VIII Rural Financial Market Development in India: Large Institutions, Poor Performance

OVERVIEW OF THE FINANCIAL SYSTEM

The current formal financial institutions in India are the result of evolution and constant Government intervention over the past three decades. After the famine of the 1960s, financial sector policies were based on the premise that constrained access to credit would impede the adoption of green-revolution technologies and delay attainment of food self-sufficiency. Poverty alleviation has been a major political objective since the late 1970s and expansion of formal finance to serve the poor has been perceived as an important strategy to achieve it. Therefore, the Government has intervened heavily in the banking sector with policies for bank branching, mandatory quotas and below-market interest rates for loans to the priority sector, frequent waivers on loan principal and/or interest, and recapitalization and refinancing of loss-making institutions. The infamous loan *melas*[1] in the 1980s, in which large volumes of

[1] Loan *melas* were loan festivals during which many subsidized loans were made by the nationalized banks to the weaker sectors. A government official was present during these festivals. Since the banks were required to make a large number of loans in a short period, the borrowers were not screened for their credit worthiness. These *melas* were discontinued three years after their introduction in the early 1980s when the then Minister of Finance left office.

funds were imprudently issued as subsidized loans to the supposedly weaker segments of society, and loan waivers offered until 1991, were classic examples of abuse of the banking sector for political purposes, especially at the time of elections.

The policies for branch banking, on the one hand, may have contributed to the expansion of commercial banks into rural areas and to their lending to the rural population. The average population covered by a bank branch declined from 65,000 in 1969 to 15,000 in 1998. More than half the branches of formal institutions, which include 27 nationalized commercial banks; 35 domestic, private commercial banks; and 29 foreign commercial banks; branches of several agricultural, urban, and land-development cooperatives; and 196 regional rural banks (RRBs) are now located in rural areas. The RRBs are a hybrid form between commercial banks and cooperatives. They were established in 1975 as a subsidiary of the public-sector commercial banks to service the rural poor, small and marginal farmers, rural artisans, landless workers, and small entrepreneurs.

Other policies such as directed credit, loan waivers, subsidies, and the bailing out of nonperforming institutions, on the other hand, have contributed to a breakdown in borrower discipline and a weakened financial sector. The percentage of nonperforming loans to total loans made by commercial banks in 1996 was about 20 for India compared with only 10 for Indonesia and 7.7 for Thailand (Claessens and Glaessner, 1998). In India, this percentage declined in 1998 to 8.2 but loan recovery rates for the majority of formal financial institutions still remain very low, averaging about 60 percent (Talwar, 1999). The performance of loans made to the priority sector under the directed credit program has been especially dismal. The cumulative losses due to nonperforming loans made to the priority sector and to small and State-owned industries amounted in 1994 to about 2 percent of the total loss rate of 8.5 percent of the banks' assets (Nayak, 1995).

In the 1990s, the country embarked on a paradigm shift in its approach to the financial sector but the political hold on the

banking sector is still significant.[2] There were efforts beginning in 1992 to liberalize the financial sector and strengthen it by re-orientating banks and other financial institutions toward a market-based financial system by increasing competition and improving the quality of financial services (Box VIII.1). The reforms have been partly successful in converting some public-sector development finance institutions into profit-oriented companies, in easing the entry of foreign and private banks, and in granting some functional autonomy to banks (Bhandari, 1997).

As of mid-1996, the country's banking regulatory framework was considered satisfactory and improving, while supervisory quality and transparency were rated as fair and improving (Claessens and Glaessner, 1998).[3] New supervisory initiatives to improve efficiency, such as an offsite monitoring and surveillance system, have been introduced to supplement periodical onsite inspections of financial institutions (Talwar, 1999). However, the effects of the reforms have yet to be realized in several other dimensions. A composite score for banking sector performance based on asset quality, management, capital adequacy, earnings, liquidity, operating environment, and transparency–on a scale in which the lower the score, the better the performance[4] –was estimated to be around 5.8 for the Indian banking sector compared to 4.6 for Indonesia and 5.2 for Thailand. While the scale for commitment to opening the banking sector in India was calculated at 2.7, the scale for actual implementation was only 2.25, indicating a gap between policies and implementation. These scores were closer to each other

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[2] The financial sector reforms were part of several reforms implemented in India beginning in1992, to address the severe macroeconomic crisis that led to the fall of foreign exchange reserves, and a degradation in India's credit rating that led to the decline of foreign lending to the country (Chandavarkar, 1998).

[3] A five-point scale based on a qualitative assessment was used for the rating. The scale is calibrated as very good, good, satisfactory, fair, and weak.

[4] Percentage weightings for calculation of overall score were 25 for asset quality, 20 for management, 15 for earnings, 5 for liquidity, 15 for operating environment, and 5 for transparency.

Box VIII.1 Selected Features of Financial Sector Reforms in India

1. **Competition**: Encouraged by allowing entry of foreign and some domestic private banks, by permitting urban cooperatives to provide agricultural finance, and by introducing local area banks and specialized, agricultural development financial institutions in rural areas.
2. **Mandatory quotas to priority sector**: The definition of priority sector has been expanded to include small business and transport operators in the rural areas. In addition, the quota for the previous components of the priority sector such as small and marginal farmers, artisans, cottage industries, and weaker sections including women and lower caste people was lowered to 10 percent of the total credit made by banks compared with 28 percent until 1992.
3. **Prudential norms**: Introduced into commercial banks in 1992/93, into regional rural banks (RRBs) in 1995/96, and into cooperatives in 1996/97.
4. **Interest rates**: Deposit and lending rates were completely deregulated for cooperatives in October 1994 and for RRBs in August 1996. Lending rates for commercial banks are still regulated up to Rs200,000 ($4,700), but deregulated above that limit.

for Indonesia and Thailand. The total volume of credit from the banking system was about 23.9 percent of GDP in 1995, the least among several Asian countries, and the ratio of M_2 (money in circulation through the banks) to GDP was about 50 percent, indicating a low level of financial deepening.

Governmental influence in the financial sector is still substantial. The Government owns about 80 percent of the banking industry (Bhandari, 1997) and the cooperatives are also significantly controlled by the states under the Cooperative Societies Act. The financial system is overstaffed with employees who oppose computerization that would close the information

gap and lower transaction costs. The legal structure is ineffective in withstanding political pressures and cannot handle the vast load of lawsuits, thereby making contract enforcement difficult (Chadavarkar, 1998). The slow pace of half-hearted reforms has made several analysts suspicious of the country's ability to create a financial sector suitable for a sophisticated market economy in the near future.

The overall structure, conduct, and performance of the financial system has a profound impact on the rural sector that constitutes about three quarters of the country and employs about two thirds of the total working population in agriculture and allied activities. A considerable decline has occurred in rural poverty in the past two decades, from 56.4 percent in 1973/74 to 37.3 percent in 1993/94. The decline was more significant during 1977–1988 (2.5 percent per year) than during 1988–1994 (1.1 percent per year). This decline was attributed to the spread of the green revolution to poorer parts of the country, the increased allocation of financial and nonfinancial resources for poverty alleviation, and the improvements made in the public food distribution system. However, the actual number of people below the poverty line and the income inequality in rural areas have increased significantly in the past two decades (Rao, 1998). The increase in rural poverty has become a major concern for the Government, leading to the formulation of several policies for poverty alleviation.

APPROACH TO RURAL AND AGRICULTURAL FINANCE

Rural finance is considered to be a major program that appeals to the rural poor. As a result, a supply-leading approach has been employed for rural and agricultural finance to cater to the rural population, which is a major vote bank for the political parties. Indeed, the majority of the governmental interventions described above were done with the rural sector as the primary focus. The interventions may have lacked

economic rationale but were loaded with short-term political objectives.

In addition to direct interventions in rural banking, the Government launched a major poverty alleviation program, the Integrated Rural Development Program (IRDP), in 1978. Loans are made through the banking system at subsidized rates to the rural poor whose household income is below Indian rupees (Rs) 11,000 ($305) per year. Besides the loan, a cash subsidy is paid to borrowers and is set at 25 percent of the total cost for projects financed for small farmers, 33 percent for projects for agricultural laborers, and 50 percent for lower-caste persons. The cash subsidies are provided at the time the loan is disbursed. There are special quotas for lower-caste persons, physically handicapped, women, freed bonded laborers and the poor who adopt family planning. Loans made by commercial banks are subject to a nominal interest rate ceiling of 12 percent per annum and the loans are made for a maximum of three years. As of 1996/97, the maximum loan under the program has been Rs25,000 ($690) with an average loan size of about Rs8,150 ($230). Since the average per capita income in India is estimated at about Rs13,000 ($365) and the poverty line is drawn at a per capita annual income of Rs11,000 ($310), one can argue that the program is targeted at the poor.

There has been a reduction in farm sizes and diversification of farm households into small and microenterprise activities since the 1980s. It has been estimated that there exists a demand for $8 billion per annum in microloans from 60 million rural poor households, but the formal sector serves only 20 percent of the demand (Anon., 1998b, 1998d). Microfinance programs are now considered essential for providing working capital and financing nonfarm activities. Microfinance has been attempted on a large scale since the early 1990s. The importance of self-help groups (SHGs) was also recognized in the late 1980s, and in 1992 a pilot linkage program was initiated under the directive of the Government to link SHGs with banks either directly or through NGOs as guarantors or intermediaries. The Government intends to link 200,000 SHGs with banks by 2002. In addition, Citibank

launched an $800,000 microcredit scheme in 1998 to provide microloans through NGOs (Anon., 1998c).

The commercial banks have introduced several innovative schemes to finance the rural sector. They include the green-card scheme that allows established farmer clients to access credit on demand without lengthy paperwork, agricultural overdraft schemes that provide credit throughout the year for farming, and installment schemes for the purchase of machinery and equipment for small businesses (Rao, 1995).

THE EVOLUTION AND CURRENT STATUS OF KEY RURAL FINANCIAL INSTITUTIONS

Participants

As of June 1998, the country had 32,662 rural and semi-urban branches of commercial banks, a cooperative network with 92,682 primary agricultural credit societies (PACS), over 2,000 branches of land development banks that primarily provide term loans for the purchase of land and land improvements, and about 14,136 branches of RRBs. The average population per rural bank branch ranges between 17,000 and 21,000 persons (Sankaranarayanan, 1998). In addition, urban cooperatives are also allowed to operate in rural areas.

The Reserve Bank of India (RBI) is responsible for broad financial sector policies and is the general regulatory authority for commercial banks and urban credit cooperatives. The National Bank for Agriculture and Rural Development (NABARD), formed in 1982, is an apex refinancing institution for the cooperatives, RRBs, and the commercial banks engaged in rural lending. NABARD is also mandated to coordinate, supervise, and build the capacity of rural financial institutions such as the RRBs and PACS. The Deposit Insurance and Credit Guarantee Corporation insures small depositors and guarantees the rural loans made by the formal institutions. The National Cooperative Development Corporation promotes the

cooperative sector and provides loans and subsidies to cooperatives to improve their performance.

The results from the All India Rural Credit Survey in 1954 helped form the basis for rural credit policy in independent India. The cooperatives, first initiated in 1904, were intended to be the major source of rural finance in the 1950s and early 1960s. In the early 1960s, however, the cooperative sector was considered to be inadequate to meet the demand, especially with the advent of the green revolution.

During 1950–1969, the role of privately-owned commercial banks in rural finance was minimal and indirect; they only financed agro-processing firms and purchased bonds floated by the land development banks. The share of agricultural loans in total lending by commercial banks ranged from 2.0 to 2.2 percent and most of their loans were made to plantations. There were few commercial bank branches in rural areas despite the RBI directive in 1954 that they open at least one branch in unbanked rural and semirural areas for every branch opened in previously banked areas. Therefore, 14 major commercial banks were nationalized in 1969 with the ostensible intention of improving services, especially in rural areas. The hidden political agenda, however, was to win the favor of the rural masses for the ruling party.

After nationalization, the share of bank loans in rural areas increased from 2.2 percent in 1968 to about 10 percent by 1976. Nearly 64 percent of the 5,375 new commercial bank branches that opened during the first three years after nationalization were located in previously unbanked areas. The population covered per rural bank branch declined from 65,000 in 1969 to 37,000 by 1972 (Jha, 1988). To further increase outreach into rural areas, RRBs were introduced in late 1975. By 1979, the number of bank branches increased three fold from 1969 levels and the population per rural bank branch in most parts of the country declined from 37,000 in 1972 to 18,000. Access was still considered to be low, so seven more commercial banks were nationalized in 1980. As a result, more than half of all bank branches were located in rural areas and the population served per rural bank branch declined to 15,000 (AFC, 1988).

Bank nationalization was also coupled with the introduction of the lead bank scheme in which all districts were allocated to the nationalized banks and a few private banks to initiate and lead development in each area. The lead bank was also responsible for priority-sector lending, and collaboration with extension agencies and other banks in the area to formulate a comprehensive local development plan. Agriculture and cottage industries were considered to be the priority sectors and banks were required to make a minimum of 30 percent of their total loans to these sectors.

Differential rates of interest were introduced in early 1972, with the result that public banks faced a ceiling of a 4 percent nominal rate per annum for loans made to the population identified as weak in the rural society. The banks were required to allocate one percent of the total loans made to the priority sector at this rate. In 1978, the RBI directed the commercial banks and the RRBs to charge a uniform nominal interest rate of 9 percent per annum on loans to the priority sector irrespective of loan size. The RBI also mandated that commercial banks should not insist on down payments for loans made to small rural borrowers.

New problems arose due to the rapid branch expansion because of inadequate numbers of trained staff. Therefore, in 1986, several bank branches were consolidated to improve efficiency and quality of services. Commercial banks were authorized to open new rural branches only if they were underbanked by RRBs, and a minimum distance of 10 kilometers had to be maintained between bank branches. The commercial banks were also advised to set up satellite or mobile units where the volume of business and logistics would not permit a regular bank branch. As a result, branch expansion slowed down. By 1986, the total number of nationalized banks, private banks, and RRBs was about 53,265, an increase of only about 23,000 from 1979. About 56 percent were located in rural areas and the population served per rural bank branch in 1986 ranged from 17,000 to 21,000 in remote rural areas. Access to rural, formal financial institutions had improved and a 1986 survey reported that only 2.9 percent of a randomly surveyed

rural sample in several states did not borrow from any formal source due to the lack of a bank branch (AFC, 1988).

The expansion of bank branches was not a random process. An analysis of data from 85 randomly drawn districts in 13 states for 1960/61 to 1980/81 revealed that the banks responded to the opportunities created by the green revolution. Branches tended to be located in villages with high irrigation potential, where the rainy season was longer, and in areas favorable to green-revolution technologies. Branch growth was lower in areas where the incidence of floods and drought was high and where the green-revolution technology was less applicable due to lack of water control (Binswanger, Khandker, and Rosenzwieg, 1993). Estimates of the effect of bank expansion on agricultural investment and output indicated that a 10 percent increase in the number of commercial bank branches increased investment in animals and pumpsets by 4 to 8 percent. The corresponding increase in tractor investment was 1.4 percent.[5] The expansion in bank outlets had a direct impact on crop output with an elasticity of only 0.02, but a larger effect was observed on the demand for fertilizer, which increased by 23 percent. It was concluded that banks tend to spur increase in output through increases in fertilizer use.

Outreach

More than 72 percent of the total 64,547 bank branches were located in rural and semi-urban areas by 1998 (Table VIII.1). The population per bank branch was then about 17,000 to 21,000 per rural branch. But the impressive expansion in bank branches was not matched by outreach, measured in terms of volume of loans made, depth of outreach as numbers of poor people served, and length of outreach reflected by the volume of short- and long-term loans made.

[5] For comparison, a 10 percent increase in investment in electrification increased investments in animals by 7 percent and pumpsets by 4 percent.

Table VIII.1: Commercial and Regional Rural Bank Branches by Region, 1979–1998

Year	Rural	Semi-urban	Urban	Metropolitan	Total branches (number)	Pop./bank branch ('000)
1979	49.7				30,201	18
1985	55.4	20.1	14.1	10.0	51,976	15
1986	55.8	19.8	13.5	10.9	53,265	14
1990	58.1	18.9	12.8	10.2	59,388	12
1992	58.3	18.7	12.9	10.1	60,528	11
1994	57.3	19.0	13.4	10.3	61,742	14
1995	56.1	19.8	13.7	10.4	62,346	14
1997	51.3	21.6	14.9	12.2	64,116	15
June 1998	50.9	21.6	15.1	12.3	64,547	15

Source: Reserve Bank of India (1998).

Despite these efforts to expand banking services into rural areas, and while the absolute volume of agricultural loans made by the major financial institutions grew from Rs89.8 billion in 1982 to Rs419.1 billion in 1996 (close to a four-fold increase in 15 years), there has been a decline in real values (Table VIII.2).[6] The ratio of agricultural credit to agricultural GDP increased only marginally from 0.159 in 1982 to 0.195 in 1989 and started to decline thereafter. There was a 15 percent decline in the real volume of credit to the agricultural sector in 1996 compared with that in 1982.

The commercial banks currently account for about two thirds of the formal sector loans made to agriculture. Nonetheless, cooperatives are still very important in rural India. The commercial bank share in term credit from all rural formal financial institutions has increased, while the share of cooperatives in short-term credit has been roughly consistent (Table VIII.3). Commercial bank lending for long-term purposes declined during 1991–1995, in part due to the Agricultural Debt Relief scheme of 1989/90 that required commercial banks to

[6] The exchange rate in 1996 was 1$ = Rs35.5.

Table VIII.2: Agricultural Loans Made by Major Rural Financial Institutions, Agricultural GDP, and Ratio of Agricultural Credit to Agricultural GDP, 1982–1997

Year	Cooperatives (Rs Billion)[a]	Commercial banks (Rs Billion)[b]	Regional rural banks (Rs Billion)[c]	Total agricultural credit (Rs Billion)	Agricultural GDP (Rs Billion)	Ag. Credit/ Ag. GDP
1982	31.1	53.7	5.0	89.8	561.5	0.159
1985	43.2	90.7	5.0	138.9	772.2	0.181
1988	62.4	141.3	5.0	208.7	1140.7	0.183
1989	73.9	169.2	5.0	248.1	1270.5	0.195
1990	68.8	171.9	5.3	246.1	1480.0	0.166
1991	75.4	186.7	6.0	268.1	1727.7	0.155
1993	101.9	212.1	9.7	323.8	2237.0	0.145
1994	94.1	239.8	10.8	344.7	2590.6	0.133
1995	104.8	242.1	13.8	360.7	2765.8	0.130
1996	124.8	275.1	19.2	419.1	3101.4	0.135

[a] Loans from primary agricultural cooperative societies only.

[b] Loans made by commercial banks in the priority sector category.

[c] Data not available before 1990. A volume of Rs5 billion is assumed, which is the average volume of loans made by RRBs during 1980–1990.

Source: Reserve Bank of India Bulletins, various years; NABARD annual reports, various years. Data on agricultural GDP from the Asian Development Bank.

waive principal and interest due for term loans. Commercial banks perceived term loans as being risky and thus contributed to a decline in term lending from 62 percent in 1990/91 to 55 percent in 1994/95. After 1996, an increase occurred in the share of commercial banks' short and term lending, while a decline occurred for cooperatives and RRBs, perhaps because several RRBs are not functioning and the cooperatives are riddled with overdues. The share of the RRBs in total loans has been small for both short- and long-term lending.

The growth rate for short-term credit from the cooperatives has remained constant at a little over 10 percent during 1978–1985 and 1986–1995; however, long-term disbursements have declined (Table VIII.4). The growth rates for both short- and long-term lending declined for commercial banks. In general, there was a slowdown in disbursements for both short and term loans from all three types of rural financial institutions from 1973–1985 to 1986–1995.

A total of Rs5 billion was disbursed in 1996/97 under the IRDP program, and a total of Rs53.6 billion has been disbursed since 1985 (Table VIII.5). With the reported average loan size of about Rs8,500, this program appears to reach poor people. It is estimated to have reached about 51 million people since its inception in the early 1980s, but this is only one sixth of the total of 300 million people estimated to be under the poverty line in rural areas. The largest share of these loans was made by the RRBs, closely followed by the commercial banks.

Sustainability

A financial institution is considered to be sustainable if it can cover all risks and transaction costs, loan losses, and cost of capital through interest and other earnings without external subsidies. Based on these criteria, none of the rural, formal financial institutions in India can be considered sustainable. Most of the institutions are plagued with huge arrears and incur high transaction costs in providing financial services. Loan losses and transaction costs are invariably higher than earnings,

Table VIII.3: Percentage Share of Formal Financial Institutions in Short-Term and Long-Term Agricultural Loan Outstandings

	1983/84	1990/91	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98
Short term								
Commercial banks	28	36	24	26	34	38	41	42
Cooperatives	69	61	71	69	60	57	55	55
RRBs	4	2	5	5	6	5	4	3
Long term								
Commercial banks	52	62	49	49	55	65	70	71
Cooperatives	41	33	43	44	39	29	25	24
RRBs	7	5	7	7	6	6	5	5

Source: World Bank (1998d); Government of India (1998); NABARD annual reports, 1993/94 and 1996/97.

Table VIII.4: Growth in Short- and Long-Term Agricultural Loan Disbursements, by Type of Institution

	Growth rates in annual disbursements (percent)			
	1973–1985		1986–1995	
Items	Short term	Long term	Short term	Long term
Cooperatives	10.8	12.0	10.6	10.4
Commercial banks	19.1	22.4	10.6	7.5
Regional rural banks	14.8	18.0	12.9	3.7
Total	13.0	17.5	10.7	8.4

Source: World Bank (1998d).

Table VIII.5: IRDP Loan Disbursement by Type of Institution, Refinanced by NABARD, 1985–1997
(Rs Million)

Years	Land development banks	Commercial banks	RRBs	Cooperatives	Total
1985–1989					12,316
1990/91	120	3,090	2,340	470	6,020
1991/92	140	3,420	2,220	690	6,470
1992/93	180	3,510	2,100	700	6,490
1993/94	160	3,300	2,360	800	6,620
1994/95	160	2,940	2,380	720	6,200
1995/96	170	1,640	2,080	720	4,610
1996/97	160	1,350	2,780	840	5,130

Source: NABARD, annual reports, various years.

such that they require constant refinancing and recapitalization by the apex institutions.

The most serious problem is poor loan recovery. The loan recovery rates measured as a percentage of loans collected to total amount due was 50 to 60 percent throughout the 1980s to the mid-1990s (Table VIII.6).[7] The recovery performance nonetheless varied by location: several southern states recovered over three fourths of the loans made, while several northeastern and northern states did not recover even half the loans made in rural areas (NABARD, 1998). Banks now report an upward trend in loan recoveries due to greater freedom in collecting loan dues and an improved legal framework to help foreclose collateral (Bhandari, 1997). Nonetheless, the recovery rates are still less than 60 percent. If this trend continues, bank capital will erode, resulting in bankruptcies or the requirement for more recapitalization from apex organizations.

[7] Loan recovery is calculated as the ratio of principal and interest collections during the period to the sum of amount falling due during the period and overdues from prior periods. However, lumping the old loans with new loans creates a problem in that it cannot be clearly discerned whether new loans are performing better than the old loans.

Table VIII.6: Percentages of Loans Recovered by Major, Rural, Formal Financial Institutions, 1982–1996[a]

Years	Primary agricultural credit societies	Primary land development banks	Regional rural banks	Commercial banks
1982/83	60	52	52	55
1986/87	60	59	50	57
1989/90[b]	51	28	33	49
1992/93	53	52	41	56
1995/96		61	56	

[a] Recovery refers to total principal and interest amount recovered relative to old and new loans that were due on that date.

[b] 1990: Worst drought year; loans written off.

Sources: Sankaranarayanan (1998); NABARD Annual Report, 1996/97.

Many rural financial institutions report losses. Only one fourth of the RRBs are profitable compared with two thirds of the cooperatives (Table VIII.7). The percentage of institutions making profits did not significantly improve from 1980/81 to 1996/97. The RRBs have incurred huge losses due to high transaction costs and low loan recoveries (Bhandari, 1997). Of the 196 RRBs, 172 reported losses in 1993 and have eroded their reserves, equity, and deposits. Based on the recommendation of the Narasimhan Committee, 49 of the profit-making RRBs were chosen for restructuring in 1996 and another 50 were chosen in 1998. However, the policy for loss-making RRBs is not clear. They will continue to drain resources if they are not immediately restructured, privatized, or closed down.

Table VIII.7: Percentage of Major Rural Financial Institutions Reporting Profits

Institutions	1980/81	1985/86	1990/91	1992/93	1995/96	1997/98
RRBs		24	22	12	22	22
PACS	59	54	56	55	61	
Land development banks	46	40	42	39	51	63

Source: NABARD (1998).

Surprisingly, little is reported regarding the use of credit guarantees by financial institutions to recoup losses. The low premiums and high loan-loss coverage may offer incentives for institutions to be lax in their recovery process. However, the high transaction costs involved in collecting on the guarantees may have resulted in little use of guarantee funds. Furthermore, there may be constraints in accessing refinance for those collecting their guarantees. The situation may indicate the redundancy of the guarantee program due in part to improper implementation and incentives.

Repayment problems have become pervasive and are the result of eroding discipline among borrowers. A 1993 survey of 600 rural households showed that only about 12 percent of the borrowers with outstanding bank loans were regular in their repayments. Of those who borrowed loans for asset purchases, about half no longer had the asset, about 16 percent did not purchase any asset, and 27 percent reported that the asset died or was stolen. The misuse of loans and defaults was more pronounced for IRDP loans than for regular bank loans. Borrowers often presumed that formal sector loans would be waived especially during the times of elections, which have been frequent in the last decade (Mahajan and Ramola, 1996).

The latest detailed study, conducted in 1988, reported that the largest proportion of overdues for loans made in 1986 was for large farmers who borrowed from commercial banks, for small farmers borrowing from RRBs, and for landless laborers borrowing from cooperatives. The highest proportion of delinquencies for both current and past loans were for small farmers in both cooperative and commercial bank portfolios, but delinquent large farmer loans were important for the RRBs; marginal farmers were the least delinquent (AFC, 1988). Large farmers were delinquent on past loans with the RRBs and on current loans made by commercial banks. Small farmers tended to delay payments on past loans obtained from the PACS and on current loans from the RRBs. Lax supervision and weak contract enforcement for loans have contributed to this situation.

Besides the alarming problem of low loan recovery, transaction costs are high for the lenders. Satish and

Swaminathan (1988) sampled some 300 rural financial institutions nationwide in 1984/85 and computed their costs and margins in making agricultural loans. The results are summarized in Table VIII.8. It was concluded that interest rates were inadequate to cover costs. The total lending costs were highest for cooperatives followed by commercial banks. RRBs registered the lowest costs next to the land development banks. Gross margins, calculated as the difference between interest income and cost of funds, were highest for commercial banks and lowest for cooperatives because of the high cost of funds for the latter. Commercial banks can access cheap deposits while cooperatives depend on funds from the apex institution. The transaction and risk costs, however, were lowest for cooperatives. Assuming a default rate of 20 percent on overdues (which may be low), the interest rates charged were inadequate to compensate for costs in all types of institutions.

The break-even nominal interest rates were shown to be around 28, 34, and 27 percent for cooperatives, RRBs and commercial banks, respectively, while these formal lenders were limited to charging only 12 percent nominal rate per annum on rural loans until 1992. Low interest rates, high transaction costs and low loan recovery rates obviously affected bank profits. A follow-up study by NABARD in 1993 confirmed that the break-even interest rates to cover costs were much higher than the interest rates the lenders were permitted to charge (NABARD, 1997).

Transaction costs for borrowers were also very high. Mahajan and Ramola (1996) reported that the transaction costs of borrowing were 17 to 22 percent of the amount borrowed from commercial banks; the effective interest rate, including transaction costs, was 26 to 38 percent per annum. Transaction costs for using savings facilities with banks were also high: 15 percent of the average monthly savings assuming one transaction per savings account per month. A study in Tamil Nadu found that the transaction costs incurred by borrowers on regular bank loans represented 4 to 6 percent of the loan amount, while they were 21 percent of the loan amount for subsidized IRDP loans (Nagarajan et al., 1996).

Table VIII.8: Cost and Margins for Agricultural Lending by Type of Rural Institution
(All costs and margins expressed in Rs for a loan of Rs 100)

Items	Cooperatives	RRBs	Commercial banks
Estimates of Agricultural Credit Review Committee (1987/88):			
Financial costs[1]	9.43	5.80	7.48
Transaction costs[2]	5.21	5.50	6 to 7.50
Risk costs[3]	1.00	1.25	1.00
Total costs[4]	15.64	12.55	14.48 to 15.98
Interest charged[5]	12.06	9.60	11.62
Gross margin[6]	2.63	3.80	4.14
Break-even interest rate when default is 20%[7]	28.5	34.2	27.5
Estimates of NABARD (1992/93):			
Total costs[4]	21.4	21.0	17.0
Break-even interest rate when default rate is 20%[7]	34.2	36.5	29.1

1 Financial costs: Costs in raising funds for on-lending.
2 Transactions costs: Lending and operational costs
3 Risk costs: Costs due to actual write-offs and/or reserve funds created for that purpose.
4 Total costs: Sum of financial, transaction, and risk costs.
5 Interest charges: Average of interest rates typically charged on loans.
6 Gross margin: Difference between income realizable and financial loans
7 Break-even rate: Sum of total costs and 20 percent of overdues divided by 1 minus the assumed default rate of 20 percent.

Source: Satish and Swaminathan (1988); NABARD (1997).

DEPOSIT MOBILIZATION

The savings performance of formal financial institutions, based on the average annual savings rate from 1950 to 1996, progressed in six distinct phases: (i) low savings phase, 1950–1968; (ii) increasing savings phase, 1968–1976; (iii) high savings phase, 1976–1979; (iv) stagnation phase, 1979–1985; (v) recovery phase, 1985–1993; and (vi) new high saving phase, 1993–1997 (Reserve Bank of India, 1997). Deposits mobilized by the commercial banks in rural areas increased at an average annual rate of 27 percent in the 1970s, 19 percent in the 1980s, and 24.5 percent during 1993–1997. For the RRBs, the average annual

growth was 123 percent in the 1970s, 68 percent in 1981–1983, and 33 percent during 1983–1989. The total deposits collected by cooperatives increased at an annual rate of 18 percent in the 1970s, declined to 15 percent in the 1980s, and picked up to 18 percent in the 1990s (AFC, 1988; Reserve Bank of India, 1997). Rural deposits accounted for only 12.5 percent of total deposits mobilized by commercial banks in 1986, even though about 43 percent of their total branches were located in rural areas.

The RRBs were not innovative in designing deposit instruments, and the public lost confidence in cooperatives as safe institutions for deposits due to several instances of failed primary agricultural cooperatives. Therefore, although cooperatives were permitted by the RBI to pay 0.5 percent nominal interest more than commercial banks on deposits, cooperatives mobilized fewer savings than did commercial banks. However, performance has improved in the 1990s. The annual growth rate of deposits in the formal sector was 20 percent during 1990–1995, and 22.1 percent in 1998. This growth is impressive considering the country's low growth rate in per capita income.

The shares of the major rural financial institutions in total institutional credit disbursed and savings mobilized, and their credit-to-deposit ratios are reported in Table VIII.9. The data show that commercial banks provide more than half of the total credit made by the formal sector in rural and semi-urban areas and mobilize more than 75 percent of total formal sector deposits in those areas. The credit-to-deposit ratios indicate that commercial banks and RRBs mobilize more deposits from rural areas than they lend in those areas, while the cooperatives loan more than the deposits they mobilize. Credit-to-deposit ratios have generally declined for all rural financial institutions, especially commercial banks, over the past decade. There has been a vast potential in rural areas for deposit mobilization and commercial banks have been vigorous in exploiting it.

In addition to the formal sector, several self-help groups, microfinance organizations operated by NGOs, and nonbank financial institutions mobilize deposits in rural areas. A study in 1997 revealed that many deposit mobilizers are unreliable. Over half the sampled households interviewed in both rural

Table VIII.9: Credit-to-Deposit Ratios, Credit, and Deposit Shares of Major Rural Financial Institutions

Item	Commercial banks		RRBs	Credit cooperatives		Total for all rural institutions
	Rural	Semi-urban		Short term	Long term	
Credit-deposit ratios						
1985/86	0.66	0.52	0.44	1.62	22.8	0.81
1990/91	0.80	0.57	0.15	1.35	14.9	0.80
1991/92	0.58	0.46	0.19	1.31	19.8	0.67
1992/93	0.55	0.44	0.19	1.57	17.9	0.71
1993/94	0.50	0.39	0.16	1.40	14.9	0.64
1994/95	0.49	0.39	0.21	1.59	15.3	0.66
1995/96	0.48	0.37	0.23	1.61	15.8	0.67
1996/97	0.45	0.41	0.27	1.39	16.2	0.64
Share in total credit disbursed by all rural institutions (1990–1997)	24.0	25.7	2.1	46.2	2.1	100
Share in total deposits mobilized by all rural institutions (1990–1997)	31.1	41.3	6.4	21.0	0.1	100

Source: World Bank (1998d).

and urban areas reported losing their investments with nonbank financial institutions (Sa-Dhan, 1998). The lack of regulatory rules for nonbanks and lack of deposit insurance to cover investments with nonbanks mean that investors with nonbanks are unprotected.

MICROFINANCE

Microfinance has been oriented towards "poverty lending" to marginal clientele with little emphasis on the profitability of operations. Microfinance has been provided by governmental programs such as IRDP and the linkage program sponsored by NABARD, by NGOs, and by a few banks. Anecdotal evidence suggests that there are about 10,000 NGOs in the country currently engaged in providing financial services. There are about 10 replications of the Grameen Bank that have received technical assistance from the Grameen Trust in Bangladesh. The overall outreach of the microfinance programs remains very low. It is estimated that about 2–2.5 million persons are assisted by IRDP every year. The NABARD linkage program has so far reached about 250,000 people. It is unlikely that NGOs reach more than 500,000 borrowers. Few of the programs are sustainable.

Like commercial lending, microfinance is not free from governmental intervention. The NABARD program to link informal self-help groups (SHGs) with banks is an effort to downscale the banking sector to service the rural poor and provide microfinance at the least cost. The program uses three models to link SHGs with banks. In model I, the SHGs are directly linked with the banks. Model II uses NGOs as facilitators/ guarantors for this linkage. NGOs are used as financial intermediaries to link SHGs in model III. As of March 1998, over 14,000 SHGs had been linked to the formal sector and NABARD has refinanced Rs214 million of the Rs236 million lent out by banks under the program. Some 265 NGOs have collaborated with 148 formal financial institutions, of which

30 are commercial banks, 101 are RRBs and 17 are cooperatives. The program has covered about 250,000 families in 21 of the 27 states in the country. The majority of the groups are linked using NGOs as guarantors/facilitators, followed by NGOs as intermediaries. Direct lending to the SHGs has been minimal and has been used only for well-established groups with long-standing relationships with banks. The majority of loans have been disbursed to groups linked with NGO facilitators such that loans can be secured by an NGO guarantee (NABARD, 1998).

A study of 300 SHGs linked to banks through two large NGOs, MYRADA and SHARE, in southern India, showed that 45 percent of the borrowers reported starting an income-generating activity with their loan. The repeat borrowers reportedly borrowed less from informal lenders, accumulated assets, and increased their incomes (Quinones, 1997). The average repayment rate has been over 98 percent for all the SHGs linked through the program (NABARD, 1996).

The costs incurred by banks to lend to the rural poor directly and through NGOs and SHGs were examined by Puhazhendi (1995). The study concluded that lending through NGOs and SHGs reduced transaction costs for the banks in screening, client selection, and contract enforcement. The estimated average transaction costs of lending per borrower amounted to 4 percent of the loan amount if the loans were made directly to the poor, but only 2.5 percent when NGOs and SHGs were used as intermediaries. The transaction costs for borrowers accounted for about 40 percent of the loan amount if the loan was obtained directly from the bank but fell to 6 percent if borrowed through a SHG. The default rates were estimated at 22 percent under direct lending, but close to zero when SHGs were used as intermediaries. While the results are encouraging and support the linkage approach used by NABARD, the magnitude of the costs incurred by NGOs and SHGs, and who bears those costs, are unclear.

Quinones (1997) evaluated 10 NGOs operating as microfinance organizations (MFOs); data on their outreach and sustainability are provided in Table VIII.10. These MFO NGOs are amongst the largest MFOs in India, with the maximum

outreach and sustainability. Nonetheless, the outreach per field staff of the best MFO in the sample (SEWA) was only 4,712 clients with loans amounting to Rs3.9 million and total deposits mobilized of Rs7.1 million.[8] This means an average loan size of about Rs840 per client and an average deposit of Rs1,520 per client. The smallest outreach per field staff in the sample (Shantidhan) was 73 clients with Rs106,000 in loans and Rs67,530 in deposits mobilized. This represents an average loan per client of Rs1,456 and an average deposit of Rs925 per client. It is interesting to observe that the field staff of only two MFOs mobilized more deposits than the volume of loans made. The loan sizes per client were generally less than Rs5,000 or 38 percent of per capita GDP, indicating the depth of outreach of these MFOs.

Table VIII.10: Outreach and Efficiency of Selected Microfinance Organizations as of 1997

Name of MFO	Outreach per field staff			Sustainability (%)	
	No. clients	Loans in (Rs'000)	Savings in (Rs'000)	Operational[1]	Financial[2]
SHARE	136	209	40	19.6	15.0
Nari Nidhi	124	91	22	23.8	15.0
WWF	391	106	26	49.5	47.9
SEWA Bank	4,712	3,941	7,195	132.1	na
Shantidhan	73	106	67	109.7	89.0
MYRADA	181	251	77	6.8	5.8
SPMS	262	616	403	89.2	73.6
Anarde	364	28	52	10.1	10.1
Lalbhai Group	83	50	48	44.2	44.2
ASAG	1,214	1,072	359	182.0	182.0

1 Percentage of operational expenses covered out of interest and other earnings without external subsidies.
2 Percentage of loan loss reserves, inflation risks, and operational costs covered out of interest and other earnings without external subsidies.
na = not available
Source: Quinones, 1997.

8 The exchange rate in 1997 was $1 = Rs38.

Several of these MFOs are not sustainable. Only three (SEWA, Shantidhan, and ASAG) are operationally sustainable in covering operating costs with interest income. Only one (ASAG) is financially sustainable in terms of covering loan losses, inflation risks, and operating costs through interest income. None can also cover the cost of funds and become subsidy free (Quinones, 1997). SEWA has the maximum outreach and is also operationally sustainable, thus refuting the argument of trade-offs between sustainability and outreach. Similarly, ASAG is both operationally and financially sustainable, and ranks second in terms of outreach to clients per field staff. The Grameen replications included in the study (SHARE and Nari Nidhi) are neither achieving good outreach nor are they sustainable. The age of the MFOs may influence their outreach and sustainability: SEWA and ASAG are the oldest, while the Grameen Bank replications have been in operation for less than five years.

The 1997 Microcredit Summit set a target of reaching 100 million families through microcredit by 2005. India's share in the target is estimated to be around 25 million and a sum of about $4.5 billion is required by the year 2005 to reach the objective. Finding the resources may not be a major problem because four apex institutions exist to fund MFOs. They include Friends of Women's World Banking (FWWB), *Rashtriya Mahila Kosh* (RMK), Small Industries Development Bank (SIDBI), and NABARD. All except FWWB are owned by the Government. As of December 1997, RMK and SIDBI had provided loans to SHGs and NGOs reaching a total of about 370,000 households, while FWWB had made loans to 50,550 women through NGOs and SHGs. In addition, there are four large NGOs that function as mini-apex organizations to foster the development of MFOs. Although resources to fund MFOs may not be a problem, the capacity of MFOs to utilize the resources effectively and provide sustainable services is inadequate. The apex operations have not made a significant impact in creating vibrant and sustainable MFOs in the country (Nagarajan and Gonzalez-Vega, 1998a).

The future of microfinance in India hinges upon the creation of a favorable environment for MFOs to grow and

innovate. Restrictive policies on deposit mobilization and negative externalities from subsidized programs such as IRDP are an impediment. Also, MFOs need more discipline to become sustainable. It is not clear if they can successfully provide financial services in rural areas. However, microfinance may become more important in the future in the diversification of farm households into small microenterprises due to declining farm sizes and the inability of the traditional bank products to reach such clientele. MFOs may be necessary to serve poorer clients.

The proliferation of MFOs has created a need for formulating regulatory and supervisory guidelines that would set standards but not hamper their creativity. It may become difficult for RBI to supervise the growing number of MFOs. The recently formed association of 20 large community development institutions, Sa-Dhan, could be evaluated as a possible self-regulatory agency of the MFOs.[9]

INFORMAL FINANCE

The importance of informal finance for rural households is subject to debate due to the lack of nationwide time-series data. Some studies suggest that the share of informal finance in total household borrowing declined with the expansion of formal finance. The results of decennial surveys presented in Table VIII.11 show that the share of informal loans declined from 93 percent in 1951/52 to 39 percent by 1980/81, while the share of the formal sector increased from 7 to 61 percent during the same period. However, a recent study by the World Bank, based on surveys of selected villages in five states in 1994 and

[9] The association was formed in September 1998 and was recognized by RBI in November 1998. The association intends to lobby for MFO interests, and to set and implement standards for the microfinance industry (Anon., 1998b).

1997, found that the proportion of total informal debt outstanding for rural households was 78 percent and only 22 percent for the formal sector. There was no significant difference in these proportions between the two survey years. In the absence of time series and panel data, it is difficult to conclude that there has been any marked change in the share of informal finance (World Bank, 1995c, 1997c).

Table VIII.11: Share in Rural Household Debt by Various Types of Lenders: Results of Decennial Surveys, 1951–1981

Lenders	1951	1962	1971	1981
I. Institutional lenders	**7.1**	**14.8**	**29.2**	**61.2**
Cooperatives	2.9	9.1	20.1	28.6
Commercial and regional rural banks	1.1	0.4	2.2	28.0
II. Noninstitutional lenders	**92.9**	**85.1**	**70.8**	**38.8**
Money lenders	43.8	14.9	13.8	8.3
Farmer lenders	24.8	45.9	23.1	8.6
Trader lenders	6.1	7.7	8.7	3.4
Landlords	2.0	0.9	8.6	4.0
Friends and relatives	14.4	6.8	13.8	9.0
Others	1.8	8.9	2.8	5.5

Source: Reserve Bank of India (1997, p. 543.)

Household surveys confirm that informal finance is clearly important for the poorer population in rural areas. The proportion of informal sources in outstanding household debt of the rural poor in 1980/81 was about 92 percent, formal sources accounting for the remaining 8 percent. World Bank studies conducted in 1994 and 1997 indicated the same pattern for households categorized in the lowest income decile.[10] The

[10] For people who owned assets valued at less than Rs20,000 (the poverty line is drawn at a per capita income of Rs11,000 per year), informal sources accounted for 64 percent of total borrowings, while the rest came from formal sources. In contrast, for people who owned assets above Rs0.5 million, the share of informal sources was 16 percent.

studies showed that 93 percent of the total household debt of the rural poor was borrowed from informal sources. Only a quarter of the poor households reported using formal sources, in contrast to over half of the richer households that held more than 35 percent of their debt with formal sources (World Bank, 1995c, 1997c). These results indicate that informal financial sources remain important, at least for the poor rural households.

Informal loans are a major source of consumption loans (Ghate, 1992). A study by Swaminathan (1991), based on panel data, showed that in 1977, loans from informal lenders financed 63 percent of loans for consumption purposes, but the proportion fell to 37 percent by 1985. The World Bank studies (1995c, 1997c) indicated that nearly 17 percent of rural household consumption expenditures were met through external financing, of which 97 percent came from informal sources. Informal lenders were the major source of consumption credit for both poor and rich households in both studies.

The expansion in formal finance has not reduced informal interest rates. On the contrary, a recent study (Dreze, Lanjouw and Sharma, 1997) reported an increase in informal interest rates. The nominal informal interest rates in the 1990s were reported to range from 35 to 60 percent per annum, while they were reported to be around 6 to 20 percent in the 1970s and 1980s. Iqbal (1981) reported a reduction in the 1970s of about 3 percent in informal interest rates in villages with a commercial bank branch.

The commercialization of the rural sector has induced a change in the importance of various types of informal lenders. The shares of traditional moneylender and farmer-lender loans declined from 44 and 25 percent in 1951 to 8 and 9 percent in 1981, respectively (Table VIII.11).[11] Swaminathan (1991) found

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[11] Commission agents sell inputs to borrowers with the promise that they will exclusively auction or sell their produce to them at harvest time. The lender-commission agent then realizes a commission of 2 percent from the buyer in addition to the interest payments from the borrower (Swaminathan, 1991).

that the share of moneylender loans in total loans of rural households declined from 59 percent in 1977 to 11 percent in 1985, while the share of loans with traders and commission agents increased from 9 to 23 percent. The informal lenders increasingly financed productive activities in addition to making consumption loans. The expansion of the formal sector into pawnbrokering has also reduced the share of informal lenders in this type of financing. The number of informal pawnbrokers in selected villages in the state of Maharashtra, for example. declined from 250 in 1974 to 95 in 1985 (Bouman and Bastiaansen, 1992).[12]

Informal finance has played an important role in mobilizing rural deposits. The rotating savings and credit associations (called chit funds) and nonrotating savings and credit associations (called *bishis*) are a very popular means of savings in rural India (Ghate, 1992). Nayar (1992) reported that the average annual growth rates of deposits mobilized by the informal sector such as in chit funds were 33 and 22 percent in 1980 and 1986, respectively, while formal sources grew at 18 percent in both years.

There has been an important attitudinal change regarding informal finance. The paradigm shift is noticeable in the current enthusiasm of policymakers about the importance of linking SHGs with the formal sector, and in the use of informal lenders such as traders and commission agents as conduits for bank loans. However, care must be taken that this enthusiasm does not lead to regulations that stifle innovations and creativity in informal finance.

[12] The trend could also have resulted from the effect of the Debt Relief Act of 1975 that scaled down debts with moneylenders and pawnbrokers, and even made them return pledged assets to the borrowers without any compensation.

IMPLICATIONS OF THE FINANCIAL CRISIS

India has experienced at least four balance-of-payment crises due to insufficient reserves. The crises in 1965–1967, 1973–1975, 1978–1981, and 1990–1991 were induced by exogenous shocks such as adverse weather conditions leading to poor harvests, and by poor inward-looking policies. However, the response to some policy reforms implemented since 1992 has been positive, leading to a growth in GDP, increased reserves and control on inflation. These developments may minimize further balance-of-payment crises (Jayasuriya, 1998). To date, India has not been greatly affected by the current financial and economic crisis in Asia. India's monetary policies have been conservative with regard to opening capital accounts and this has limited the impact of the financial crisis. Ironically, the slow pace of the financial sector reforms and the limited use by Indian banks of foreign resources has served as a blessing in disguise.

The current crisis may affect the country directly and indirectly in the future. Revenues may fall due to a decline in exports to Southeast Asian countries, and to increased competition in world markets due to the devaluation of currencies of other countries. These effects may be attenuated, especially in rural areas, due to the country's large domestic market. But the effect could be significant for India if the global economy is caught in the contagion. The effect could also be dramatic for the rural economy if there is a significant reverse migration from urban to rural areas and a decline in urban consumption of rural produce that may occur with falling urban incomes due to the crisis.

Several lessons have been learned from the financial and economic crisis in Asia with respect to financial reforms: a currency crisis may be induced by rapid liberalization of the financial sector without strengthening regulatory and supervision capacity, a lack of transparency, and a high degree of governmental intervention in the financial sector (Stiglitz, 1998b). Some analysts argue that India's slow pace in financial market liberalization may be a better approach to avoid potential crises.

But with increasing capital inflows, substantial and swift reforms are required to reduce governmental intervention and improve the regulatory environment to make the financial sector crisis-proof. Furthermore, improving access to information is paramount for creating a strong and transparent banking system. If the country continues to lag in improving the environment for the financial sector so that it can function on market principles, a crisis may be unavoidable in the future.

CURRENT POTENTIAL AND CONSTRAINTS FOR RURAL FINANCE

The financial sector has significantly expanded over the past three decades in numbers of banks and bank branches, especially in rural areas. The wide networks of financial institutions in rural areas offer an excellent infrastructure to reach the rural population. The high level of rural bank branch penetration and the increase in absolute volume of credit to the rural sector from the formal institutions are a positive impact of the interventionist policies. Rural deposit mobilization has been vigorous, especially by the commercial banks, and this has placed India first among South Asian countries in growth in deposit mobilization (Khanna, 1995). Increases in deposits may increase the capital base of the banks and reduce their dependency on governmental funds. Eventually, the banks may become more independent and resist governmental pressure to disburse funds imprudently.

There has been a gradual policy shift in the 1990s toward a more market-based financial system. The 1992 financial sector reforms placed greater emphasis on the viability and sustainability of institutions, competition among financial institutions, transparency of operations, quality services, and reduced State control of the financial sector. By redefining priority sectors, financial institutions can more easily meet their mandatory quotas by lending to larger clientele and less risky activities. A debt tribunal has been created to address the

problem of debt foreclosures. These measures can improve the potential of the financial sector to offer better services.

Several factors constrain the effective functioning of rural financial markets. The indiscriminate expansion of bank branches in the 1970s and 1980s through mandatory requirements and subsidization led to many nonviable, rural financial institutions. There are far too many bank branches and there is limited institutional capacity to supply services. The financial technology used and the level of employee skills have been inadequate to service the demand for term and consumption loans. Therefore, despite the rapid expansion of rural bank branches, the supply of formal sector loans has been limited. Informal finance continues to be important, particularly for the rural poor for consumption loans, and there is no clear indication of a decline in informal interest rates despite the expansion of the formal sector. The problem of low loan recovery, especially on loans made in rural areas, has persisted over the past two decades. Several RRBs and PACS are reported to be bankrupt.

The Indian approach to cooperatives during the past two decades has neglected deposit mobilization, and the primary agricultural credit societies have been used mainly to channel funds from the apex cooperative organization to the final borrowers. This reduces the incentives for the cooperatives to mobilize deposits.

Directed credit programs and subsidized lending such as in the IRDP have damaged the financial discipline of borrowers. Overdues were as high as 94 percent in 1997 (NABARD, 1997). Furthermore, the easy refinancing of directed credits has destroyed the incentives for banks to engage in prudent lending. Considering the evidence that the program has had little impact on the borrowers, the IRDP appears to be an expensive program for poverty alleviation and a great drain on resources. The NABARD linkage programs have created an awareness of the importance of SHGs, but the sustainability of the program has not been adequately addressed.

The financial sector reforms have limitations: they are not comprehensive and have been half-heartedly implemented.

First, the Government still plays a dominant role in formulating financial sector policies and uses the banking sector to disburse subsidized IRDP loans for poverty alleviation. Fortunately, loan waivers have been resisted since 1991 despite recent natural disasters that led to crop failures and mounting overdues in several parts of the country. However, due to political pressure there were disguises of waivers, such as increased funds for refinance programs to disaster-affected states. But the actual disbursements were low because the majority of farmers reduced their demand for agricultural loans (NABARD, 1998). Their demand for consumption loans and term loans to diversify into disaster-proof enterprises cannot be met through existing financial technologies and funding sources.

Second, although the mounting overdues are a concern, financial institutions have only limited freedom to collect loans. Political groups still lobby for relaxation in recovery procedures, especially during crisis times, thus undermining the collection efforts of institutions. The recent debacle with farmers in southern India who were subjected to several natural disasters since 1996 highlights this situation. The reason quoted for the 150 suicides among cotton and spice farmers during 1997–1998 was their inability to pay back huge overdues because of continuous crop failures (Assadi, 1998; Halarnkar, 1998). The political parties condemned the banks for collecting loans during the crisis and lobbied strongly for loan waivers. It was difficult for the banks to resist the political pressure so they had to settle for loan rescheduling, thus aggravating the overdues problem.

Third, while the RRBs and cooperatives are allowed to charge interest rates to cover costs, the commercial banks still face an interest rate ceiling for small loans. Competition, therefore, has been thwarted. In addition, the RBI guidelines are not mandatory for the cooperatives because they are controlled by state governments through the registrar of cooperatives. Several state governments, for political reasons, are reluctant to deregulate interest rates. Therefore, the flexibility offered by RBI to determine interest rates has not been fully utilized by cooperatives and RRBs. Furthermore, the rates were deregulated before the RRBs and cooperatives could acquire

the necessary skills to screen borrowers and charge rates according to risk.

Fourth, mandatory lending for the priority sectors has been reduced, but still exists. Fifth, although the viability of many rural branches is low, due in part to low volume of business, additional institutions such as urban cooperatives are now permitted to operate in rural areas. This may result in more overcrowding and create even more nonviable institutions. However, if the Government avoids bailouts, competition may weed out nonviable branches and institutions, leaving the fittest to survive. A problem is that there are few clear exit options for nonviable institutions. Sixth, the skill level of banking sector employees is generally too low to access and process information efficiently.

A high-level committee was recently commissioned to formulate rural credit policies in line with the financial reforms (RBI, 1998). Although the committee represents yet another Government intervention, it has recommended several useful changes in loan screening and monitoring procedures to improve the quality of loan portfolios, and to increase transparency in reporting requirements. Implementation of these recommendations, however, is highly dependent on politicians who have blocked the autonomy of the RBI to carry out effective reforms. There are several issues that deserve attention: policy environment, financial infrastructure, and institutional development.

Creating the Policy Environment

The financial reform process has been slow due to political instability, but has protected the country from experiencing a financial crisis. The recent crises in Southeast Asian countries that rapidly liberalized their financial sectors have set back the enthusiasm for reforms in India. However, carefully planned and rapidly implemented financial reforms are now crucial to ensure the country's future economic growth. There is a need to create a favorable policy environment and clear-cut guidelines

regarding the sequencing of reforms. Lessons need to be learnt from the causes and consequences of the crises elsewhere and applied to the country's current endeavor to reform the financial sector.

The commitment of shifting from the old directed credit policies to a market-based financial sector has not been strong due to political objectives. The practice by the Government of advocating policies from both the old and new paradigms creates a confused environment for private sector initiatives. It will be important to create a policy environment that is freer of short-term political motives.

Interest rate subsidies must be phased out, and ceilings on lending and deposit rates should be completely deregulated for all institutions. This is the only way for true competition to emerge and to give institutions the possibility of covering costs. Targeted lending programs must be narrowly focused and used judiciously to achieve the best results at lowest cost and with the least negative spillovers into nontargeted sectors. Donors need to support a more intensive policy dialogue on interest rates between the Government and financial institutions. Donors can also help disseminate the successes and limitations of targeted programs in other countries.

Clearer policy guidelines are needed so that the RBI has the autonomy to curb political interference. The concept of NABARD as an apex refinancing institution needs to be examined in light of the huge potential to mobilize deposits from the public. As the public becomes more of a stakeholder in financial institutions, there will be pressure to discipline the institutions and encourage them to function more prudently.

Creating and Strengthening the Financial Infrastructure

Financial reforms need to be strictly preceded by efforts to strengthen the financial infrastructure, including the supervisory and regulatory system. Although there are fairly clear guidelines and adequate human resources to regulate and

supervise the sector, there has been a reluctance to enforce standards and penalize violators due to political interference. Once again, achieving autonomy is crucial if the infrastructure is to work properly.

Computerization of the banking sector is important in order to process information efficiently and improve the transparency of banking records. Dissemination of information on best practices is required through electronic and print media. The government and donors can also contribute to the creation of credit bureaus and credit-rating agencies that will improve the generation and dissemination of information, leading to better screening of applications.

Institutional Development

The majority of the financial institutions in the country are faced with mounting overdues. Strong institutions cannot be built on weak portfolios. There is an urgent need for rigorous debt collection efforts through debt tribunals backed by enforceable laws. Loss-making bank branches need to be liquidated quickly and nonviable institutions should be closed. Proper exit mechanisms should be devised for closing down nonviable institutions. If clear guidelines are lacking for liquidation procedures, they need to be developed to ensure the smooth exit of nonperforming institutions.

Low loan recovery reflects the cumulative effect of a deteriorating credit culture exacerbated by frequent loan waivers announced by politically motivated governments. The lack of information and skills among bankers to screen applicants effectively and make good loans, as well as the lack of effective enforcement mechanisms, also contributes to recovery problems. The institutions need to become more proactive in order to withstand governmental interference in loan collection efforts. Improvement in the repayment culture can only occur in an environment free of political involvement and by applying tough sanctions against defaulters. Strategies such as penalties for delinquent borrowers, and incentives for early and prompt

payers should be introduced; they have been used effectively by the Bank for Agriculture and Agricultural Cooperatives in Thailand and Bank Rakyat Indonesia.

Strong institutions are run by skilled and satisfied employees. The skill levels of the bankers must be improved so they can better screen applicants and make good loans. Training programs need to be strengthened in all the states. Enhancing the skills of bank employees will have limited impact, however, if they are not well rewarded and provided with sufficient resources to perform well. Financial incentives are needed for the best performing bank staff as well as penalties for those whose performance is below standards. Performance-based compensation and incentive packages are required in order to attract and retain quality personnel in rural areas. Loan recovery should be one of the criteria for compensation. Modern equipment is essential to utilize properly the knowledge gained by personnel through skill-enhancement programs. A one-time subsidy from the Government or donors to financial institutions to update the latter with modern banking equipment and software may produce a much higher return than directly subsidizing interest rates.

The feasibility of introducing technological innovations such as automatic teller machines (ATM) and credit cards needs to be carefully examined as a means to reduce transaction costs. The quality of financial services in rural areas must be improved and low-cost and flexible products for loans, deposits, and insurance need to be designed. Some government banks may have to be privatized in order to attract private resources into banking and reduce the drain on public funding.

India is a vast country with wide geographic variations, but research to understand the changes in the demand for and supply of financial services has been traditionally concentrated in only a few locations. More research covering diverse regions is required in order to document the results of various experiments that are underway to help build institutions to address location-specific issues. There may be some advantage in decentralizing the central bank to deal with location-specific variations. It may also be advantageous for donors to identify

and work with states with stable governments that are willing to experiment and have a stake in the new initiatives in financial sector development. Donors could also help to improve the research capacity of banks and research institutions and bring them closer to international standards.

India presents a challenge for donors interested in helping it to improve its rural financial markets. On the one hand, a number of recent reforms are moving the system in the right direction such that the current environment is somewhat encouraging for donor involvement. On the other hand, India is not a country that is entirely open for donors to implement a complete overhaul of the system or to introduce new institutions or financial products. Donors must work within the restrictions imposed by the political environment, diversity in financial market philosophies, and institutional capacities. The continued presence of donors who take responsibility for their initiatives and actively work on the financial system may facilitate shifts in the right direction in the long run.