraisal procedures to overcome some of the supply factors contributing to non-recovery of loans. Proper appraisal of loan proposals and post disbursement supervision will reduce risk costs. There is, therefore, a need for further sensitising and training rural branch staff in this regard.**

Risks in Agriculture

4.27 Farmers face risks that are specific to individuals or idiosyncratic (covariate risks) as well as common to a large group (systemic risks).

Individual Risk

4.28 Personal insurance often offers protection against individual risks. Insurance products offering protection against accidents and critical illness could also help improve the borrower ability to repay. While SHG lending in some states provides borrowers life insurance cover for self and dependants, life insurance products suited to farmers' economic conditions are not available to most borrowers except KCC holders. There is, therefore, an urgent need for more innovative products in this category. When facing idiosyncratic risks, farmers adopt on their own many alleviation mechanisms, both preventive and curative. The former include measures to reduce income variation such as inter-cropping, drought resistant crops, and contractual share cropping, while the latter are mainly strategies to cope with losses incurred, such as selling stored produce, liquidating assets, participating in labour market, etc.

4.29 Market price fluctuations are the other major factor impairing farmers' repayment capacity. Minimum support prices provide some protection, but their spatial coverage is limited and they are seen as subsidies. Contract farming is a private mechanism that could help farmers cope, since at least in theory, it provide a guaranteed buy-back of produce at predetermined price and transfers the market risk to buyers. Its actual performance needs to be thoroughly analysed before considering its wider application.

4.30 Derivative and commodity futures markets provide some protection against price volatility allowing farmers to hedge market risks. Derivative contracts could be cost-effective in managing price and weather risks. Commodity exchanges enable a better price discovery and access to better price risk management mechanism. Dematerialised warehouse receipts could be traded directly on exchanges, as is the case of equities. While setting up NCDEX is a right step in this direction, these institutions are not yet well developed in India in the absence of linkages between geographically dispersed commodity markets, systematic processes and facilities for cleaning, grading, sorting, warehousing and transportation of commodities and free and reliable information flow. **Farmers' participation in commodity exchanges could be enhanced through education, dissemination of index price information, investing in rural connectivity and building warehousing capacity.**

Systemic Risk

4.31 Systemic risk is common to a large group of farmers and could be mitigated through crop insurance. Conventional crop insurance based on claims verification does not seem to have been successful except in certain pockets and at that only for a few cash crops. Premia charged were a flat rate, not computed on an actuarial basis, effectively an increased rate of interest on the credit availed. They ranged from 2 per cent for paddy and wheat due to state government subsidies to 7 - 8 per cent for cash crops including cotton and tobacco, which effectively raised interest rates up to 19 per cent. **Even as the present crop insurance scheme covers production risks to some extent, innovative, farmer-friendly insurance products not involving high overhead and supervision costs are still needed. The index-based rainfall insurance presently tried out on a pilot basis by an insurance company is one such product. To cover market risks arising from bumper crops, banks could take forward trading positions to the extent of perceived risks, taking advantage of commodity exchanges now in operation.**

4.32 Restructuring of loans, as discussed in Section 5 of this Report, affords temporary relief to farmers; however, long term remedies to deal with impairment of farmers' repaying capacity caused by recurrent external adversities such as droughts and floods are also needed. **The Committee, therefore, recommends setting up of an *Agri-Risk Fund* with equal contribution from Central and state governments and participating banks. It feels that such a fund would moderate the risk of lender banks as they could take recourse to the fund in the event of a genuine default; it would also assuage some of the farmer hardships.**

ANNEXURE 4.1

Banks' Aggregate Margins

% of total assets

Agency	Financial Margin	Cost of Operation	Gross Margin	Risk Costs	Net Margin
CBs [2002-03]	2.91	2.24	2.33	1.35	0.98
RRBs [2002-03]	3.48	2.98	1.26	0.34	0.92
DCCB [2001-02]	2.99	1.69	1.90	1.91	(0.01)

Source: **Report on Trends and Progress 2003** for CBs, NABARD data for RRBs and CBs

Estimates of Likely Aggregate Impact of 2% reduction of Interest on Agriculture Loans on Costs and Margins of Public Sector Commercial Banks (2003)

% of total assets

Parameter	Actual	Post-reduction
Financial return	8.35	8.20
cost	5.44	5.44
margin	2.91	2.76
Total transaction cost	2.24	2.24
Miscellaneous income	1.66	1.66
Gross margin	2.33	2.18
Total risk cost (provision)	1.35	1.35
Net margin	0.98	0.83

Source: **Report on Trend and Progress of Banking in India 2002-2003,** RBI

Financial margin is the interest received less interest paid. Cost of operations includes salary of staff and other establishment cost of the banks. Gross margin is arrived at by netting cost of operation and other miscellaneous expenses from the aggregate of financial margin and other incomes. Net margin is gross margin net of the risk costs.

The absolute amount of direct agriculture credit outstanding was calculated by multiplying total outstandings by the percentage of net bank credit of the public sector banks for agriculture. A weighted average rate of interest was derived by assuming that aggregate agriculture loan outstanding had the slab-wise composition as the total loan. The post-reduction figures were worked out by reducing the weighted average interest rate by 2%.

Costs and Margins of Profit and Loss Making RRBs (2003)

% of total assets

Parameter	Profit-making RRBs		Loss-making RRBs		All	
	Actual	Post reduction	Actual	Post reduction	Actual	Post reduction
Financial return	9.93	9.57	7.98	7.66	9.62	9.26
cost	6.12	6.12	6.23	6.23	6.14	6.14
margin	3.81	3.45	1.75	1.43	3.48	3.12
Total transaction cost	2.42	2.42	3.53	3.53	2.59	2.59
Miscellaneous income	0.40	0.40	0.52	0.52	0.76	0.76
Gross margin	1.80	1.43	(1.63)	(1.96)	1.25	0.9
Total risk cost (provision)	0.26	0.26	0.72	0.72	0.34	0.34
Net margin	1.54	1.17	(2.36)	(2.68)	0.92	0.56

46 % of the total outstanding have been assumed to be direct agriculture advances.

Source: NABARD

Costs and Margins of DCCBs (2002)

% of total assets

Parameter	Actual	Post-reduction
Financial return*	10.13	9.58
cost	7.14	7.14
margin	2.99	2.44
Total transaction cost	1.69	1.69
Miscellaneous income	0.60	0.60
Gross margin	1.90	1.35
Total risk cost (provision)	1.91	1.91
Net margin	(0.01)	(0.56)

50 % of the total outstanding have been assumed to be direct agriculture advances.

Source: NABARD

5

NPA NORMS AND AGRICULTURAL FINANCE

5.1 Reserve Bank introduced norms for income recognition, classification of assets and provisioning for Non-Performing Assets (NPA) as part of the prudential norms framework for banks in 1992-93. These norms are aimed at identifying assets which have ceased to earn interest at the stipulated rates, or instalments of principal which have fallen due but have not been paid within the stipulated time, and ensuring that unrealised income from them is not factored into the income stream of the bank. Current prudential norms track defaults not only to a specific loan account, but also to a borrower. If any loan account of a borrower is classified as NPA, all other loans to the same borrower are automatically classified as NPA, even if they are regularly repaid.

5.2 Existing norms for classification of agricultural loans as NPA, as defined in various Reserve Bank circulars, for commercial and co-operative banks are as under:

Commercial Banks

5.3 In respect of advances granted for agricultural purposes, where interest and/or instalment of principal remains unpaid after it has become overdue for two harvest seasons but for a period not exceeding two half-years, such an advance should be treated as NPA. These norms are applicable to direct agricultural advances only.

5.4 In respect of agricultural loans, other than those specifically mentioned in the Master Circular No DBOD. No.BP.BC.15./21.04/048/ 2003-04 dated 22 August 2003, identification of NPAs would be done on the same basis as non-agricultural advances. Such advances attract the 90 days delinquency norm with effect from March 31, 2004.

Co-operative Banks

5.5 In respect of agricultural advances of SCBs and DCCBs where interest payment is on a half-yearly basis synchronising with harvest, banks have been advised to adopt the agricultural season as the basis. It is stipulated that if interest is not paid during the last two seasons of harvest (covering two half-years) after principal has become overdue, such advance should be treated as NPA.

Need for Revisiting Current NPA Guidelines

5.6 Agriculture faces uncertainties caused by fluctuations in rainfall, floods, droughts and other natural calamities, among others. Such uncertainties are particularly severe in rain-fed areas. Inadequate rainfall, for example, results in lower income and poorer capacity to repay. Since farmers use agricultural loans to generate their livelihood, they would normally not behave in a manner which would permanently jeopardise credit support. Therefore, even if an agricultural loan is not repaid on time due to vagaries of climate, it could be eventually repaid out of the income of subsequent seasons, if the borrower could sustain himself during the period and his overall debt burden did not financially ruin him. Thus, income and cash flows may smoothen out over a cycle and there is a possibility of the dues being cleared over a period, if there are no successive droughts. This ground reality suggests a differential treatment of reckoning farm cash flows and identifying NPAs.

5.7 The present NPA norm of non-recovery of interest/principal up to two crop seasons or covering two half years after the due date does not fully mirror differing crop maturity periods, some of which may extend up to 18 months. There are also regional disparities in crop duration. The current prescription of two half years is not appropriate for longer duration crops. **The Committee, therefore, recommends that while the current norm of default for two crop seasons could be retained for classification of loans as NPA, the added stipulation of two half years could be removed. Crop season for this purpose would mean the period required for the concerned crops to mature for harvesting. The technical committee appointed for fixation of scales of finance could also determine durations of seasons for different crops in a given area in consultation with agricultural scientists to avoid adoption of arbitrary norms by any individual bank. This would be ratified by DLCC/SLBC. Two crop seasons after the due date should refer to only those two consecutive crop seasons in which the farmer normally undertakes crop production. For long duration crops, a loan may be treated as non-performing if interest or principal remains unpaid for one crop season (as defined above) after becoming due.**

5.8 Both crop and term loans are repaid out of farm income. If crops fail due to natural calamities, recovery of *all* loans is adversely affected. **Therefore, relaxations suggested in respect of crop loans may also be, *mutatis mutandis*, made applicable to agricultural term loans.**

5.9 Advances to allied activities are treated at present on par with non-farm activities for the purpose of asset classification, without any linkage to the crop situation. In reality, allied activities are closely linked to agriculture and are subsidiary activities taken up to augment the family income. Income from them is also not evenly spread throughout the year and the uneven spread of cash generation from them causes temporary distortions in cash flows leading to possible delays in repayment. Subsidiary incomes may not be adequate to repay the bank loan and interest besides sustaining the family when the principal farm activity is adversely affected. The present 90-day norm applied to these activities for classification of NPAs does not take into account such temporary disruptions in cash flows. **The Committee, therefore, suggests that the earlier norm of 180 days default for classifying a loan as NPA may be restored for loans for allied activities.**

5.10 Generally, farmers who take agricultural term loans also borrow for crop production. As per prevailing guidelines on classification of assets, outstanding amounts of all loan accounts of a borrower are classified as NPA if there is a default in any one of them. Banks need to distinguish between crop and term loan accounts to ensure that credit is available for production. **The Committee recommends that when a farmer has availed both production and investment loans, only the account with default be considered for NPA classification and outstandings in regular accounts not be counted as NPA.**

5.11 The state government procedure for declaration of *annawari* is cumbersome and takes a long time. As a result, conversion of existing loans and sanction of fresh credit to farmers are also delayed and results in even those loans which would be eligible for restructuring being classified as NPA. To avoid delays, the lead district manager of the lead bank should arrange to get from the district authorities timely information on crop losses in the district caused by flood/drought, etc. **On the basis of such information, a committee headed by the district manager of the lead bank and comprising district development manager of NABARD, district agriculture officer and managers of a few major banks operating in the district as members, may consider crop losses due to weather aberrations in the district, in consultation with agricultural scientists/local agricultural university and take a decision on conversion/restructuring of agricultural loans. All banks operating in the district should extend the facility of restructuring of loans to eligible farmers on this basis once such a decision is made. It should be promptly reported to the convenor of SLBC and may be recorded in the proceedings of the immediately following meeting of the SLBC. Banks may authorise their branches to take up conversion/rescheduling of loans based on the recommendations of the above district level committee.**

5.12 Some farmer-specific events beyond their control could affect the repayment capacity temporarily. Major ailments of any member of the farm family, fire damage to house and agriculture assets, localised pests, etc are some such events. **Banks may have the freedom to allow restructuring of loans on a case-to-case basis in such situations, ensuring that this does not lead to the phenomenon of ever greening, i e continuing restructuring. Such restructuring of loans should be with the specific approval of the controlling authority of the branch.**

5.13 **The conversion and restructuring of farm loans should be done at reasonable rates of interest.** Restructuring of any loans involves banks sacrificing interest to ensure borrowers' viability after restructuring. **Banks, therefore, need to ensure that the interest rate on restructured loans is lower than that on the original.**

6

IMPEDIMENTS TO FLOW OF CREDIT TO THE DISADVANTAGED

Background

6.1 A wide network of rural bank branches has been involved in implementing specific poverty alleviation programmes, including creation of self-employment opportunities through bank credit, for almost two decades. Yet a very large number of the poor continue to remain outside the fold of the formal banking system. Banking systems and procedures, and deposit and loan products are perhaps not ideally suited to meet the most immediate needs of the poor. They need better access to timely financial services at affordable costs, rather than subsidised credit.

6.2 The recent Rural Financial Access Survey (RFAS, 2003) by the World Bank and National Council of Applied Economic Research shows that while 19 per cent of rural households accessed credit from formal sources in Uttar Pradesh, 44 per cent depended on non-formal sources. The corresponding figures for Andhra Pradesh were 24 per cent and 33 per cent respectively. The share of formal sources in total debt of the borrowing households was again low at 56 per cent and 51 per cent in the two states respectively. The small and marginal farm households' access to formal credit was extremely low.

Table 5.1 Access to Formal Credit by Types of Household

per cent households

Category/State	Marginal	Small	Medium	Large	Other households	Total households
AP	11.8	33.8	41.9	56.3	20.7	24.0
UP	13.5	24.7	30.8	36.1	17.7	19.4

Source: **Rural Finance Access Survey** (2003)

6.3 As per the current guidelines, domestic commercial banks are required to extend not less than 10 per cent of net bank credit (NBC) to weaker sections comprising small and marginal farmers, landless labourers, artisans, borrowers of government-sponsored poverty alleviation programmes, etc. Under the differential rate of interest (DRI) scheme, domestic scheduled commercial banks are required to lend at least 1 per cent of their aggregate advances as at the end of the previous year to the very poor borrowers with annual incomes below Rs 6,400 in rural areas and Rs 7,200 in urban areas. As on 31 March 2003, public sector banks had extended only 6.8 per cent of NBC (Rs 32,304 crore) to weaker sections. Only six of the 27 public sector banks had achieved the 10 per cent goal, with the rest ranging between 2.0 and 9.4 per cent. Banks have been reporting declining trends in financing weaker section borrowers for well over last few years: from 1.76 crore accounts as on 31 March 2000 to 1.43 crore accounts 31 March 2003. Several reasons could explain these trends: write-offs by banks, erstwhile small borrowers migrating to higher brackets, increasing coverage of the poor under SHG-bank linkage programme, etc. The result is that the disadvantaged are increasingly sidelined while accessing commercial bank credit.

Impediments

6.4 Some of the major factors affecting institutional credit flow to the disadvantaged are:

- Higher transaction costs to both banks and borrowers;
- Client-unfriendly procedures, systems and documentation formalities;
- Borrowers' inability to provide collateral securities;
- Distortion of normal banking principles caused by linking credit with capital/interest subsidies under various poverty alleviation programmes;
- Announcements or expectations of interest/loan waivers affecting recovery climate;
- Legal difficulties in foreclosure of loans;
- Non-availability of tenancy agreements/updated land records;
- Inadequate risk mitigation mechanism available to small borrowers in the event of micro-enterprise failure and to the banks in the event of loan failures; and
- The mindset that banking with the poor is not profitable.

6.5 The Committee offers the following suggestions to address some of the impediments in reaching out to the disadvantaged sections of the rural society:

i. **Banks may pass on the benefits of the several measures discussed in Section 3 to the small borrowers to make their rates of interest on small loans reasonable and improve the efficiency of credit delivery.**

ii. The dividing line between production and consumption needs of the poor is very thin. A lack of short-term consumption loans results in the diversion of productive investments. Small borrowers, therefore, need to be provided a fall-back credit mechanism for meeting their exigent consumption needs. **Therefore, banks should provide a separate flexible revolving credit limit to small borrowers of production or investment loans for meeting temporary shortfalls in family cash flows. Banks may evolve suitable credit products/packages in this regard.**

iii. The poor often shy away from formal institutions for want of information about procedures. **Banks may adopt measures to reduce this information gap. Application forms for loan products should contain a comprehensive checklist of documents/information to be furnished as also procedural requirements to be complied with for availing of loans.**

iv. **As observed in Section 3, use of individual volunteers, farmers' clubs or NGOs/SHGs as direct selling agents in villages would help bridge the information gap. Banks may explore possibilities of outsourcing loan appraisal and monitoring at branches, using such facilitators as business partners.**

v. **A branch advisory committee comprising select elected representatives, including women leaders, of local *panchayati raj* institutions within the service area of the branch, may be established at every rural branch. It should meet at least once a quarter. These meetings may be made mandatory and be attended by the controlling official of the bank.**

Financing Oral Lessees, Marginal Farmers

6.6 Another major challenge for the rural financial institutions is that of financing oral lessees and marginal farmers, the number of whom has already assumed large proportions and would continue to grow in the next decade with increasing fragmentation of land. **The Committee has examined various issues relating to financing of oral lessees and is of the opinion that Joint Liability Group (JLG) and SHG approaches have the potential of addressing the issues relating to these sections. Banks may have to explore these financing models through pilot projects until such times as states address issues of legalising tenancy.**

Contract Farming

6.7 Contract farming has evoked considerable interest among corporate entities, banks, state governments and farmers. Banks report mixed experiences in their initial association with contract farming. They opine that for contract farming to succeed, the stake of contracting agencies has to be critical. **The Committee feels that the approach has the potential for expanding credit outreach, especially to the small/marginal farmers and oral lessees. Banks may increasingly consider associating with contract farming, subject to availability of proper legal and regulatory framework in different states.**

6.8 Early contract farming initiatives have experienced legal difficulties in enforcing contracts, as also in relation to Agricultural Produce Marketing Acts. Produce quality disputes have led to differential payments. **A mechanism for proper certification of produce quality needs to be put in place to avoid or resolve such disputes. State governments may have to play a major facilitation role in this regard.**

Issues in Improving Quality and Outreach under SGSY

6.9 The Ministry of Rural Development informed the Committee of the declining trends in financing under Swarnajayanti Gram Swarojgar Yojana (SGSY) over the last few years. The Committee notes with concern the inadequate response of the banking system to SGSY. **The Committee feels, based on the feedback it received in field visits, that there is a need to look again into the design of the programme, especially with regard to moderating the timing and quantum of subsidies. An in-depth study may be taken up to ensure that group dynamics issues are properly factored into the programme design.**

SHG-Bank Linkage Programme

6.10 The major achievement is the NABARD-led rural SHG-bank linkage programme, which had credit linkages of over 10 lakh SHGs by 31 March 2004 and was the largest and the fastest growing micro-finance programme in the world. Micro-finance initiatives of SIDBI and Rashtriya Mahila Kosh have also shown positive results.

6.11 NABARD evolved this to meet the needs of the disadvantaged in accessing financial services of the banking system. It has met with significant success in southern states and Orissa, West Bengal, Uttar Pradesh and Rajasthan. By March 2004, over 10 lakh SHGs were credit-linked and providing access to micro-finance services of savings and credit to nearly a crore and a half of rural poor families (Table 6.2). The experience of banks, NGOs and the poor has been excellent with nearly 95 per cent repayments of loans. The SHG-Bank Linkage Programme has helped in credit delivery even to some tenant farmers and is also found to be working well even in the areas affected by militancy.

Table 6.2: Region-wise Spread of SHG-Bank Linkage Programme

Region/ Year	No of new SHGs			Cumulative No of SHGs as on 31/03/04*	Cumulative Loans Ssanctioned as on 31/03/04 Rs lakh
	2001-02	2002-03	2003-04		
Northern	10,309	15,602	16,357	51,280	12,242
North-eastern	1,013	2,579	8,137	12,206	1,986
Eastern	23,640	45,001	53,155	1,44,048	22,163
Central	19,330	33,402	45,426	1,27,009	27,633
Western	13,775	12,862	12,635	54,815	14,088
Southern	1,29,586	1,46,436	1,63,825	6,27,537	2,78,833
All-India	**1,97,653**	**2,55,882**	**2,99,535**	**10,16,895**	**35,69,44**

* Provisional

Source: NABARD

6.12 Banks in states where the programme has not shown satisfactory progress need to gear up their rural branches for facilitating bank linkages of SHGs. B**anks may evolve a three-year action plan at each controlling unit level for scaling up the programme.** Such plans may include a strategy for sensitising and training staff, facilitating promotion and nurturing of SHGs through networking with NGOs, and other SHG promoters. Some banks have already earmarked officials to work in micro-finance cells. **The Committee feels that such special attention to micro finance will go a long way in expanding this segment of business. All banks may set up adequately staffed micro-finance cells at central offices and in each state.**

6.13 The Committee came across complaints such as delays/refusal to open savings bank accounts of SHGs, large number of branch visits required to access credit, inadequate credit support extended by banks, delays in renewal of credit limits, and impounding of SHG savings as collateral for loans. This shows that even in states with sizeable numbers of SHGs financed, quality of linkage reflected in client satisfaction continues to be low. **Banks need to address these issues urgently, to make access to financial services smooth and client-friendly.**

6.14 Many older SHGs now manage sizeable resources. Studies show that this leads to an increasing demand for diversified savings and credit products. **The Committee recommends offering them need-based savings and credit products. Further product innovations are, therefore, required. Banks may explore possibilities of offering SHGs credit cards similar to KCC and Swarojgar Credit Cards.**

6.15 The quality of books of accounts maintained by SHGs is an area of concern in view of the low functional literacy of the SHG membership. **Banks may encourage using local book writers in association with concerned agencies promoting these SHGs.** These writers could be from some literate members of SHGs, their families or others such as anganwadi workers, rural teachers, etc. Ideally, such an arrangement should be on a cost-sharing basis, with some support from banks**.**

6.16 A number of successful SHGs have amassed sizeable funds through member savings and interest collected, besides bank loans. They need the escort/hand-holding services to take up higher level micro-enterprises. **All development agencies including governments, banks, NABARD and NGOs need to converge on these SHGs and provide them necessary skills, market linkages, technological support, etc.** The need to build up enterprise promotion capacities of the 3,000-odd NGO partners under the programme is equally important. **Specialised enterprise promotion agents/agencies/ corporate entities may have to be involved in this effort. NABARD may continue to take the lead role in this regard.**

6.17 The share of co-operative institutions in the SHG-Bank Linkage Programme is limited. DCCBs in districts such as Hooghly, Bidar, South Canara, Ajmer etc which have taken up banking with the poor through SHGs and have demonstrated that this could be an important tool for revitalising even the dormant co-operative societies. Some of these banks have also taken up promotion of SHGs directly through their own and PACS staff. **Co-operative banks**

may take up SHG banking on a significant scale with active support from NABARD and state governments.

Emerging Federations of Self Help Groups

6.18 Some of the NGOs are now promoting federations of SHGs. Two main types of federations of SHGs have emerged so far: federations which provide umbrella support to member SHGs, including book writing/audit services, conflict management, monitoring and cross-learning, engaging paid employees, value-added services such as insurance, supplementary education, health care, etc and federations which undertake resource balancing among SHGs and also do financial intermediation.

6.19 **The Committee feels that as long as federations evolve in response to articulated demands of SHGs, the non-financial intermediary type need to be encouraged to provide umbrella support to member SHGs. It feels, however, that more experimentation of the financial intermediary type federations is needed to determine cost of promotion of such federations, capacity building of federations, their organisational and financial sustainability and above all, the quality of value-addition being achieved by these federations.**

NGO - MFIs

6.20 Institutions parallel to conventional banks have also emerged to provide micro finance services to the poor, both in rural and urban areas. About 800 NGO-MFIs are estimated to be undertaking financial intermediation in India. These also include a handful of commercial MFIs, which account for bulk of their outreach.

6.21 The Committee has looked into the role of MFIs and the need for their regulation and supervision. The key issue brought to the notice of the Committee by representatives of the sector was access to public/member deposits, while lack of equity funding, soft loans, capacity building needs, were also mentioned as other issues. The Committee sought answers to the following issues and concerns to be able to assess the need for a separate regulatory framework for MFIs.

i. Does the absence of a separate regulatory framework hinder the growth of the sector ?

ii. Are MFIs sustainable in medium term? If so, will they continue to focus on the poor?

iii. Is access to public/member deposits the key issue influencing their sustainability?

iv. Can MFIs offer income-generation loans at interest rates affordable by the rural poor?

v. Is it possible to evolve commonly agreed standards for MFIs covering performance, accounting and governance issues, which open up possibilities of self-regulation?

vi. Has the activity reached a critical mass where regulation becomes important?

6.22 Discussions with stakeholders brought out the fact that while a few MFIs have reached significant scales of outreach, these institutions as a whole are still evolving. This is reflected in wide debates ranging around the desirability of NGOs taking up financial intermediation, as yet unproven financial and organisational sustainability of the model, high transaction costs leading to higher rates of interest being charged to the poor clients, absence of commonly agreed performance, accounting and governance standards and heavy expectations of low cost funds, including equity and start-up costs, etc.

6.23 Greater recourse to the MFI route obviously implies that regulatory and supervisory framework would have to be strengthened. Savings is among the most important services MFIs provide to their clients and possibly even others in their operational area. These savings could be possibly at risk unless certain minimum precautions are taken. A dynamic regulatory framework would continue to evolve over time. While good internal governance of MFIs would be the focal point of such a system, the policy environment would have to be addressed to supervising and regulating certain other crucial factors related to governance.

6.24 The current thinking on development of a regulatory system for the MFIs identifies three stages: In the first, MFIs would be made to appreciate the need for certain common performance standards. The second stage would make it mandatory for them to register with designated institutions. In the third stage, the development of a network of MFIs acting as a quasi self-regulatory organisation at a later date would be encouraged or a suitable organisation to these arrangements would be identified.

6.25 The stage one task, development of performance standards agreeable to a wide range of players, needs considerable work. Meanwhile, even as MFIs continue to work as wholesalers of micro credit by entering into tie-ups with banks and institutions, **further experimentation is needed to establish the MFI model. These experiments need to be encouraged in areas where banks are still not able to meet credit demands of the rural poor adequately, such as North-eastern states and tribal dominated states such as Jharkhand, Chhattisgarh and Orissa.**

6.26 The Committee recognises the importance of offering thrift products as a service to the MFI clientele. **It feels, however, that NGO-MFIs could play an important role in facilitating their clients' access to savings services of the regulated banks. The Committee considers that NGO-MFIs may not be permitted to accept public deposits unless they comply with the extant Reserve Bank regulatory framework, to protect the interests of depositors. When they do not accept public deposits, MFIs need not be regulated by the Reserve Bank.**

6.27 **Since MFIs are known to be charging high rates of interest to their borrowers, lenders to MFIs may ensure that these institutions determine the rates of interest they charge to their clients on a cost plus reasonable margin basis.**

7

REGIONAL RURAL BANKS AND AGRICULTURE CREDIT

Introduction

7.1 Government of India promoted Regional Rural Banks (RRBs) under Regional Rural Banks Act, 1976 (referred to in this section as "the Act") on the recommendations of the Narasimham Committee (1975). Government of India, state governments and commercial banks hold RRB equity in the ratio of 50:15:35 respectively. The Act mandates these banks to develop rural economy by providing credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs for development of agriculture, trade, commerce, industry and other productive activities. Section 18 of the Act requires RRBs to carry on the business of banking; they might engage in one or more forms of business as defined/specified in sections 5 and 6 respectively of the Banking Regulation Act, 1949 (hereinafter referred to as "the BR Act")

7.2 By the end of March 2003, there were 196 RRBs in operation with 14,443 branches, covering 516 districts across the country (Annexure 7.1). They accounted for about 43 per cent of the total rural branches of the scheduled commercial banks. The rural and semi-urban branches of RRBs constitute about 98 per cent of their branch network indicating their rural orientation.

Business Growth

7.3 One of the objectives of establishing RRBs was mobilising rural savings and canalising them for supporting productive activities in rural areas. RRBs' aggregate deposits increased from Rs 4,035 crore in 1990-91 to Rs 48,346 crore in 2003 (Table 7.1), registering an annual average growth rate of over 84 per cent. This growth in their deposits could be attributed to their geographical spread and opening of new branches in unbanked areas. Their credit disbursal increased from Rs 3,378 crore in 1990-91 to Rs 21,773 crore in 2003, at an average growth rate of about 42 per cent per annum. Although RRBs have grown impressively in mobilisation of rural deposits, their credit disbursal has not kept pace with their growth in deposits, resulting in deceleration of the credit deposit ratio (CD Ratio) (Table 7.1, Fig 7.1).

Table 7.1: RRB Deposits and Credit Disbursed

Rs crore

Year	Deposits	Credit	CD Ratio
1990-91	4,035	3,378	83.7
1995-96	11,25 2	6,117	54.4
2000-2001	37,02 7	15,579	42.1
2001-2002	43,22 0	18,373	42.5
2002-2003	48,34 6	21,773	45.0

Sources: **Report on Trends and Progress of Banking in India 2002-2003**, RBI, and NABARD.

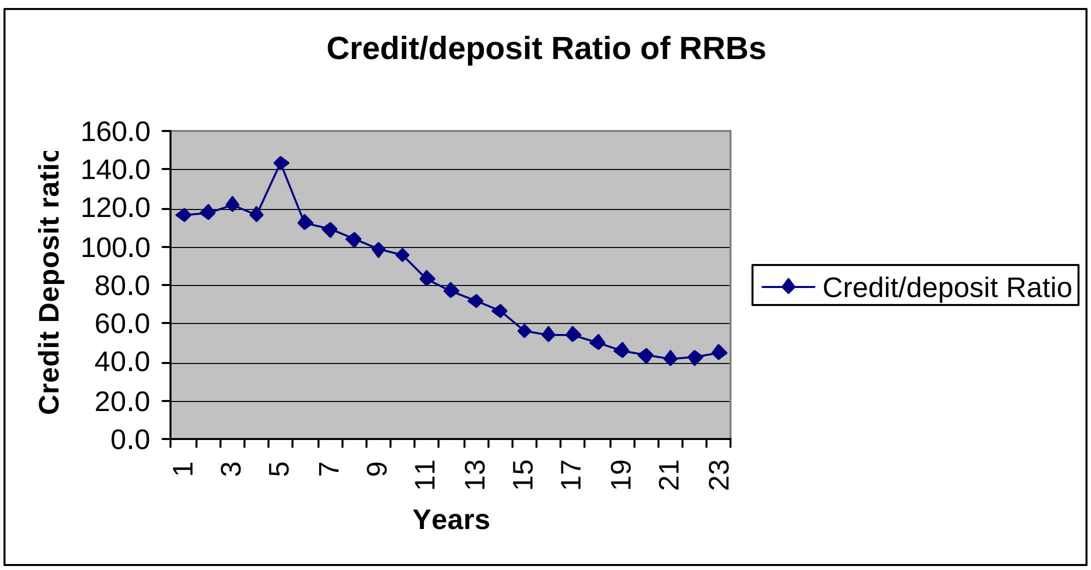


Fig 7.1: Credit Deposit Ratios of RRBs

Credit Disbursement to Priority Sector

7.4 Another objective of establishing RRBs was to provide financial assistance to productive activities of the poor in rural areas. The particulars of priority sector advances granted by RRBs are given in Table 7.2.

Table 7.2: Priority Sector Advances of RRBs

Rs crore

Purpose	1995	2002*	%Growth
Agriculture	2,177 (35.0)	4,594 (43.5)	13.9
Non-Agriculture	4,049 (65.0)	5,977 (56.6)	5.9
Total	6,226 (100.0)	10,571 (100.0)	8.7

Figures in brackets indicate percentage to total

Source: * **Report on Trends and Progress of Banking in India, 2002-2003,** RBI; and NABARD

The agriculture and non-agriculture advances of RRBs under priority sector taken together increased from Rs 6,226 crore in 1995 to Rs 10,571 crore in 2003 (Table 7.2), at a rate of 8.7 per cent per annum. Agriculture credit grew at 13.9 per cent a year, while non-agriculture credit rose at just 5.9 per cent annually in this period. Short-term agriculture credit increased at about 29 per cent per annum, but term loans *declined* by 2.6 per cent a year. Despite the strong RRB rural branch structure, accounting for 30 per cent of all such branches of scheduled commercial banks, their share in the total agriculture credit at the national level has remained abysmally low right from their inception, at 8 to 9 per cent.

Recovery of Loans and NPAs

7.5 The asset quality of RRBs has significantly improved over the past few years. This became possible due to their improved recovery performance. The rate of recovery was 60.0 per cent in 1999; it improved to 71.5 per cent in 2003 (Table 7.3). NPAs nearly halved from 27.8 per cent to 14.4 per cent in this period. The improvement in recovery of dues could also be attributed to progressive linkages undertaken by RRBs with micro credit institutions such as SHGs. RRBs have been playing an important role as self help groups promoting institutions (SHPI) in rural areas. In 2002, 24 RRBs from 13 states had promoted and linked 9,120 SHGs. The cumulative number of SHGs promoted by RRBs as of March 31, 2004 was

23,638 while those linked to banks was 13,591. The SHGs linkage has helped RRBs increase their outreach and has become a platform for successful implementation of many other developmental programmes.

Table 7.3: Recovery and NPAs

Year	% Recovery to Demand	% NPA to Total Outstanding Loans and Advances
1999	64.1	27.8
2000	68.2	23.1
2001	70.6	18.8
2002	71.5	16.5
2003	73.5	14.4

Source: **RRBs – Key Statistics as of 31/3/2003**, NABARD

7.6 The region-wise position of total loans outstanding and NPAs, however, varied widely (Table 7.4). The NPA proportion was the highest at 26.4 in the North-Eastern region and lowest at 7.9 per cent in Northern region.

Table 7.4: Region wise Advances, NPAs as on March 31, 2003

Rs crore

Region	**Total Loan Outstandings**	**NPAs**	**NPAs as % to Total Outstanding**
Northern	2,761	217	7.9
North-eastern	772	204	26.4
Eastern	4,253	780	18.3
Central	5,820	1,075	18.5
Western	1,316	241	18.3
Southern	7,236	683	9.4
All India	22,158	3,200	14.4

Source: **RRBs – Key Statistics as of 31/3/2003**, NABARD

Financial Performance

7.7 The financial performance of the RRBs was determined to a large extent by major policy initiatives taken from time to time, RRB business strategies in response to these policies, investments in risk-free government securities and innovative ways of RRBs to address challenges and opportunities. Some 156 of the 196 RRBs earned profits in 2003 (Table 7.5). The higher number of loss-making banks in 2003 as compared to 2002 could be attributed to declining yield from investments, among other factors. Interest on investments was about 52 per cent of the total income in 2003 while interest on advances was 37 per cent of the income. The number of RRBs which had wiped off their accumulated losses increased to 97 as on March 31, 2003 from 86 a year earlier. These 97 RRBs together also built up reserves of more than Rs 2,335 crore as on the same date. Another 59 RRBs earned current profits; their accumulated losses were reduced to Rs 1,183 crore as on March 31, 2003 from Rs 1,641 crore at the end of the previous year.

Table 7.5: Number of Profit/Loss Making RRBs

Year	In Profit	In Loss
1999	147	49
2000	162	34
2001	170	26
2002	167	29
2003	156	40

Source: **Review of Performance of RRBs, 31/3/2002,** and **RRBs – Key Statistics as of 31/3/2003**, NABARD

Costs and Margins

7.8 Table 7.6 shows financial margins, costs of operation, gross margins, risk costs and net margins as defined in Annexure 4.1. The year-to-year variation in net margins ranged from 0. 8 to 1.4 per cent. This variation is largely caused by fluctuations in the yield from investments and advances in the face of relatively high financial, transaction and risk costs. Most of these banks have taken recourse to investments in government securities of relatively higher real interest rates, thus resorting to narrow banking. In a declining interest rate regime, however, their profitability might be adversely affected. Therefore, they may have to devise new products for their clientele and diversify their lending portfolio.

Table 7.6: Financial Margins, Cost of Operation and Net Margin of RRBs

Year	Financial Margin	Cost of Operation	Gross Margin	Risk Cost	Net Margin
1999	3.8	3.2	1.1	0.3	0.8
2000	3.8	2.9	1.5	0.3	1.2
2001	3.9	2.7	1.7	0.3	1.4
2002	3.8	3.0	1.6	0.3	1.2
2003	3.5	3.0	1.3	0.3	0.9

Source: **Review of Performance of RRBs, 31/3/2002,** and **RRBs – Key Statistics as of 31/3/2003**, NABARD

Recommendations of Earlier Committees

7.9 The Committee on Rural Banks (Dantwala Committee) reviewed RRB operations in 1978. It recommended that RRBs should also finance to non-target group borrowers. The Working Group on RRBs (Kelkar Committee) recommended in 1986 enhancement of the share capital of the RRBs, investment of their funds in high-yielding government securities and greater support and involvement of the sponsor banks. The Committee on Financial System (Narasimham Committee) recommended in 1991 that sponsor banks might decide whether to retain the identities of sponsored RRBs or to merge them with rural subsidiaries of commercial banks to be set up as recommended by the Committee.

Initiatives for Revitalisation of RRBs

7.10 RRB stakeholders (Central Government/sponsor banks/state governments) started their recapitalisation in 1994-95 as a part of comprehensive restructuring programme. The process continued until 1999-2000 and covered 187 RRBs with aggregate financial support of Rs 2,188 crore from shareholders. Preparation of annual development action plans for attaining financial viability within a definite time frame was also introduced in 1994-95 under NABARD guidance. The result was the impressive turnaround of loss-making RRBs noted earlier.

Reasons for Slow Progress of RRBs

7.11 The general perception of RRBs despite the above initiatives is that they have not lived up to the expectations of their role as the third channel for rural credit delivery. The turnaround of most of the RRBs is more due to their treasury operations rather than their commercial banking operations. Some external and internal factors, which seem to hamper the working of the RRBs, are:

- Limited area of operations of RRBs and their narrow client base;
- High transaction cost caused in part by a large number of small accounts;
- Lack of professionalism in management;
- Inappropriate and inadequate training of their staff;
- Ineffective boards of directors, since government/sponsor bank still retain most decision-making powers.

Relevance of RRBs

7.12 The Tenth Five-Year Plan working group on agricultural credit, co-operation and crop insurance estimates that a 4 per cent growth in agriculture sector requires credit of about Rs 7,36,000 crore in the plan period. These estimates coupled with the RRB share of 9 per cent in agriculture credit suggest that RRBs would be required to disburse loans of Rs 66,000 crore. **Considering this magnitude of projected flow of agricultural credit, the Committee feels that RRBs have an important role to play, particularly because of their strong rural branch infrastructure and rural orientation of their staff, the current low share of RRBs in agriculture credit notwithstanding. The Committee, therefore, feels**

that the mandate of RRBs has to continue, even as they need to be restructured into viable financial institutions, simultaneously retaining their regional character and rural focus.

7.13 Various working groups and committees from time to time have examined this problem and prescribed various measures as also models for restructuring the RRBs. The Committee has examined the following options, including the one recommended by the IBA Committee of Commercial Banks:

- Merger of RRBs with sponsor banks;
- All RRBs sponsored by a single sponsor bank to be amalgamated into a single, wholly-owned subsidiary of the sponsor bank;
- Each RRB to be a wholly-owned subsidiary of its sponsor bank;
- Consolidation of all RRBs into a National Rural Bank;
- Continuation as of now;
- Privatisation of RRBs;
- Amalgamation of RRBs into zonal banks;
- Amalgamation of RRBs into state-level banks;
- State level amalgamation of RRBs of a sponsor bank.

7.14 **The Committee has not considered the option of merger with the sponsor bank, as it would go against the rationale of the third channel for rural credit with a clear rural focus and regional orientation.** The Committee notes that each of the options mentioned above has certain merits and demerits. Subsidiarisation of the RRBs may require huge capitalisation by the sponsor bank; creation of the National Rural Bank of India may lead to a monolithic institution with a vast area of operation and an unmanageable number of branches. Continuing the existing structure would result in perpetuation of the problems listed above. Evolving revitalisation packages for individual RRBs may not be feasible for some of the very weak banks. Privatisation is also not feasible for the same reason. The zonal level merger of RRBs will result in loss of the regional and state focus while the state level mergers may cause problems of amalgamation of diverse work cultures and systems and procedures of the different RRBs. **The Committee firmly believes that none of the above options could apply in isolation because of the diverse socio-economic conditions and region-specific problems prevailing across the country. It is, therefore, of the opinion that a hybrid model combining several options has to be evolved to make RRBs more vibrant.**

7.15 **The Committee believes that two different models need to be applied. It recommends a zonal bank for RRBs in the North-East and rural banks at state level for the rest of the country.**

Model 1: Zonal Bank for North-Eastern States

7.16 **The Committee recommends that all the RRBs in the North-Eastern states be merged into a zonal bank. This bank will work on stand-alone basis. Its equity would be held by NABARD, State Bank of India and United Bank of India, the latter two being principal sponsor banks in the region, in the ratio of 26:37:37, through a holding company. The holding company will return the share capital and additional share capital deposits contributed by the Central and state governments at a price based on the book value. The newly constituted bank will function independently with a CEO and a Board of Directors, and will be delinked from the sponsor bank. It will retain the rural character and focus of the merged entities. The sponsor bank with the maximum number of RRBs in the present set-up may provide managerial support to the new zonal bank for the first five years. The zonal bank should develop managerial staff in-house in this period. The status may be reviewed after 5 years.**

Model 2: State Level Regional Rural Banks

7.17 **The Committee recommends a two-step reorganisation of RRBs for the rest of the country. As a first step, all RRBs of a sponsor bank in a state would be amalgamated into a single unit in that state. There could be more than one amalgamated RRB at the state level depending upon the number of sponsor banks in the state. For this purpose, each sponsor banks may establish one holding company under the Companies Act to serve as a special purpose vehicle in the state. Sponsor banks and NABARD will contribute to the equity of the holding company in the ratio of 74:26. The holding company, in turn, would contribute to the equity of the various state-level RRBs of the sponsor bank. It will also return the share capital and additional share capital deposits contributed by the Central and state governments at a price based on the book value. Loss-making RRBs (post amalgamation), if any, may be given a reasonable time frame to turn around with a clear understanding that they may not be allowed to continue the business thereafter. The first stage of reorganisation will reduce the number of RRBs to 74 from 196.**

7.18 Funds required by NABARD for investment in the holding companies may be provided by the Central Government out of the capital to be refunded on restructuring of RRBs.

7.19 Some important parameters of the resultant RRBs, if restructured as above, are given in Annexure 7.2. They are based on the financial position of the existing RRBs as on March 31, 2003.

7.20 Boards of Directors of the reorganised RRBs have to be professional, the same way as those of the commercial banks are under the BR Act, to ensure their viability. These RRBs need to be functionally and administratively autonomous so that they could develop cost-effective innovative financial products to suit the local requirements.

7.21 **The Committee recommends that the state/zonal RRBs may be permitted to seek cheaper funds through issue of Certificates of Deposit.**

7.22 **The Committee also feels that the income tax exemption granted to RRBs may be continued to the newly formed state/zonal RRBs, since they would be deploying 60 per cent of their advances to the priority sector as is applicable now.**

7.23 **The Committee recommends that within a period of three to five years, state-level holding companies should harmonise staffing patterns, procedures and policies of their various amalgamated RRBs operating in a particular state, as the second step of state-wise consolidation and formation of state level rural banks. Thus 20 state-level rural banks will emerge after the second stage.**

7.24 In view of the above recommendations, the revised structure of RRBs will be different from that envisaged in the Act. As this calls for several amendments, **the Committee recommends that RRBs Act 1976 may be repealed and replaced by a new Act, with suitable provisions for functional autonomy to the restructured RRBs and professionalisation of management and boards of directors.**

7.25 The Committee feels that these models have the following advantages:

i. The regional orientation, rural focus and local feel of these banks would be retained;

ii. Consolidation of RRBs at state level would not disturb the arrangements abruptly;

iii. The two-stage amalgamation at the state level avoids conflicting work cultures, systems and procedures and service conditions;

iv. State- and zonal-level banks could scale up their operations due to their larger size enabling them to be viable;

v. Manpower would be optimally used through mobility and geographical relocation from surplus to deficit areas with in the state;

vi. Amalgamated banks would have a greater autonomy in undertaking the business depending on the potential available in a more focused manner;

vii. Boards of amalgamated banks could be strengthened by presence of professionals and experts in different financial and economic fields;

viii. Administrative expenses could be cut severely, as redundant head offices will be closed;

ix. Unsatisfactory working of individual RRBs may not contaminate the balance sheets of sponsor banks, in view of the presence of the holding company;

x. NABARD presence will ensure different sponsor banks' concentrated attention on rural credit;

xi. The expanded structure would permit sanctioning of higher limits to single or group borrowers and still comply with the Reserve Bank prudential norms.

7.26 **This is the Committee's preferred approach. This needs to be further explored for detailing all the procedural and formal requirements.**

Annexure 7.1

Regional Spread of RRBs (2003)

Region/ State	No of RRBs	Districts	Branches	Staff
Northern Region				
Haryana	4	18	293	1,582
Himachal Pradesh	2	7	133	584
Jammu & Kashmir	3	13	268	1215
Punjab	5	16	204	743
Rajasthan	14	34	1,014	4,356
Sub-total	**28**	**88**	**1,912**	**8,480**
North-eastern Region				
Arunachal Pradesh	1	6	19	64
Assam	5	23	398	1,974
Manipur	1	9	29	101
Meghalaya	1	4	51	184
Mizoram	1	8	54	177
Nagaland	1	5	8	28

Tripura	1	4	86	707
Sub-total	**11**	**59**	**645**	**3,235**
Eastern Region				
Bihar	16	38	1,486	6,303
Jharkhand	6	21	391	1,608
Orissa	9	30	835	4,222
West Bengal	9	20	873	5,197
Sub-total	**40**	**109**	**3,585**	**17,330**
Central Region				
Chhattisgarh	5	17	438	1,820
Madhya Pradesh	19	44	1,056	4,471
Uttaranchal	4	13	171	624
Uttar Pradesh	36	72	2,845	14,418
Sub-total	**64**	**146**	**4,510**	**21,333**
Western Region				
Gujarat	9	23	368	1,614
Maharashtra	10	20	588	2,448
Sub-total	**19**	**43**	**956**	**4,062**
Southern Region				
Andhra Pradesh	16	23	1,158	5,741
Karnataka	13	29	1,103	5,733
Kerala	2	10	354	2,559
Tamil Nadu	3	9	210	1,074
Sub-total	**43**	**71**	**2,825**	**15,107**
Grand Total	**196**	**516**	**14,433**	**69,547**

Source: **RRBs – Key Statistics as of 31/3/2003**, NABARD

Annexure 7.2

Profits and Losses of RRBs According to States and Sponsor Banks

	No of RRBs	Profit-making RRBs		Loss-making RRBs	Losses, Rs lakh	Net Profit/Loss, Rs lakh	Accumulated Losses, Rs lakh
Andhra	2	2	5,97	0	0	5,97	0
Indian	2	2	5,72	0	0	5,72	0
SBH	4	4	11,07	0	0	11,07	0
SBI	5	4	20,57	1	(2,31)	18,26	(40,17)
Syndicate	3	3	47,33	0	0	47,33	0
Andhra Pradesh	**16**	**15**	**90,65**	**1**	**(2,31)**	**90,65**	**(40,17)**
CBI	8	3	12,01	5	(44,97)	(32,96)	(3,88,44)
PNB	4	4	35,38	0	0	35,38	(43,28)
SBI	1	0	0	1	(2,08)	(2,08)	(28,87)
Uco	3	1	65	2	(13,62)	(12,96)	(65,79)
Bihar	**16**	**8**	**48,06**	**8**	**(60,66)**	**(12,62)**	**(5,26,38)**
CBI	1	1	43	0	0	43	(32,11)
Dena	1	1	412	0	0	4,12	(14,80)
SBI	3	1	92	2	(5,61)	(4,68)	(1,03,16)
Chhattisgarh	**5**	**3**	**5,46**	**2**	**(5,61**	**(14)**	**(1,50,07)**
BOB	3	3	6,29	0	0	6,29	(5,46)
Dena	3	3	9,48	0	0	9,48	(20,33)
SBS	3	3	8,24	0	0	8,24	0
Gujarat	**9**	**9**	**24,01**	**0**	**0**	**24,01**	**(25,79)**
PNB	3	3	14,27	0	0	14,27	(17,09)

Syndicate	1	1	32,61	0	0	32,61	0
Haryana	**4**	**4**	**46,89**	**0**	**0**	**46,89**	**(17,09)**
PNB	1	1	2,88	0	0	2,88	0
SBI	1	1	1,23	0	0	1,23	0
Himachal Pradesh	**2**	**2**	**4,11**		**0**	**4,11**	**0**
J&KB	2	1	9,92	1	(3,71)	6,20	(32,27)
SBI	1	0	0	1	(12,11)	(12,11)	(67,42)
Jammu & Kashmir	**3**	**1**	**9,92**	**2**	**(15,82)**	**(5,90)**	**(99,69)**
BOI	4	2	3,90	2	(10)	(6,28)	(62,67)
SBI	2	0	0	2	(13,42)	(13,42	(59,00)
Jharkhand	**6**	**2**	**3,90**	**4**	**(23,60)**	**(19,70)**	**(1,21,68)**
Canara	4	4	31,23	0	0	31,23	0
Corporation	1	0	0	1	(96)	(96)	0
SBI	1	1	5,36	0	0	5,36	0
SBM	2	2	4,59	0	0	4,59	0
Syndicate	4	4	34,17	0	0	34,17	0
Vijaya	1	1	1,63	0	0	1,63	0
Karnataka	**13**	**12**	**76,98**	**1**	**(96)**	**76,02**	**0**
Canara	1	1	18,54	0	0	18,54	0
Syndicate	1	1	11,30	0	0	11,30	0
Kerala	**2**	**2**	**29,84**	**0**	**0**	**29,84**	**0**
Allahabad	1	1	1,81	0	0	1,81	(10,37)
BOB	1	0	0	1	(2,09	(2,09)	(36,25)
BOI	4	3	3,91	1	(1,00)	(2,92)	(37,26)
CBI	7	7	5,72	0	0	5,72	(85,86)
SBI	3	3	1,04	0	0	1,04	(59,12)
SBIndore	1	1	3,29	0	0	3,29	0
Uco	1	0	0	1	(2,42	(2,42)	(27,73)
Union	1	1	1,22	0	0	1,22	0

Madhya Pradesh	**19**	**16**	**16,99**	**3**	**(5,49)**	**11,50**	**(2,56,59)**
BOI	4	2	7	2	(4,19)	(4,12)	(54,51)
BOM	3	1	1,30	2	(14,33)	(13,03)	(64,51)
CBI	3	3	2,80	0	0	2,80	(11,30)
Maharashtra	**10**	**6**	**4,17**	**4**	**(18,52)**	**(14,35)**	**(1,30,32)**
Andhra	1	1	8,64	0	0	8,64	0
BOI	1	1	1,15	0	0	1,15	(38,34)
IOB	2	2	3,36	0	0	3,36	(57,57)
SBI	3	0	0	3	(21,230	(21,23)	(1,73,32)
Uco	2	0	0	2	(22,74)	(22,74)	(1,90,60)
Orissa	**9**	**4**	**13,15**	**5**	**(44)**	**(30,82)**	**(4,59,83)**
P&SB	1	1	2,15	0	0	(2,15)	0
PNB	3	3	29,67	0	0	29,67	0
SBP	1	1	3,62	0	0	3,62	0
Punjab	**5**	**5**	**35,44**	**0**	**0**	**35,44**	**0**
BOB	5	4	4,13	1	(6,30)	(2,16)	(1,09,03)
BOR.	1	1	33	0	0	33	(13,85)
CBI	1	1	50	0	0	50	(25,36)
PNB	2	2	21,19	0	0	21,19	(10,32)
SBBJ	3	2	6,38	1	(1,00)	5,38	(19,08)
Uco	2	2	6,47	0	0	6,47	(19,08)
Rajasthan	**14**	**12**	**39,00**	**2**	**(7,29)**	**31,70**	**(1,96,72)**
IOB	1	1	13,75	0	0	13,75	0
Indian	2	2	4,59	0	0	4,59	0
Tamilnadu	**3**	**3**	**18,33**	**0**	**0**	**18,34**	**0**
Allahabad	6	6	47,11	0	0	47,11	(4,12)
BOB	9	9	41,99	0	0	41,99	(56,74)
BOI	3	3	17,48	0	0	17,48	0
CBI	2	1	3,74	1	(91)	2,83	(11,64)

Canara	3	3	23,62	0	0	23,63	0
PNB	6	6	19,18	0	0	19,18	(43,22)
SBI	2	2	19,42	0	0	19,42	0
Syndicate	1	1	36,62	0	0	36,66	0
UPSCB	1	0	0	1	(4,30)	(4,30)	(34,29)
Union	3	3	31,58	0	0	31,58	(7,38)
Uttar Pradesh	**36**	**34**	**2,40,75**	**2**	**(5,21)**	**2,35,53**	**(1,57,39)**
BOB	1	1	4,07	0	0	4,07	0
SBI	3	3	3,49	0	0	3,49	(1,97)
Uttaranchal	**4**	**4**	**7,57**		**0**	**7,57**	**(1,97)**

CBI	1	0	0	1	(3,53)	(3,53)	(56,40)
UBI	5	5	4,71	0	0	4,71	(1,80,25)
Uco	3	2	3,90	1	(4,95)	(1,05)	(45,32)
West Bengal	**9**	**7**	**8,60**	**2**	**(8,48)**	**12**	**(2,81,97)**
All States except NE	**185**	**149**	**7,23,78**	**36**	**(1,97,92)**	**52,586**	**(24,65,66)**
SBI	1	0	0	1	(11,19)	(11,19)	(22,35)
Arunachal Pradesh	**1**	**0**	**0**	**1**	**(11,19)**	**(11,19)**	**(22,35)**
SBI	1	0	0	1	(3,26)	(3,26)	(22,42)
UBI	4	4	4,74	0	0	4,74	(81,40)
Assam	**5**	**4**	**4,74**	**1**	**(3,26)**	**1,49**	**(1,03,82)**
UBI	1	0	0	1	(2,15)	(2,15)	(14,23)
Manipur	**1**	**0**	**0**	**1**	**(2,15)**	**(2,15)**	**(14,23)**
SBI	1	1	3,10	0	0	3,10	0
Meghalaya	**1**	**1**	**3,10**	**0**	**0**	**3,10**	**0**
SBI	1	1	29	0	0	29	(5,58)
Mizoram	**1**	**1**	**29**	**0**	**0**	**29**	**(5,58)**
SBI	1	0	0	1	(16)	(16)	(1,58)
Nagaland	**1**	**0**	**0**	**1**	**(16)**	**(16)**	**(1,58)**
UBI	1	1	2,05	0	0	2,05	(1,39,02)
Tripura	**1**	**1**	**2,05**	**0**	**0**	**2,05**	**(1,39,02)**
North-eastern States	**11**	**7**	**10,18**	**4**	**(16,75)**	**(6,57)**	**(2,86,59)**
All-India	**196**	**156**	**7,33,96**	**40**	**(21,468)**	**5,19,29**	**(27,52,25)**

8

ROLE OF NABARD

Mandate of NABARD

8.1 NABARD was set up in July 1982 through an Act of Parliament based on the recommendation of the Committee to Review the Arrangements for Institutional Credit for Agriculture and Rural Development set up by Reserve Bank in March 1979. The mandate given by the Act is "providing and regulating credit and other facilities for the promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas, and for matters connected therewith or incidental thereto."

Review by Committees

Agricultural Credit Review Committee (ACRC, 1989)

8.2 ACRC reviewed NABARD performance in its initial years and offered suggestions for making it a strong development bank for India's growing agricultural and rural sector. The highlights of its recommendations were:

- NABARD had three main functions, namely, providing refinance, institutional development and inspection of client banks. The refinance function had attracted relatively more attention and resources, keeping NABARD from building up the co-operative credit delivery system and forging better linkages between its supervision and development functions;
- It should pay greater attention to revitalising the co-operative system and also to non-farm business and agro-processing activities;
- It should build up capacities of client banks and make them appreciate better the technical and financial appraisal requirements of various schemes;
- NABARD could resort to direct lending under special circumstances in the wider interest of regional or sectoral development.

Expert Committee on Rural Credit (ECRC, 2001)

8.3 ECRC noted later amendments to the NABARD Act empowering it to take a more active stance for development through credit. ECRC's suggestions for a more active role for NABARD are referred to in appropriate paragraphs below.

Functions of NABARD

8.4 NABARD carries out three broad functions of development, credit and supervision.

i. *Developmental functions* include interventions aimed at building a viable institutional network for rural credit, human resource development in RFIs, potential mapping and facilitating credit flow towards actuating such potential, evolving banking products and approaches for improving agricultural productivity with focus on dryland areas, employment generation in farm and non-farm activities, gender development, expanding access of financial services to the rural poor, building a climate conducive to repayment in rural areas, enhancing credit absorption capacity especially in backward regions, and building awareness and policy advocacy for different sectors.

ii. *Credit functions* primarily cover provision of short-term refinance for production and marketing to co-operatives and RRBs, refinance to co-operatives and RRBs for conversion, rephasing of short-term loans, provision of investment refinance to all eligible banks including commercial banks, loans to state governments for purchase of shares of co-operatives, and financing of rural infrastructure. A synergy between credit and development functions exists because they are complementary to each other. Development initiatives ultimately translate into credit demand.

iii. *Supervision function*, carried out on behalf of Reserve Bank in respect of co-operatives and RRBs, includes on-site inspections of banks, off-site surveillance, recommending bank/branch licences to Reserve Bank, recommending exemption from application of Section 11 (1) of the BR Act, 1949 to co-operative banks, monitoring banks' compliance with relevant provisions of the BR Act, 1949 and the RBI Act, 1934, follow-up action on inspection reports including evaluation of quality of compliance, internalisation of findings, providing guidelines for strengthening internal control systems and procedures in banks, monitoring of complaints against banks/bank staff, organising seminars/workshops for the benefit of officials of co-operative banks, RRBs and state governments on supervision related areas, etc. NABARD has constituted a Board of Supervision, which gives direction and guidance in respect of policies and on matters relating to supervision and inspection.

Achievements and Shortcomings

8.5 Some of the major achievements of NABARD are highlighted below:

i. Its aggregate disbursements under short-term production/marketing loans and investment loans have increased from Rs 2,055 crore in 1982-83 to Rs 14,650 crore in 2003-04. This has had a significant impact on private capital formation in key sub-sectors of the rural economy, such as minor irrigation, farm mechanisation, plantations and horticulture development, animal husbandry, fisheries, cold storages and rural godowns, rural non-farm activities, rural housing, micro-finance, etc.

ii. NABARD recognises the need to build strong rural financial structure and has made significant efforts to build up human capital of the co-operative credit institutions and RRBs. Organisational development intervention carried out in all RRBs and 50 SCBs/DCCBs has made a good contribution to their turning around. Its system of signing MoUs on the basis of a development action plan (DAP) has been recognised as a major step towards revitalisation of many RRBs.

iii. Several NABARD initiatives aimed at improving productivity of agriculture in dryland areas through watershed development (274 projects in 10 states) and tribal development programmes through development of *wadi*s (coverage of over 15,000 tribal families) have achieved significant successes.

iv. NABARD also spearheaded the rural credit extension programme of Vikas Volunteer Vahini (VVV) under which Farmers' Clubs (over 10,000) work as a link between banks and rural communities, promoting development through credit and inculcating virtues of timely repayment. Its efforts at evolving innovative credit products such as Kisan Credit Cards and Swarojgar Credit Cards are also noteworthy.

v. Its micro-finance initiative of evolving and scaling up the SHG-Bank Linkage Programme is now recognised as the largest and fastest growing programme of its kind in the world. Repayment under this programme has been consistently around 95 per cent. This is discussed in Section 5.

vi. NABARD promotes self-employment in non-farm sector through initiatives such as rural entrepreneurship programmes (over 5,400 programmes covering over 1.5 lakh rural unemployed youth), district rural industrialisation projects (covering 75 districts), cluster development programmes (55 clusters in 18 states), schemes for promotion of market interventions for artisan products, women development programmes, etc., in partnership with a large number of NGOs and banks. They have become models for replication.

vii. NABARD has also developed expertise in appraisal and monitoring of rural infrastructure projects. This is evident from the fact that over 78,000 projects out of 1,73,000 projects funded by it were completed in time. These projects, funded with loans of Rs 34,678 crore, have made significant additions in the rural infrastructure such as minor irrigation, rural roads and bridges, etc.

8.6 NABARD still needs to address certain areas, some of which were listed by ACRC. Other areas deserving more attention include supporting value-addition in agriculture through post harvest operations, encouraging investments for diversification from subsistence to commercial agriculture, facilitating access to oral lessees and tenant farmers through product innovations and increasingly using various funds at its disposal for institutional development and generating quality inputs for policy formulation through research and studies. NABARD also need to give a renewed thrust to its mandate of policy advocacy for various sub-sectors of rural economy.

Key Questions

8.7 Making available timely, adequate and hassle-free credit at reasonable rates of interest for rural borrowers through a viable credit delivery unit in villages continues to be an important mandate for NABARD. Even as it continues to make considerable progress towards this goal, the constantly changing rural environment impacts on the quantity and quality of demand for credit and institutional health of the credit delivery system. Access to credit has been recognised as a key input to agriculture and rural development. The Committee has attempted to address the following key issues concerning the role of NABARD as a development finance institution (DFI) for rural areas against this background:

i. Is there a continued justification for DFI for rural areas?

ii. Are the three major functions of development, finance and supervision well-positioned within NABARD? *and*

iii. What constraints does NABARD face in scaling up its operations?

8.8 The share of capital formation in agriculture has declined from 1.6 per cent of GDP in 1995-96 to 1.3 per cent in 2000-01. Its absolute value fluctuated between Rs 14,895 crore and Rs 18,057 crore at 1993-94 prices in this period. Although the public sector investments in agriculture increased from Rs 3,919 crore in 2000-01 to Rs 4,794 crore in 2001-02, it continued to be below the level of Rs 4,849 crore in 1995-96. Therefore, investment in agriculture needs to be sustained and scaled up significantly. While private sector contribution to capital formation in agriculture has gone up between 1993-94 and 2001-02, it needs to be further enhanced by facilitating private long-term investments. Two-pronged efforts in this direction are required, providing resources and building viable delivery points. Such a direction and thrust to the capital formation in rural areas can only be handled by a DFI such as NABARD. The continuance of DFIs under financial sector reforms is being questioned in some quarters. **In view of the critical need to enhance production, productivity and employment generation through credit interventions in rural areas, the Committee reiterates that NABARD's role as DFI should be strengthened.**

8.9 Development of rural infrastructure is recognised as an important intervention to improve credit absorption capacity of rural areas. Infrastructure projects being generally long-term in nature, are better handled by a DFI such as NABARD.

8.10 The Tenth Five-Year Plan envisages a 4 per cent growth rate in agriculture. A substantial gap between credit requirements to meet this target and projected credit flows is likely to emerge by the end of the plan period unless suitable remedial measures are taken. A DFI for rural areas could have a positive influence in bridging the gap between demand and supply of farm credit.

8.11 Development through credit continues to occupy an important role space in a society where nearly a third of the rural population has only peripheral participation in economic growth. A DFI alone could provide the required lead to the banking system to providing access to financial services to these segments of the rural society.

8.12 The increasing commercialisation of agriculture envisaged depends on latest technological inputs and an enabling environment. These are best achieved through adequately funded specific projects, policy advocacy and co-ordination at all levels. In this way, a DFI has a major role to play in bringing together commercial agricultural entrepreneurs and the banking system.

8.13 In view of the above, **the Committee endorses the need and rationale for an organisation such as NABARD as a development finance institution. All three functions of NABARD, i e credit, development and supervision continue to be of high relevance to the rural economy. Building a stronger rural credit system and converting credit needs into effective demand are the two most important expectations from NABARD.**

8.14 NABARD is increasingly expected to work as a commercial organisation, implying self-reliance, market orientation, and being subjected to corporate income tax, etc. At the same time, it is expected to undertake significant development initiatives in areas of institutional development, development of credit markets through base level district credit planning, potential mapping, implementation of VVV programme, watershed development schemes, rural non-farm sector development, gender development, micro-finance, etc. **The Committee recognises the trade-off between the commercial and development goals. Keeping in view its predominant developmental and promotional roles, NABARD need not be driven by commercial considerations alone.** On the one hand, its strong balance sheet enables it to leverage resources at competitive rates; on the other, its surplus resources are being ploughed back into rural areas in the form of refinance and developmental initiatives. **Therefore, profit maximisation or its balance sheet cannot be the sole criteria for judging its performance. Right signals from its owners would go a long way in enabling it to strike a proper balance between developmental and commercial agenda.**

Strengthening NABARD Resource Base

8.15 **The NABARD resource base needs to be strengthened urgently to enable it to influence ground-level credit flow to desired sectors and regions.** NABARD has been increasingly relying on market borrowings to mobilise resources through capital gains bonds, tax-free bonds, priority sector bonds, non-priority sector bonds and corporate borrowings. Its average cost of borrowings was 5.4 per cent for 2003-04. ECRC had recommended a greater credit support to NABARD, with an increase of 10 to 15 per cent annually in the General Line of Credit (GLC) and allowing it to access National Industrial Credit (Long Term Operations) Fund. The NABARD's ability to provide concessional refinance is being increasingly constrained in view of the GLC interest rate being at Bank Rate and no significant contributions forthcoming to the National Rural Credit Fund.

8.16 **While NABARD may continue to mobilise resources from the market, keeping in view the limitations of market borrowings, the Committee recommends a judicious mix of market borrowings supplemented by Central Government funding out of profits transferred to it by Reserve Bank, to further expand the NABARD's scale of operations.**

8.17 Apart from this, the following recommendations are made for strengthening the resource base of NABARD:

i. *Permission for External Commercial Borrowings*: **Given possibilities of leveraging its strong balance sheet to mobilise commercial borrowings at lower costs, the Government of India (GoI) and Reserve Bank may consider allowing competitive external commercial borrowings to NABARD for justifiable purposes. Section 20 of the NABARD Act may suitably be amended to empower the NABARD Board of Directors to allow raising of funds up to the extent permitted by Reserve Bank under the automatic route. GoI may provide sovereign guarantees with lower charges for both external commercial and development assistance borrowings. Appropriate tax exemptions should also be provided to reduce the cost of market borrowings.**

ii. *Contingency Credit Line*: **In view of the Reserve Bank's decision to phase out GLC, there is a need to provide a contingent credit line to NABARD. The Committee recommends that Reserve Bank may arrange for a contingency credit line from the banking sector at a reasonable rate of interest so that NABARD can draw funds in case of need.**

Reviewing the Corporate Income Tax on NABARD

8.18 ECRC had recommended that imposition of corporate income tax on NABARD may be deferred for five years and a review of the situation may be undertaken in 2007, mainly in view of the fact that NABARD has many development schemes crucial to the well-being of rural areas and which do not generate income. **This Committee endorses the ECRC views, except that the exemption may not cover income from its commercial business such as treasury operations, co-finance, etc.**

Institutional Development - Building Network of Rural Financial Institutions

8.19 ECRC had stressed the need for sharpening the DAP–MoU mechanism and automatic suspension of credit facilities from higher-level institutions on non-submission of progress reports by stated dates. **This Committee endorses the above recommendation. While continuing its focus on reviving the DCCBs and SCBs, NABARD may reorient its institutional development interventions to the base unit of co-operatives i e PACS, besides other co-operative clients. The Committee also suggests early implementation of the recommendations of the Task Force to Study the Functioning of Co-operative Credit System and Suggest Measures for its Strengthening (Capoor Committee) and the Joint Committee on Revitalisation Support to Co-operative Credit Structure (Vikhe Patil Committee) relating to duality of control, recapitalisation, etc.**

8.20 Although grants of nearly Rs 50 crore have been extended out of the Co-operative Development Fund (CDF) set up by NABARD for supporting developmental initiatives of co-operatives, it has not served the purpose. **Given the deteriorating health of co-operatives, NABARD may step up its technical and financial support to them, especially in areas of skill-building for PACSs, provision of performance linked infrastructure support for computerisation, etc. The Committee stresses the need for more effective utilisation of CDF for the purpose.**

8.21 Some DCCBs, especially in West Bengal and Karnataka, have successfully used banking with SHGs as a tool for revival of weak primary co-operatives. **NABARD may aggressively associate more DCCBs in SHG-Bank Linkage Programme with required financial assistance.**

8.22 Long-term co-operative credit institutions have been playing an important role in purveying investment credit primarily with financial support of NABARD. It has a substantial financial exposure on these institutions. The financial health of the long-term co-operative structure is deteriorating. **State governments need to support NABARD's efforts at revitalising them through measures such as facilitating faster repayments of their loans and recapitalisation of weak institutions.** Borrowers of SCARDBs have to approach other banks for their crop loan requirements. **Pending integration of short and medium-term structures, NABARD may also explore possibilities of extending short-term agricultural loans through SCARDBs in areas where PACSs are non-functional.**

8.23 While the Committee has taken a specific view on restructuring RRBs, **NABARD may continue with its strategic partnership and stake in these specialised rural financial**

institutions. These partnerships could be further strengthened in the areas of human resource development, building of systems and computerisation, simplification of processes, product development, micro-finance, etc.

Promotional Initiatives

8.24 The Committee recognises that promotional initiatives of NABARD need to be enhanced. **As a guiding principle, such initiatives should lead to improvement in credit absorption capacity in rural areas, improvements in outreach of the formal banking system to the rural poor, improvements in production processes and productivity, and sensitisation of the formal credit delivery system to the emerging credit demands. The primary aim of such promotional initiatives should be to create replicable models with a clear built-in exit strategy.**

8.25 NABARD has set up specially earmarked funds such as microFinance Development Fund, Rural Promotion and Credit Fund, Credit and Financial Services Fund, etc, from its own surpluses and external support. **The Committee recommends that the utilisation of these funds be enhanced.**

8.26 **NABARD needs to adopt a holistic intervention strategy and take up development projects on a pilot basis to demonstrate the effectiveness of the integrated approach for development initiatives and to make a visible impact on the disadvantaged sections and regions.**

8.27 The Committee has received generally positive feedback about the quality of PLPs. It also observed, however, that significant variations do exist between PLPs and District Credit Plans. Inputs provided by PLPs should be beneficially used for preparation of realistic credit plans at block/district levels. **NABARD needs to be represented in state and national planning mechanisms to dovetail PLPs with overall development plans, wherever such representation does not exist.**

8.28 DDMs of NABARD have played a key facilitation role in credit planning, monitoring and co-ordination. ECRC had suggested opening more DDM offices. **Efforts may be made to expand the coverage of districts under DDM offices since NABARD's presence at district levels has been quite useful**.

8.29 **NABARD may revive its thrust on the VVV programme and ensure that such clubs exist at a large number of rural branches.**

8.30 **Training and awareness building among client institutions, including commercial banks is an on-going need. NABARD may increasingly collaborate with existing institutions promoted by banks and others. Training of ultimate borrowers also needs to be addressed through a collaborative process**.

Policy Advocacy Functions

8.31 NABARD has been envisaged to be the apex agency on all matters relating to rural credit. **To sharpen its policy advocacy role, NABARD may communicate its views on rural credit annually as an input to the Reserve Bank's Annual Policy Statement and devise its own Action Plan on the basis of the Policy Statement.**

8.32 **NABARD may take up monitoring of the entire rural credit situation in a holistic manner, including that of commercial banks, presently handled by Reserve Bank, to discharge effectively its responsibilities as the apex development bank and also to play an effective advocacy role.**

Credit Functions

8.33 The ability of refinance to influence ground-level credit flow has been declining over the last few years. The share of NABARD refinance has gone down from 22.0 per cent in 1999-2000 to 18.1 per cent in 2001-02, although it marginally improved in 2002-03.

Table 8.1: Proportion of NABARD Refinance in Ground-level Credit Flow

% of credit flow

	1999-2000	**2000-01**	**2001-02**	**2002-03**
Short-term production credit	20.1	17.8	15.7	17.1
Investment credit	25.3	27.3	22.2	22.1
Total	22.0	21.1	18.1	18.8

8.34 The Committee has received suggestions from banks about various refinance product options such as flexible terms of refinance, a blanket line of credit to a bank on the basis of overall disbursements of short/medium term loans, flexible repayment options under refinance schemes, etc. Other suggestions related to adoption of securitisation of loan portfolios, floating rates of interest on refinance and giving an option to client banks to opt out of refinance with a minimum lock-in period, etc. **NABARD may review its refinance products in line with the market expectations. Some commercial banks did not avail refinance due to comfortable liquidity available in the system. Therefore, NABARD needs to focus on other areas such as project formulation, appraisal and monitoring for a fee and direct finance in partnership with RFIs. NABARD may review its core strength of technical expertise and where required, even outsource such needs to tap the emerging potential of commercialisation of agriculture.** Some projects such as bio-technology enterprises, where institutional credit may not be forthcoming, call for venture capital support. **NABARD, as earlier suggested by ECRC, may also explore the possibility of setting up a venture capital fund for promotion of projects, which have a bearing on agricultural growth.**

8.35 NABARD has built up expertise in financing and monitoring of rural infrastructure projects over the last few years. **While continuing to support the efforts of the state governments, it may also look towards increasing direct partnership with private sector in building rural infrastructure.**

8.36 While insurance companies innovate in areas of income insurance, weather insurance, micro insurance etc, NABARD's efforts in this direction have remained confined to providing consultative inputs to others. NABARD should take the lead in addressing the issue of risk mitigation, especially when working with the marginalised sections. **NABARD could explore the area of micro insurance for entry by leveraging its vast base of clients from banking and NGOs.** This could be done through partnerships with existing insurance companies.

Supervision Function

8.37 NABARD undertakes supervision function in respect of RRBs, SCBs and DCCBs on behalf of Reserve Bank. The Board of Supervision gives direction and guidance on relevant matters. **NABARD should continue with the supervision function both to safeguard its own interests as well as to strengthen the economic viability of co-operatives and RRBs in view of its close financial and developmental relationships with them. The role and composition of the Board of Supervision may be reviewed in this context. Periodic exchange of experiences between Reserve Bank and NABARD officials working in the supervision departments would add value to the common goals of both the agencies.**

8.38 **The Committee suggests that operating systems may be reviewed, especially at the regional level, to help build up synergy in all of its functions, in view of the increasing decentralisation of functions within NABARD.**

Autonomy of NABARD

8.39 The issue of operational autonomy for NABARD assumes importance given the challenges of operating in an increasingly liberalised economy and its strong developmental role. While the NABARD Act has been amended, some areas still restrict its autonomy, making it necessary for it to approach Reserve Bank and GoI for specific approvals. **The Committee feels that NABARD should have full operational autonomy in the areas of credit and developmental interventions, if necessary by amending the Act for enabling provisions. For example, Sections 21, 22, 23 and 25 of the NABARD Act may be amended whereby the NABARD Board can decide the eligibility of the purposes/institutions/bodies for finance, which at present is required to be approved by Reserve Bank.**

Human Resource Development in NABARD

8.40 Maintaining high standards of excellence, motivation, orientation and team spirit among the staff is a prerequisite for NABARD to discharge its diverse but mutually complementary functions. This has become even more important in view of the fast changing environment under which it operates and increasing responsibilities and resources being placed with it. Issues such as the need for building specialisations in different functions up to a certain level of hierarchy, delegation of powers, performance incentives and accountability become crucial in an increasingly market driven environment. **NABARD may review and suitably adjust its human resource management and development policies in its endeavour to meet the ever-changing client expectations. A client satisfaction survey and linkage with other knowledge systems such as agriculture universities could give inputs for redrawing its operational policies.**

9

RURAL INFRASTRUCTURE DEVELOPMENT FUND
LOK NAYAK JAI PRAKASH NARAYAN FUND

Genesis

9.1 The Eighth Five-Year Plan (1992-97) period witnessed a deceleration in public sector investment in agriculture and rural infrastructure, mainly due to lack of resources. State governments, which were mainly responsible for development and maintenance of rural infrastructure, were experiencing a severe resource crunch. At the same time, many commercial banks, which were required to channelise at least 18 per cent of their net bank credit to agriculture and 40 per cent of their net bank credit to priority sector, were unable to fulfil their commitments.

9.2 Government of India announced in the Union Budget of 1995-1996 the setting up of a Rural Infrastructure Development Fund (RIDF) in NABARD with contributions by commercial banks with shortfalls in their agricultural lending. These contributions were reckoned as the banks' indirect lending to agriculture. The fund was to assist state governments and state-owned corporations in speedy completion of on-going projects relating to minor and medium irrigation, soil conservation, watershed management and construction of rural infrastructure components such as rural roads and bridges, market yards, etc. Subsequently, RIDF was extended on a year-to-year basis through announcements in the Union Budget, and domestic scheduled commercial banks with shortfalls in lending to priority sector or agriculture were allocated amounts for depositing in the fund.

9.3 RIDF has now completed ninth year of its operation. Initially, irrigation projects were given a major thrust, and rural roads and bridges received priority from RIDF II onwards. Since then, many other activities, such as rural drinking water schemes, soil conservation, rural market yards, rural health centres, primary schools, *shishu shiksha kendra*s, *anganwadi*s, mini hydel plants, power system improvements etc were added to the list of eligible activities. From RIDF V onwards, the fund's ambit covered rural infrastructure projects undertaken by panchayati raj institutions. The government decided in 2003-04 (RIDF IX) that RIDF loans may be granted for projects offering more direct benefits to farmers, and that rural roads and bridges projects may be sanctioned only in exceptional cases.

9.4 The corpus of all nine tranches of RIDF taken together amounted to Rs 34,000 crore. RIDF loans to state governments are secured by means of irrevocable letters of authority (mandate) executed by them, authorising Reserve Bank to debit their accounts in case of default. From RIDF VII onwards, interest rate on banks' contributions to RIDF was linked inversely to the extent of their shortfall in agricultural lending against the target of 18 per cent, to deter banks from considering RIDF contributions as an easier alternative to their own lending. NABARD retains a margin of 0.5 per cent and the balance interest spread earned is credited to the Watershed Development Fund.

9.5 All loans sanctioned and disbursed under RIDF, as at the end of March 2004, added up to Rs 34,648 crore and Rs 21,067 crore respectively. Rural connectivity – roads and bridges – and irrigation projects accounted for nearly 84 per cent of the cumulative sanctions between 1995-96 and 2002-03. About 60 per cent of the amount sanctioned under RIDF IX was for irrigation and other priority areas, while rural connectivity and social sector/innovative projects accounted for 33.4 and 6.6 per cent of the amount respectively.

9.6 Disbursements to state governments under any tranche of RIDF took a few years to complete, but state governments were required to pay interest at the rates decided at the time of operationalisation of the tranche or sanction of the projects by NABARD, irrespective of the market rates prevailing at the time of actual disbursement. This practice placed states at a disadvantage in a falling interest rates situation. Some states, therefore, requested for pre-payment of RIDF loans and/or a flexible rate of interest for RIDF loans sanctioned under earlier tranches. The objective was to bring interest rate charged on loans disbursed during a particular year on par with the rate of interest for the current tranche. Reserve Bank allowed such pre-payments provided projects for which the loans were disbursed did not suffer. NABARD's receipts of such prepayments were to be refunded to banks contributing to the respective tranche, which was within the provisions of the scheme.

9.7 Keeping in view the declining interest rates scenario and the need to further rationalise the interest rate structure under RIDF, the lending and deposit rates in respect of the undisbursed amounts of RIDF IV to IX were restructured with effect from 1 November 2003. The revised rates are:

Table 9.1 RIDF Interest Rates According to Tranches

Tranche	Interest Payable to Banks (% per annum)	Interest Payable by State Governments (% per annum.)
IV	6	7
V	6	7
VI	6	7
VII	6	7
VIII - IX	Linked to shortfall, varying between Bank Rate and Bank Rate - 3 (currently varying between 6% and 3%)	Bank Rate + 0.5 (currently 6.5%)

In case of RIDF VIII and IX, the rates of interest on deposits continue to be linked to the shortfall in lending to agriculture as under:

Table 9.2 Shortfalls and Interest Rates on RIDF Deposits

Shortfall in Lending to Agriculture (% age points)	Interest on Entire Deposit in RIDF VIII - IX % p a
Less than 2	Bank Rate (6 per cent at present)
2 and above, but less than 5	Bank Rate – 1%
5 and above, but less than 9	Bank Rate – 2%
9 and above	Bank Rate – 3%

ECRC Recommendations

9.8 ECRC felt that commercial banks had found contributing to the RIDF to be a far easier way of meeting the mandated level of lending to priority sectors. High interest rates on RIDF deposits at that time acted as an incentive for banks not to achieve the agricultural lending target. The committee, therefore, recommended a substantial reduction in RIDF interest rate to levels just enough to cover the interest cost of deposits.

9.9 Interest rates on undisbursed amounts under earlier tranches of RIDF have been revised downwards. Banks presently earn between 6 and 3 per cent under RIDF VIII and IX, depending on the extent of their shortfall.

Lok Nayak Jai Prakash Narayan Fund

9.10 The Union Finance Minister announced in his Interim Budget speech for 2004-05 the setting up of Lok Nayak Jai Prakash Narayan Fund (LNJPNF) (also called Agricultural Infrastructure and Credit Fund) with NABARD, with a corpus of Rs 50,000 crore spread over the next three years (April 2004 to March 2007). RIDF has since been discontinued. The fund would create a mechanism for efficiently aggregating resources from various providers of long-term finance, facilitating resource flow from the market and channelising it for agriculture and rural infrastructure development. It will thus facilitate diversification and value-addition in agriculture, as well as agricultural exports and help improve the efficiency, productivity and profitability of Indian agriculture. This, in turn, would enhance rural incomes. The fund would also improve the rural credit absorption capacity.

9.11 The fund has the following three components:

i. Finance for infrastructure through state governments – Rs 30,000 crore;

ii. Refinance for investments in agriculture and commercial infrastructure through banking system and selective co-financing – Rs 18,000 crore; *and*

iii. Development measures and risk management mechanisms – Rs 2,000 crore.

9.12. *Finance for Infrastructure through State Governments*: Eligible purposes include minor irrigation, micro/drip/sprinkler irrigation, rain-fed agriculture/integrated watershed development, reclamation of waterlogged areas, wasteland development, flood control and drainage, public cold storage facilities at various exit points, *apni mandi*, rural *haats* and other marketing infrastructure, livestock development infrastructure such as artificial insemination centres, animal breeding units, etc, plantation and horticulture development, grading and certifying mechanisms such as testing and certifying laboratories, etc. and modern abattoirs. The NABARD Board has been authorised to add or delete activities and purposes that qualify for support from the fund. Eligible clients include state governments, state-owned undertakings and corporations, panchayati raj institutions and other local bodies.

9.13 *Refinance for Investments in Agriculture and Commercial Infrastructure through Banking System and Selective Co-financing*: Activities eligible for assistance include rain-fed agriculture, micro irrigation, plantation and horticulture, marine fisheries, contract farming/agri-export zones, organic farming (priority areas), post-harvest related support such as cleaning and grading, quality control/certification mechanism, dairy sector, milk products, meat and meat products, modern abattoirs, grain processing, horticultural products, fisheries, and agricultural marketing related activities such as private sector cold storages including facilities at exit points for transportation (airport, seaport, major railway stations), transport vehicles and retail outlets to maintain the cold chains, market yards, private sector rural market infrastructure such as farmers' *mandi*, *apni mandi*/*Rythu Bazars*, rural godowns, storage units and information technology linkage with agriculture and rural development. Other areas include minor irrigation, wasteland development, forestry, land development including land purchase, inland fisheries, animal husbandry, farm mechanization, bio-technology, agri-clinics, etc. The NABARD Board has been authorised to add or delete activities and purposes that qualify for support from the fund in this category also. These projects are to be implemented by corporates, NGOs, individuals and any other agency.

9.14 *Development Measures and Risk Management*: NABARD is planning certain development measures and risk management initiatives to encourage diversification of agriculture and stimulate demand. These measures would be initiated at a later stage of the scheme. They include farm technology dissemination/IT kiosks, peoples' participation, expansion of farmers' clubs, participatory watershed development, wasteland development, initiatives for grading, sorting and certification of agricultural produce, livestock upgradation and development, tribal development, venture fund for technology support in agriculture and a farm credit calamity fund.

Corpus and Sources of Fund

9.15 The funding of the three components of the Fund has been phased over a period of three years as follows:

Table 9.3 Phasing of LNJPNF According to Purposes

Rs crore

Eligible Purposes/Year	2004-05	2005-06	2006-07	Total
Agriculture infrastructure	7,800	9,700	12,500	30,000
Investment credit including trust and innovative areas, commercial infrastructure	4,740	6,010	7,250	18,000
Development measures and risk management	-	-	2000	2,000
Total	12,540	15,710	21,750	50,000

Government of India has indicated that the fund for the first year of its operation (2004-05) would be created out of the contributions to be made by the public and private domestic scheduled commercial banks, on account of their shortfall in agriculture lending. Banks would contribute as and when NABARD makes a demand in 2004-05. They would, thus, not have to deposit their allocated amount upfront with NABARD, but in phases depending on the demand for funds from state governments. The Union Finance Minister had mentioned in his announcement on January 9, 2004 that the Government would provide, in consultation with Reserve Bank, any funds NABARD needed for the Agricultural Infrastructure and Credit Fund, in addition to the existing unutilised RIDF funds, through an appropriate mix of finance raised from the capital markets and budgetary resources. He also mentioned that the Government would consider favourably NABARD's requirements of reasonable risk mitigation measures, including partial guarantees. If it becomes necessary to access the market for funding projects under LNJPNF, it would have to decide terms and conditions for it in consultation with the Government of India.

9.16 The Minister had announced in his Interim Budget speech for 2004-05 that the Fund would provide credit at highly competitive rates, expected to be 2 percentage points below the Prime Lending Rate, without compromising financial prudence.

9.17 **The Committee feels that resources mobilised from commercial banks out of their shortfall in agricultural lending should be used only for the infrastructure through state governments component of the fund (Rs 7,800 crore in the first year, 2004-05) and not for the investment credit component, for which NABARD may find alternative sources. Further, if the aggregate shortfall of domestic scheduled commercial banks in lending to agriculture is less than the corpus required for infrastructure development, NABARD should again make alternative arrangement for funding the balance. Cost of credit should be a consideration in making these alternative arrangements, since the cost of funds raised from the market is likely to be higher.**

9.18 Projects identified for assistance under LNJPNF primarily include those which would impact agricultural development through improved production and storage/marketing. Rural roads and bridges, which were the largest beneficiaries under RIDF, have been excluded as also projects for power sector, medium irrigation, drinking water supply etc. Some states have represented that these projects should also be covered. The Committee has examined these suggestions. Creation of rural infrastructure is of utmost importance requiring enormous amounts of resources, and, therefore, the fund needs to be judiciously used. **Risks associated with projects sanctioned for assistance under the fund should be assessed thoroughly and properly, as the risk profile of projects would generally differ from project to project. The Committee is of the view that assistance under Lok Nayak Jai Prakash Narayan Fund should be for projects that have the capacity to generate some resources in future, which would help state governments repay the loans taken.**

9.19 **The Committee also feels that the corpus of LNPPNF meant for infrastructure development should be channelised through state governments/local bodies/ panchayati raj Institutions. Private sector rural infrastructure projects should be financed directly by banks**.

9.20 The corpus of Lok Nayak Jai Prakash Narayan Fund for infrastructure development is substantially higher than that of the earlier RIDF tranches I to IX. The year-wise disbursements under RIDF is as under:

Table 9.3 Year-wise RIDF Disbursements

Rs crore

1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
387	1,087	1,009	1,313	2,278	3,177	3,790	4,103	3,922

Thus, the maximum amount disbursed in a year was Rs 4,103 crore only. State governments may find it difficult to identify suitable projects to absorb the scaled-up corpus of Rs 7,800 crore in 2004-05, and Rs 9,700 crore and Rs 12,500 crore in the next two tears. **Therefore, Government of India/NABARD may make a realistic assessment of such needs and the corpus of the fund meant for infrastructure development through state governments may be suitably readjusted.**

9.21 State governments were required to execute a mandate in favour of Reserve Bank under the RIDF scheme authorising it to debit their accounts in case of default. Although there has been no occasion to invoke this mandate so far, it is appropriate that state governments should limit their contingent liabilities and the automatic debit mechanism under RIDF/LNJPNF should be phased out. **In such a case, state governments should make adequate budgetary allocations for payment of interest and repayment of principal amount. They may also consider establishing a sinking fund for this purpose through budgetary allocations.**

9.22 The Committee has noted suggestions received earlier from some quarters that banks should not be paid any interest on their deposits in RIDF as a penalty for not achieving their agricultural lending target. Deposits under RIDF IX presently carry a varying rate of interest, ranging between Bank Rate and Bank Rate minus 3 percentage points (6 and 3 per cent at present), depending on the shortfall of the bank in lending to agriculture against the sub-target of 18 per cent, while state governments pay Bank Rate plus 0.5 per cent (6.5 per cent at present). Financial positions of banks would be seriously affected if no interest is paid on RIDF deposits and would ultimately harm bank depositors' interests. **The Committee feels that the existing system of linking the interest rate on RIDF deposits inversely to the shortfall in agricultural lending seems adequate as a punitive measure, as banks with higher shortfalls receive lower interests, which would be less than their cost of funds. The interest rate structure as applicable to RIDF IX may be continued in case of deposits/advances under LNJPNF.**

9.23 The RIDF deposits were reckoned as banks' indirect lending to agriculture under the priority sector. **The Committee is of the view that this may be continued under Lok Nayak Jai Prakash Narayan Fund also. Since sanctions out of the fund would be project-specific, banks may be required to place deposits with NABARD only when there is a demand from state governments.**

9.24 The Committee is aware of the need for building up rural infrastructure and the role played by RIDF in it. Experience of RIDF schemes has also generated some confidence in this regard. **Since a large number of projects have been sanctioned under RIDF and there is a gap between sanction and actual utilisation of assistance so far, the Committee feels that the scheme should be reviewed after three years. Implementation of projects assisted under the fund should be properly monitored to ensure that sanctioned projects are completed in time.**

9.25 Utilisation of RIDF finances by states such as Bihar, Jharkhand, Uttaranchal and those in the North-east has been quite low. Increasing their share in LNJPNF is, therefore, a challenge. This is of particular significance in view of the fact that inadequate infrastructure is one of the reasons for credit disbursements not picking up in these states. **Government of India and NABARD need to take appropriate steps in this regard in consultation with the concerned state governments.**