

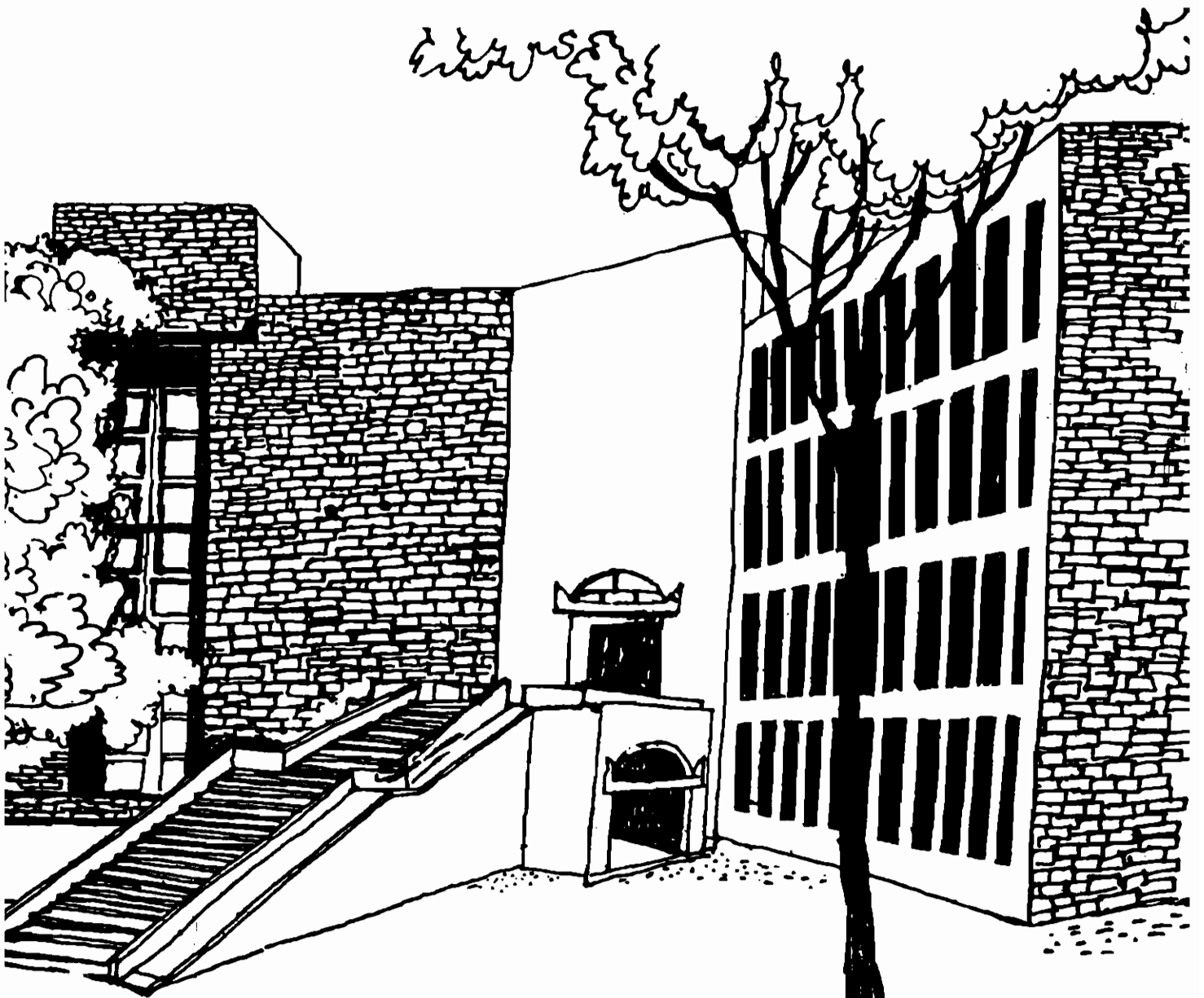


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# Working Paper



RECENT POLICIES FOR RURAL BANKING BY  
COMMERCIAL BANKS

By

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## RECENT POLICIES FOR RURAL BANKING BY COMMERCIAL BANKS

Bhupat M. Desai\*

Recently three policy changes have been introduced by the Government of India and the Reserve Bank of India for rural banking operations of the commercial banks. These are:

- (1) continuation of minimum interest rates on loans upto Rs.2 lakh but lowering them by one percentage point for loans above Rs.2 lakh;
- (2) lowering of maximum interest rates by one percentage point on fixed deposits; and
- (3) permission to close loss making rural branches<sup>1</sup>.

These policy changes have been entirely prompted by the concern for improving profitability of the commercial banks. But there are two other objectives for promoting rural banking. These are to encourage (i) private investment for agricultural development, and (ii) financial deepening of the rural sector.<sup>2</sup> Both these objectives are pursued by the rural financial institutions (RFIs) irrespective of whether they are government or private or nationalized or cooperatives<sup>3</sup> all over the world. It seems that the GOI and the RBI have not explored all possible policy alternatives for improving profitability of the commercial banks without reconciling the other two objectives. This paper explores this. The paper first discusses likely impact of the recent policy changes. In the third section rationale for

promoting rural banking infrastructure is discussed besides comparing it with China. In the fourth section operations of the rural branches are discussed. Customary concluding section follows this.

### Likely Impact of Recent Policy Changes

The three policy changes can be considered as price (i.e. changes in interest rates) and non-price (i.e. changes in branch network) instruments for developing rural banking. Our comprehensive cross national literature review on institutional finance for agricultural development reveals that rural clients respond more to non price instrument compared to price instrument (Desai and Mellor 1993). Thus, the policy of closing loss-making rural branches will reduce the density of field-level offices and thereby adversely affect both rural loan demand and rural deposit supply. While the decline in rural loan demand would discourage already declining private investment in agriculture, the decline in rural deposit supply will discourage financial deepening of the rural sector. That both credit and deposits have increased much more for the rural branches can be seen from Table 1. Thus, the growth in deposits, credit and credit-deposit ratio during 1980-85 was the highest for rural branches, followed by semi-urban, urban, and lastly metropolitan branches. Table 2 gives average transaction (i.e. establishment/administrative) costs, profits and profitability of various branch groups of the commercial banks during 1984 to 1986 (Gothoskar 1989). It first

Table 1  
 Deposit and Credit Growth Rates of Various Branch  
 Groups of Commercial Banks during 1980-85

Branch Groups	% Increase in		% Increase in credit to deposit ratio
	Deposits	Credit	
Rural	162.7	221.3	22.3
Semi urban	116.1	160.3	20.5
Urban	111.6	108.8	-1.3
Metropolitan	105.0	82.8	-13.1

Source: Adapted from Gothoskar 1989.

Table 2

Average Transaction Costs, Profits and Profitability  
of Various Branch Groups of Commercial Banks  
during 1984 to 1986

Branch Groups	No. of sample branches	Average transaction costs as a % of average deposits + loan balances	Average profit (Rs. '000/branch)	Average profit as a % of average deposits + loan balances
Rural	292	2.2	12	0.1
Semi urban	214	2.1	349	1.1
Urban	139	1.9	426	0.9
Metropolitan	114	1.2	1057	1.2
All India	759	1.7	346	1.0

Source: Same as in Table 1.

reveals that average transaction costs of both rural and semi-urban branches was closely comparable to that of urban branches. Secondly, both rural and semi-urban branches earned profit though it was lower than the profit of urban and metropolitan branches. Thirdly, it also shows that the profitability of semi-urban branches (which are also considered rural) was higher or about the same as that of urban and metropolitan branches. These findings suggest that rural banking is not always loss making. Further evidence to this can be seen from Table 3 on profitability of rural branches of a nationalized commercial bank in 1991-92 (Analyst 1993). This table more importantly reveals that the profitability of rural branches was even higher than that of semi urban and also urban branches. This is despite the fact that the average interest as well as transaction costs for them were the highest among the four groups of branches of this bank. Yet another important finding is that the average transaction costs of semi urban branches was lower than that of urban branches. Average transaction costs of rural branches given in Tables 2 and 3 are closely comparable to those found in many other developing countries.

But the popular notion is that rural branches are necessarily loss making and have very high transaction costs.<sup>4</sup> This is not to deny the possibility and existence of some loss-making rural branches. But what is questioned is the policy of permitting commercial banks to close their such branches. Such a policy is based on highly restrictive role of commercial banking



Table 3  
 Cross Revenue, Costs and Profitability Ratios  
 of Various Branch Groups of a Nationalized  
 Commercial Bank in 1991-92

Branch Groups <sup>1</sup>	Interest and non interest revenue ratio <sup>2</sup>	Interest cost ratio <sup>2</sup>	Transaction cost ratio <sup>2</sup>	Profitability ratio <sup>2</sup>
	..... Percent .....			
Rural	12.94	8.19	2.19	2.56
Semi-urban	11.68	7.75	1.76	2.17
Urban	11.93	7.75	1.85	2.33
Metropolitan	10.25	6.18	1.24	2.83
Total	11.45	7.26	1.67	2.52

1 The bank had 2000 branches of which 56.5 percent were in rural areas covering both agriculturally developed and backward states.

2 Ratios are in relation to working funds.

Source : Adapted from Analyst 1993.

wherein the objective is to merely make money (rather than profit) and completely disregard the earlier mentioned two additional objectives.

As regards the policy of continuing minimum interest rates on loans upto Rs.2 lakh and lowering them on loans above Rs.2 lakh is concerned, it will not encourage rural and/or agricultural loan demand. This is because loan requirements of most rural clients are lower than Rs.2 lakh. The earlier cited Desai and Mellor study also found that rural loan demand is elastic with respect to real interest rate. The average elasticity for rural households was in the range of -1.12 to -1.37 in 1986-87. Under these conditions together with the policy of continuing existing interest rates (of 10 to 16 percent) on loans upto Rs.2 lakh rural loan demand would decline. This would adversely affect the volume of business of RFIs and thus reduce scale economies in their transaction costs leading to adverse impact on their viability/profitability. It would also discourage much needed private investment in agriculture. The disadvantages to the rural clients are further compounded by the policy of reducing maximum interest rates on fixed deposits. Rural depositors are deprived of earnings on their hard earned incomes and deposits.

#### Rationale for Promoting Rural Branches

The preceding discussion has to some extent indicated why rural branch network must be created. Nonetheless, it is

important to make the rationale more explicit and comprehensive. It is essential to increase density of field-level offices of RFls as it (a) improves accessibility for both rural households and the formal lenders which in turn generates more intimate understanding and resulting situation specific identification of lending and deposits potential by RFls; (b) enables intensifying and widening the scope of lending and non-lending operations to reap scale economics which are crucial to spread common transaction costs so peculiar to RFls; (c) facilitates more effective competition with the informal lenders and thereby enlarge coverage of farmers and other rural households which would further induce achieving scale economies; and (d) reduces transaction costs of rural borrowers and depositors.

At the end of June 1989 India had just 1 (to be precise 0.987) field office of RFls<sup>20</sup> per 1000 hectare of arable land. This compares rather very poorly with the density of 3.735 in China in 1979. The corresponding density for India was only 0.669. In a period of ten years it has increased by only 43.25 percent. It is in this context the policy of closing loss making rural branches of commercial banks must be questioned. It should also be questioned on two more grounds. One, similar policy is not introduced for loss making urban and metropolitan branches. And two, once such a policy exists for commercial banks RRBs and other RFls would also lobby for similar policy. This would further reduce already low density of banking infrastructure in the country. As a result growth in private investment for

agricultural development and that in financial deepening of the rural sector would be severely affected. And it will undoubtedly lead to lower agricultural growth and rural economic growth.

#### Operations of Rural Branches

Normally rural branches mobilize different types of deposits and make various types of loans. Less known fact is that they also provide non-fund based credit, check clearing facilities etc. for which also they earn. Still less known fact is that these branches can promote loans not only to farmers and other rural households (known as direct rural credit) but also to entrepreneurs engaged in selling agricultural inputs and services (known as indirect rural credit) and in marketing and processing agricultural produce (known as trade and industry credit), besides extending credit to such other sectors as industry, transport etc. Such a diversified loan portfolio for the rural branches can be seen from Table 4 (Gothoskar 1989). In the case of rural branches proper nearly 48 percent of credit was extended for non-agricultural purposes in June 1985. The corresponding percentage for semi-urban branches was as high as 65. Even the loans extended to agriculture would include earlier mentioned indirect rural credit which is essentially for trading in agricultural inputs.<sup>6</sup> Such a credit earns the interest rates of 15 to 18 percent for these branches. If such credit is reclassified as trade or more appropriately service credit then the share of agricultural credit would further decline. These

Table 4

Percentage Distribution of Credit according to Purpose for various Branch Groups of Commercial Banks, June 1985

Branch Groups	Purposes					
	Agri culture	Industry	Trans port	Personal and pro fessional services	Trade	Others
Rural	52.8	16.1	6.5	7.0	10.8	6.8
Semi urban	34.8	30.0	6.6	8.1	12.0	8.5
Urban	14.1	49.7	5.4	8.4	14.7	7.7
Metro politan	1.6	49.4	3.2	4.6	36.3	4.9
Total	17.6	41.3	4.8	6.4	23.4	6.5

Source: Same as in Table 1.

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findings raise a question as to why some other rural branches are in loss. Our informed judgement is that these branches have succeeded in mobilizing deposits but not in making loans. Consequently, they have very little interest spread which is inadequate to meet their average transaction costs. Is this because the areas where they are located have low credit absorption capacity? Is it the case for all types of credit, i.e. direct rural credit, indirect rural credit, industrial loans, trade and transport loans etc.?

Our hunch is that this may be the case for some types of term loans for agriculture and that of industrial loans. But credit absorption capacity has to be judged in a dynamic rather than static context. Moreover, the entire function of providing credit needs to be interpreted as a marketing task. At present the banks do not view it this way. We further contend that when agriculture is poised for technological breakthrough as is the case now in less developed rural areas also it generates demand for loans from farmers (termed as agricultural production subsystem (APS) loans). It also encourages them to substitute loans from informal lenders by loans from formal lenders. These provide a large loan business potential from APS and other rural households. The agricultural technology breakthrough also increases loans from entrepreneurs engaged in selling agricultural inputs (termed as agricultural inputs subsystem (AIS) loans), and in marketing and processing of agricultural produce (termed as agro-marketing and processing subsystem

(AMPS) loans). Thus, instead of viewing lending opportunities in the traditional sectoral sense it should be viewed in a systems framework wherein the three subsystems of agriculture are considered directly interdependent.<sup>7</sup> Loans to APS generate demand for farm inputs, assets and services. Loans to AIS and AMPS generate supply of these resources. Extending loans to all the three subsystems would lead to more balanced demand and supply forces and thereby avert inflationary implications of credit. It would also encourage backward (BWL) and forward (FWL) linkages among the three subsystems as shown diagrammatically below:



Such linkages increase agricultural productivity, production and value added. This would in turn improve loan repayment capacity of farmers and thereby result into higher loan recovery<sup>8</sup> and recycling of funds by the rural branches. The viability of these branches would also improve because AIS and AMPS loans carry higher interest rates ranging from 15 to 18 percent. More importantly, such an approach to developing rural lending portfolio would also provide an opportunity to reap scale economics in transaction costs and thereby further improve viability.

The policy of direct rural credit for working capital

includes only loans for crops, but not for dairy animals, sheep-rearing, cottage industries etc. Similarly, loans for soil and moisture improvement works, land reclamation and levelling, and simple soil turning operations which farmers periodically undertake even in a drought year are rarely planned for. Thus, direct rural credit policy needs revision to combine term and working capital loans and requires vigorous marketing approach to extend it for all these purposes including those for purchase of bullocks and carts, livestock, farm implements, well irrigation, lift irrigation, power tillers, tractors etc.

The policy of providing indirect credit to AIS is innovative. This innovation needs to be further developed and made a mainstream of rural banking policy formulation. Three modifications in indirect rural credit policy are required. One, commercial banks unlike cooperative banks do not get refinance for promoting loans to agricultural inputs dealers. But, commercial banks should also get this refinance facility. This is because the time at which demand for inputs distribution credit arises does not match well with the time at which commercial banks can mobilize deposits. Moreover, extending refinance and/or temporary credit accommodation by RBI/NABARD to commercial banks for their inputs distribution loans is not necessarily inflationary. This is because such credit unlike trade credit for agricultural or consumer goods does not encourage speculative hoarding as inputs have to be sold at specific time. And refinance for such credit like that for



direct rural credit would accelerate technological change in agriculture. Two, presently commercial banks loans to private units in AMPS is not considered indirect rural credit. But cooperative banks loans to cooperative units in AMPS is considered indirect rural credit. This anomaly must be rectified. This will provide an impetus to commercial banks to identify lending opportunities for agro-processing industries which tend to be located nearer their raw materials. And three, the scope of indirect agricultural credit may be widened to include processing and manufacturing functions of seeds and modern small hand and bullock-drawn implements industries as such industries need to be promoted for technological change in agriculture. Thus, what is proposed is a systematic diversification of agricultural lending portfolio of rural branches of the commercial banks, as a solution to their viability problem. If attempted, it would also lead to achieving two additional objectives of rural banking mentioned earlier. Before concluding a word about rural deposits mobilization and induction of personnel for rural branches must be briefly discussed.

What is presently done by the rural branches is to merely transfer the same deposit schemes which are urban service-class-oriented. These seem to have served well as deposits mobilization performance is quite impressive. But it has led to high interest costs of funds and by-passed some potential depositors. For this what is needed is fixed deposit schemes for

shorter durations like 15, 20, and 30 days carrying correspondingly lower interest rates, since rural surpluses are for shorter period. Such schemes are widely promoted with success in rural China. These schemes should also be credit-linked in the sense that the depositor is allowed to borrow the amount that is equivalent to the difference between the cost of a particular asset/purpose and his deposit which would serve as a margin money. This is indeed different from the existing credit-linked deposit scheme. Needless to say that the systematic marketing of the earlier discussed lending portfolio would also provide opportunity to mobilize deposits from the entrepreneurs operating in all the three subsystems.

On induction of personnel for rural branches it must be recognized that adequate number of appropriately trained staff is absolutely must. Administrative costs also reduce loan delinquency since they enable better supervision and follow-up. Moreover, this personnel should be required to be posted in rural branches for at least five years or so. They should also be trained not only in serving the farmer level loans and deposits but also in AIS and AMPS related portfolios. Induction of self-help groups, NCOs and other intermediaries cannot be a substitute for adequate and appropriately trained rural branch personnel.

#### Concluding Observations

From the preceding, three policy alternatives can be identified for improving profitability of rural branches of the commercial banks. These are (1) closing loss making rural

branches, (2) improving the interest spread (i.e. the difference between the interest rates on loans upto Rs.2 lakh and interest rates on fixed deposits) for these branches, and (3) diversifying lending and deposit portfolios with commensurate interest rates and non price policy support to encompass all the three subsystems of AIS, APS and AMPS for such branches. Policy choice for the first two is short sighted, means piecemeal treatment of the problem, and completely ignores the objective of financial intermediation. But the third alternative has a potential to overcome the problem besides serving the fundamental objective of transferring funds from depositors to investors for promoting agricultural and rural development. Such an alternative is also needed for improving profitability of the rural branches already making profits. Our conclusion on minimum interest rates on loans upto Rs.2 lakh is that they should also be lowered by one percentage point to enable rural borrowers to benefit from lower inflation rate. This would encourage growth in rural loan demand and thereby enlarge volume of loan business leading to scale economies in transaction costs of the rural branches. But we do not suggest increase in interest rates on fixed deposits as rural deposits supply is inelastic to real interest rate.\* And we underscore the importance of promoting low interest bearing fixed deposits of shorter durations than prevailing now. We also strongly plead that this policy alternative be kept in view for formulating future financial reforms.

### Notes

The author is grateful to N.V. Namboodiri for his assistance in the preparation of this paper.

- 1 For a thought provoking and convincing critique of this policy see editorial in *Economic and Political Weekly*, vol.28, no.33, September 18, 1993. This critique also refers to proposals of several committees about restructuring rural credit delivery system for Regional Rural Banks (RRBs) and Commercial Banks. What is proposed in this paper is also relevant for restructured rural banking system and cooperative credit system. For details on cooperative credit system see Desai and Namboodiri 1991, and 1993.
- 2 For some evidence on what rural banking has accomplished for these two objectives in India see Desai and Namboodiri 1991, and Binswanger, Khandker and Rosenzweig 1989. Also see Desai and Mollor 1993 for a critique of underestimation of the impact of banking infrastructure on agricultural output by Binswanger et al 1989.
- 3 For some evidence on this for such countries as Bangladesh, China, Japan, Taiwan, South Korea, U.S.A. etc. See Desai and Mollor 1993.
- 4 Desai and Mollor 1993 found that 22 out of 25 RFIs spread over Bangladesh, India, Sudan, Thailand, and South Korea are profitable. They also found that the average transaction costs of institutional lenders center around 2 to 3 percent for most countries which are located in as diverse regions as Africa, Asia, Latin America and the Near East and Mediterranean Basin. Moreover, they found that 7 out of 16 RFIs in Asian developing countries enjoyed scale economies in transaction costs. Another 7 enjoyed constant returns to scale in these costs. Only two suffered from scale diseconomies. One of the 7 RFIs which enjoyed scale economies in transaction costs include nationalized commercial banks in India. This RFI initially suffered from scale diseconomies until its volume of business (loans plus deposits) was only Rs.1 million but once it grew it rapidly

reaped scale economies upto Rs.30 million volume of business. Interestingly, its scale economies in transaction costs continued beyond Rs.60 million.

- 5 RFI's included in this are primary agricultural cooperative credit societies (79019) plus branches of cooperative land development banks (2210) plus branches of RRBs (14697) plus rural (33014) and semi-urban (11166) branches of commercial banks.
- 6 As on 30th June 1989 nearly 30 percent of indirect rural credit of the commercial banks was to private agricultural inputs dealers. Such a large share is significant enough to develop policy of more durable kind. In 1989 there were 1.91 lakh private input dealers just for fertilizers and pesticides. They represent a new class of entrepreneurs. In 1988-89 only about 57 percent of credit needs of Rs.5260 million for private inputs distribution business was met by the banking sector. For details on this including a critique of the estimate of this credit by Khusro Committee see Desai and Namboodiri 1993. In this context it is worthwhile to note that the Khusro Committee estimated credit needs separately for AIS, APS and AMPS.
- 7 For some cross national evidence on RFI's serving all these three subsystems see Desai and Mellor 1993. This includes such countries as Taiwan, South Korea, Japan and U.S.A. which are known for successful RFI's and agricultural development.
- 8 For the discussion on reasons for high loan delinquency rate of direct rural credit and the policies including the role of indirect rural credit needed to reduce this see Desai and Namboodiri 1991, and Desai and Mellor 1993.
- 9 For evidence on this for some low and middle income countries including South Korea see Desai and Mellor 1993. Even in the U.S.A. interest elasticity of deposits supply by farmers range from a low of +0.33 to a high of +0.42 only.

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