194

WP: 194

Working Paper

IIM
WP-194

विद्याविनियोगाद्विकासः
IIM
AHMEDABAD

INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD

VIABILITY AND EQUITY OBJECTIVES
OF INSTITUTIUNAL CREDIT FOR
AGRICULTURE

by

B. M. Desai

W P No. 194
Jan. 1978

The main objective of the working paper series
of the IIMA is to help faculty members
to test out their research findings
at the pre-publication stage

INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD

VIABILITY AND EQUITY OBJECTIVES OF INSTITUTIONAL CREDIT FOR AGRICULTURE

B.M. Desai*

I

Implicitly, if not overtly, institutions providing agricultural credit in India have been concerned with both the objectives of viability and equity of their operations.[1] The

---

*The author wishes to thank Shri Ketan Panchan and Shri Narayana Rao for their assistance in preparation of this paper.

[1]In addition to these two concerns, the institutional agencies have yet another concern. This is the goal of economic efficiency of activities financed by credit. For the discussion on three goals, see Credit for Small Farmers in Developing Countries. G. Donald, Westview Press, Boulder, Colarado, 1976. Chapter 7. Gordon also discusses the interrelationship between economic efficiency and equity objectives and argues for a potential to strike a middle ground in the simultaneous pursuit of these two goals. Lately, in India many commercial banks have found that the lending criterion of incremental income which has been enunciated by the Reserve Bank of India has become a constraint to liberalization of credit. And hence some experts in banking argue that the credit demand for approved purposes should be viewed not from the point of view of incremental income but from the viewpoint of availability of surplus to repay the loan obligations. See, for example, "Role of Commercial Banks in Rural Development", L.D'Mello, State Bank of India Monthly Review, Volume XVI, No.10, October 1977. However, as will be seen in the paper this change in lending criterion also does not ensure fulfilment of equity objective, without impairing the viability objective.

attempts to reorganize the size of both the primary agricultural credit societies (PACS) and the District Central Cooperative Banks (DCCS) can be be traced to the concern for the viability of these institutions.[2] The recommended norm of the credit business of Rs.2 lakhs for every PACS has also been prompted by this concern. Similarly, the latest attempt to establish Regional Rural Banks (RRBs) has been partly guided by the high costs of operations of the nationalized commercial banks. In part it has also been guided by the considerations of equity in the distribution of credit to different sections of the rural community.[3]

[2] The debate on small and large sized primary cooperatives began in early fifties. However, for some reasons, this debate got relegated in the background in late fifties. But once again it revived in 1960 with the appointment of the Committee on Cooperative Credit by the Government of India. For, details, see: Government of India, Report of the Committee on Cooperative Credit, New Delhi, 1960, All-India Rural Credit Survey, Vol.II, Reserve Bank ofIndia, Bombay, 1964, Report of the Informal Group on Institutional Arrangements for Agricultural Credit, Reserve Bank of India, Bombay, 1964, Report of the All-India Rural Credit Review Committee, Reserve Bank of India, Bombay, 1969. Report on Study of Viability of Primary Agricultural Credit Societies, Apte S.G., Government of India, Planning Commission, New Delhi, 1973, Report of the Study Team on Overdues of Cooperative Credit Institutions, Reserve Bank of India, Bombay, 1974, particularly Chapter VII, and Report of the National Commission on Agriculture, Part XII, Government of India, New Delhi, 1976.

[3] Government of India, Report of the Committee on Rural Banks, New Delhi, 1975. Also See Report of the Expert Committee on Consumption Credit, Department of Revenue and Banking, Government of India, New Delhi, 1976.

Even the nationalization of commercial banks in 1969 was guided by, among other factors, similar consideration. The concern for equity objective can also be traced to providing credit at concessional interest rate, statutorily pre-empting certain proportion of credit for small farmers and the poorer people, and to such other policies. The provision of finance to cooperatives at interest rate below the bank rate has also its roots in making them financially viable.

The paper first discusses whether or not there exists, on a priori grounds, any conflict between the two objectives. It then goes on to show the past experience in this regard. And finally it suggests how the conflict between the two objectives can be minimized.

II

Cooperatives which account for about three-fourth of the total institutional credit for agriculture in India operate on no-profit-no -loss basis.[4] It may be reasonable to assume that the nationalized banks may also follow similar objective func-

[4]This does not imply that costs that are to be covered at one particular institutional level, say primary cooperative, include the costs of management overheads that are provided by the middle and top tiers in the cooperatives. It is presumed that each of the three tiers would attempt to cover the operating costs from the margins specified for them. For example, the State Cooperative Banks which get a margin ranging from one-half to 1.25% would cover their costs for administering credit given to the District Central Cooperative Banks. They in turn would do so for credit given to the PACS from their margin of about 2 to 2.5. And the agency at the bottom tier which gets a margin of 2.50 to 3 per cent would cover its costs for credit given to the final borrowers.

at least with regard to their agricultural credit operations. Under this condition, these agencies would attempt to earn enough to cover their operating costs. Two major items of out-of-pocket costs can be identified for this purpose. These are (i) administrative costs, and (ii) interest cost or cost of capital borrowed to undertake lending operations. In addition, there are two more items of costs, the account of which many institutions take by a variety of practices in their financial management. These are (ii) allowance for default of loans advanced, and (iv) allowance for inflation. Most infinancial institutions would be partially guided by the concerns for these two items of costs in creating their reserve funds. Some of them would even create separate funds for absorbing bad and doubtful debts.

Having identified the four main elements of costs of credit operations[5], we shall now discuss how the pursuit of equiry objective would affect these elements. A priori, administrative costs of advancing a given amount of loan would be smaller for large farmers than those for small farmers. This is because the credit institutions would have to cover smaller number of

---

[5]It is doubtful whether the financial institutions particularly Cooperatives in India take into account the allowances for default and inflation. See B.M. Desai, "Costs of Operations in Agricultural Financing by Formal Agencies", Economic and Political Weekly, 1978 (Forthcoming). Also See Donald G., op. cit., 1976, pp. 112-116.

accounts to advance a given amount of loan to the large farmers compared to that to the small farmers. Additionally, these institutions would require to spend less time in scrutinizing the collateral of the large compared to the small farmers. This is because the large farmers, because of their political and economic influence, can mobilize the requisite information about the land records, sureties and other collateral more easily and quickly. Consequently, the credit agencies would find cost advantages in lending relatively more to the large farmers than to the small ones.

As regards the cost of a given amount of capital borrowed to advance loans to the two groups of clients, normally, one would not expect any differences. The quality of money cannot differ with whether it is borrowed to lend to large versus small clients. Similarly, the allowance for inflation that the financial institutions would require to make in devising their costing may not differ for the two groups of clients. However, the lower repayment capacity of the small borrowers would require these agencies to make higher allowance for default risks in their case compared to that in the case of large farmers.

Thus, a priori, at least two types of costs namely administrative, and the allowance for default risks are higher for credit operations for small and poorer rural households than those for the larger ones. This in turn would adversely affect the viability of institutional agencies, if they were to provide more credit to poor households than to the large farm-households without fully accounting for these two costs. In the interest of serving the equity objective, therefore, it is common to find highly subsidized refinance facilities, liberal provisions to reschedule the repayment period in case of default, occasional use of penalty and other stringent actions in case of default, and such other policies. If these policies are not pursued, and if the full costs are accounted for determining the price of credit, the smaller farmers would perhaps find institutional credit exhorbitantly expensive.

III

To empirically examine the conflict between the two objectives would require us to study the data on (i) the skewness in the distribution of credit among different sized farm house-holds including the landless, (ii) overdues as a percentage of outstanding loan of these households, (iii) administrative costs for every Rs.100 of an outstanding loan and (iv) allowances for default risks. All-India data on these aspects are fragmentary and suffer from, as will be seen later, certain limitations undesirable from our viewpoint. Moreover, data on the second and the third aspects covering all the institutional credit are non-existent. We shall, therefore, intuitively analyse the question of conflict by abstracting out the past experiences. Wherever possible, we shall also give empirical support to this method.

There is a widespread impression that both cooperative and commercial banks' credit is skewed against the small farmers despite their better loan repayment performance. Table 1 can be interpreted to show this for the short term as well as long term credit. Firstly, the distribution of long-term credit is more unequal than that of the short-term credit. Secondly, the distribution of long term loans provided by the Land Development Banks (LDBs) in 1973-74 did not differ much from that in 1969-70. Thirdly, inequality in the distribution of long term credit directly aids the inequality in the acquisition of income-generating farm assets. Fourthly, despite the persistence of high degree of inequality, the extent of overdues of the long term loans has considerably grown; it being 13 per cent in 1969-70, and 30 per cent in 1973-74. Finally, what is suggested by the long-term credit data is also applicable to short-term credit data. The loan repayment performance of the small farmers is better than that of the large farmers. Some evidences to this effect are given in Table 1 from selected micro studies[6] that were readily available. For example, overdues as a percentage of outstanding loans of 84 PACS decreased with the decrease in holding sizes consistently for three years in late fifties.

Tables 2 and 3 present results for more recent years from the report of the Study Team on Overdues of Cooperative Credit Institutions appointed by the Reserve Bank of India in December 1972.

These data show that the extent of overdues is about the same for all groups of farmers except for those with less than three acres. While this does not directly support what is argued earlier, it does suggest that, contrary to a priori expectations, the extent of overdues is not low for large farmers. Secondly, and more importantly, these results do not reveal the real position of overdues, because many institutions resort to book adjustments and hence overstate the loan recovery performance. To quote from the same report of the Study Team,

> "The overdues reported by cooperative credit institutions on the basis of which the above analysis has been made do not present the real position since many of them resort to book adjustments

---

[6] Rao C.H.H., "Farm Size and Credit Policy", Economic and Political Weekly, Vol. V. No.52, December 26, 1970. Also see Desai B.M., "Formal and Informal Credit Sources in Tribal Areas: A Case of Dharampur Taluka" Artha-Vikas, Vol.XII, No.2, July-December 1976, and Planning and Evaluation Organization, Evaluation Report on the Working of the Large and Small Sized Cooperative Societies, Planning Commission, April 1959.

> of different types and in varying degrees to camouflage the recoveries, with a view to presenting a better picture of their financial and operational efficiency, obtaining better audit classification and higher eligibility for refinance from the higher financing agencies."7

Thirdly, given the above observations, the systematic consistency between Tables 2 and 3 revealing decreasing chronic overdues and decreasing extent of overdues as farm size increases can also be interpreted pervertly(!).

Default being the other side of the "repayment performance" coin, the preceding discussion suggests that the allowances for such purpose would have to be higher, if one were to cost the credit operations after taking this factor into account. Not only the allowance for default would have to be higher, but even the administrative costs would be higher because of the higher costs of recovering loans from large farmers. Consequently, any cost advantages that the financial institutions can reap in administering credit for such farmers are reduced, if not fully wiped out.

Two possible explanations can be provided for the pooer repayment performance of the large farmers. One, the large farmers being politically and economically influential do not observe the financial discipline, in addition to preventing the usual control mechanisms to operate in case of their default.

---

7 Reserve Bank of India, op. cit. 1974, p.20.

And two, these farmers, again contrary to a priori explanations, do not have higher incremental income and repayment capacity compared to the small ones. While some empirical evidences to support the former exist[8], the latter factor has not yet been well documented.[9] However, lack of evidences need not deter us here from questioning the conflict between the viability and equity objectives that was earlier argued out. This is because there exists ample bases to implicate the underlying assumptions behind higher repayment capacity, and the better financial discipline that are implied in the earlier analysis. Nonetheless, strategically it would be imprudent to contend that there can never exist any conflict between the two objectives. And on that basis, suggest that the financial institutions should concentrate all of their credit on small and other poor rural households.

---

[8]Reserve Bank of India, <u>op. cit</u>. 1974; Also see, Dadhich, C.L. <u>Overdues in Farm Cooperative Credit</u>, Popular Prakashan, Bombay, 1977, and B.N. Choubey, <u>Institutional Finance for Agricultural Development</u>, Saraswat Shubhada Press, Pune, 1977.

[9]For some evidences on this, See, <u>Bank Credit to Farmers for Irrigation Development: Studies in Micro-Analysis of Feasibility</u>, Reserve Bank of India, Bombay, 1969.

This is because we think that there can also exist a phenomenon like "demonstration effect" even for financial discipline. The poor ones have a fine example to emulate from their fellow-clients in this regard. Moreover, the administrative costs could still remain high when credit distribution is in favour of smaller clients. Keeping these in view, some suggestions are offered in the last section to minimise a possible incompatibility of the viability and equity objectives of the institutional credit.

IV

At the outset, let us recognize that the liberalized policy prescriptions that have been made to serve the equity objective do not seem to reach the intended target groups. We, therefore, suggest that such policy provisions be kept to a bare minimum. Secondly, let us recognize that the small and poor rural households are also efficient and respond to innovations. The experiences of technological change centering around water-seed-fertilizer show that the demands for continuous managerial decision-making are more easily met at the small-farm scale. Concentrating credit resources on the small farmers, therefore, does not necessarily mean that the choices must be made between the viability and equity objectives.

The past experiences have shown that the allowances for default risk need not have to be higher when credit is concentrated on the smaller farmers. However, there does not exist a strong basis to suggest that the administrative costs in this strategy can be prevented from being high. Thus, the financial institutions would have to devise mechanisms to lower these costs. This could be done by them by innovative evaluation, monitoring and control operations for loan administration.

The basic feature of the innovative operations revolves around the idea of group approach to financing.[10] Indeed, such approach has been advocated in the past precisely for it would lower the cost of operations.[11] Such approach should aim at enlarging the size of the loan business administered from a given stock of managerial resources. In addition, it should

---

[10] For more elaborate presentation, See, Desai, Op. cit. 1978. Also see Gordon, D., op. cit., pp.118-128, and N.S. Jodha, "Role of Credit in Farmers' Adjustment Against Risk in Arid and Semi-Arid Areas of India", paper presented at the conference on Research in Rural Finances July 28-Aug.2, San Diego, USA (Mimeo).

[11] Reserve Bank of India, Financing of Agriculture by Commercial Banks, Report of the Seminar held at Bombay, December 6-8, 1968. Also see, for some illustrative data "Village Adoption - A Strategy for Intensive Agricultural Financing by "A" Commercial Bank Branch", B.M. Desai and S.C. Bandopadhyay. CMA 343(R), Indian Institute of Management, Ahmedabad, 1976.

emphasize on organizing groups such that the individual ownership of the asset/loan is not deprived. And that the group members find functional identity among themselves.[12] Keeping these in view, three different types of groups may be evolved. These are (i) villagers within a village, (ii) villagers together with some commercial entities who are functionally dependent on each other; for example, villagers, input dealers, crop-produce buyers, and processors, and (iii) villagers together with some commercial and non-commercial entities including government departments who provide auxilliary services. The instruments through which the functional interlinkage among the members of the group are achieved should be under the control of a financing agency. Also it should be impersonal in nature. Instruments of this kind may be identified from amongst the existing indigenous bills of exchange, in addition to introducing new bills with varying terms and conditions for rediscount. Moreover, this approach would make it possible to reduce the size of application forms, and the need for loan approval procedures. For example, for appraising working capital loans for crops the

---

[12] Desai B.M., op. cit., 1978. Also see, Victor S. Doherty and N.S. Jodha, "Conditions for Group Action Among Farmers", Occasional Paper 19, Economics Programme, International Crops Research Institute for the Semi-Arid Tropics, Hyderabad, October, 1977.

use of incremental income criterion can be avoided and thus the form size can be reduced. Similarly, collateral like land need not be acquired under this approach since it makes possible the use of co-signers as collateral. The new approach has also a potential to reduce the default rate since it can induce loan repayment by the mutual pressures of the group-members.

To conclude, the approach suggested here would make it possible to reduce both the administrative costs and the allowances for default. Both of these merits can assist the formal credit agencies in striking a judicious compromise or combination of the objectives of viability and equity. But such combination can be realized only if, we contend, the liberalized credit policies such as highly concessional refinance facilities, easier loan conversion conditions, and so on are kept to a bare minimum.

Table 1 Some Results on Distribution of Agricultural Credit And Default by Farm Sizes

Study/Source	Year	Region	Institution	Short or Medium or Long Term	% of Numbers and Amount	Farm-Size Groups (Acres): Upto 2.5/2	2.5/2 to 5	5 to 10	10 to 20/25	20/25 & above	All Grou
RBI	1969-70	All India	PACS	ST	% Borrowers	-----32---		-------68------			10
					% Amount Borrowed	-----29----		-------71------			10
RBI	-do-	-do-	LDB	LT	% Borrowers	16	20	28	24	12	10
					% Amount Borrowed	9	16	26	30	19	10
RBI	1973-74	-do-	-do-	-do-	% Borrowers	11	25	35	20	9	10
					% Amount Borrowed	8	22	34	22	14	10
C.Rangarajan	March 30, 1973	-do-	Commercial Banks	ST	% Borrowers	45	24	16	---15---		10
					% Amount Borrowed	24	21	21	---34---		10
-do-	-do-	-do-	-do-	LT	% Borrowers	14	22	26	---38---		10
					% Amount Borrowed	5	12	21	---62---		10

Table 1 (Contd..)

Study/Source	Year	Region	Institution	Short or Medium or Long Term	% of Numbers and Amount	Farm-Size Groups (Acres) Upto 2.5/2	2.5/2 to 5	5 to 10	10 to 20/25	20/25 & above	Al Gr
6. Rao, C.H.H.	1956-57	All-India	PACS	ST	% Amount borrowed	7	21	21	27	24	
	1957-58	-do-	-do-	ST	-do-	9	25	22	28	16	
	1958-59	-do-	-do-	ST	-do-	8	21	21	30	19	
						Overdues As A % of Outstanding L					
7. Rao C.H.H.	1956-57	-do-	-do-	ST	-	17	10	16	22	41	
	1957-58	-do-	-do-	ST	-	20	14	17	20	46	
	1958-59	-do-	-do-	ST	-	10	9	11	11	31	
8. Desai B.M.	1974-75	Dhafampur Tehsil Gujarat	-do-	-ST		36	35	------59--------			
				MT	-	88	0	------78--------			
9. RBI	1973-74	All-India	PACS	ST	-	----------Not Available----					
	-do-	-do-	LDB	ST	-	----------Not Available-----					
10. Ghiara B.M.,	-do-	-do-	Commercial Banks	ST & Term Loans	-	----------Not Available-----					

Table 1 (Contd..)

Study/Sources:

1,2,3,9: Reserve Bank of India, Statistical Statements Relating to the Cooperative Credit Movement in India, Part I, Credit Societies, 1969-70, and 1973-74.

4,5 : Rangarajan C., "Banking Development Since Nationalization And Reduction in Disparities", Sankhya: The Indian Journal of Statistics, 1974, Vol. 36, Series C, Parts 2 & 4.

6 & 7 : Rao C.H.H., "Farm Size and Credit Policy", Economic and Political Weekly, Vol. V, No.52, December 26, 1970.

8 : Desai B.M., "Formal and Informal Credit Sources in Tribal Areas: A Case of Dharampur Taluka", Artha-Vikas, Vol.XII, No.2: July-December 1976.

10 : Ghiara B.M., "Agricultural Financing by Commercial Banks: A Look Ahead", Prajnan, Vol.VI, No.3, July-September 1977.

Table 2 Overdues of Short-term Cooperative Loans Advanced by Selected Primary Agricultural Cooperative Societies by Farm Size, 30th June 1972.

Details	Size of Farms (Acres)					
	Tenants etc.	Below 3	3-5	5-10	10 and above	Total
1. % of Defaulters to Borrowing Member Farmers	90 (2,435)[a]	83 (11,722)[a]	83 (7,686)[a]	80 (6,929)[a]	73 (7,539)[a]	80 (36,411)[a]
2. % of Overdue Amount to Outstanding Loan	76 (10.56)[b]	71 (33.61)[b]	67 (40.10)[b]	64 (55.09)[b]	63 (126.79)[b]	65 (266.15)[b]

a. Figures in these brackets are total number of borrowing-member-farmers of 233 societies.

b. Figures in these brackets are total outstanding loans (measured in Rs. lakhs) advanced by 233 societies.

Source: Reserve Bank of India, Report of the Study Team on Overdues of Cooperative Credit Institutions, Bombay, 1974, p.45.

Table 3 **Chronic** Overdues of Short-term Cooperative Loans Advanced by **Selected** Primary Agricultural Credit Societies, by Farm-Size, 30th June 1972.

Details	Farm-Size (Acres)					
	Tenants etc.	Below 3	3-5	5-10	10 and above	Total
Overdues for 3 years and above to Total Overdues						
(a) % of Defaulting Members	56 ((1,422)[a]	46 (3,897)[a]	41 (2,029)[a]	38 (2,575)[a]	38 (3,107)[a]	43 (13,030)
(b) % of Default Amount	39 (5.20)b	37 (11.22)[b]	32 (9.55)[b]	30 (18.11)[b]	22 (58.34)[b]	27 (102.42)

a. Figures in these brackets are total number of defaulting members of 153 societies.

b. Figures in these brackets are total amount of outstanding loans that are overdue (measured in Rs. lakhs) in 153 societies.

Source: Reserve Bank of India, op. cit., p. 48.