SPECIAL ARTICLE

Strengthening Rural Lending

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The development of critical complementary infrastructure for customer data (such as credit bureaus and alternate-data repositories); warehousing, particularly of the type which facilitates making electronic warehouse receipts directly available to small farmers; land registries; weather stations; registries for movable collateral; and the development of markets for second-hand assets, would also be very important to strengthen rural lending

EXPANDING access to finance in rural areas has been an important focus of banking sector policy for a number of decades and while there is no doubt that there has been progress, the overall situation that obtains currently is very grim from a cost, risk, and effectiveness perspective. While India as a whole has a low credit to GDP ratio of about 70 per cent for agriculture, at less than 36 per cent, it is even lower, indicating poor outreach of formal credit to the sector despite all the policy priority that has been given to it. This has resulted in the continued prevalence of informal indebtedness among farmers - only 14 per cent of the marginal farmers (with land holdings less than 1 hectare) were taking institutional credit in 2009, with the remaining largely relying on informal sources of credit for their credit needs[1].

There are also very large regional imbalances. States such as Bihar have an overall credit to GDP ratio of less than 16 per cent despite the fact that it has one of the lowest levels of GDP in the country. During 2007-2012, 38 per cent of agricultural credit was accounted for by the Southern States despite them constituting less than 20 per cent of India's Gross Cropped Area while the Eastern and North-Eastern states accounted for only 8 per cent, despite having comparable Gross Cropped Area. Central India received only 13 per cent of agricultural credit with 27 per cent of Gross Cropped Area[2]. Even those credit flows that do take place are not consistent with cropping patterns - while month-wise credit disbursement patterns should have been in line with ground level requirements of Kharif (June, July, September) and Rabi (December, January) seasons, one-fourth of the disbursements by banks instead happen in March, a month that is not critical to agriculture production[3]. The problems of low effectiveness in rural lending are compounded by the fact that at close to 5 per cent, Non-Performing Asset ratios for rural (priority sector) assets are very high and are double those of other sectors despite all the subsidies that have been directed at this sector. The cost-to-serve for small loans for national full-service banks exceeds 30 per cent while they are required to lend money to this sector at spreads ranging from 3 per cent below their base rate to 2 per cent above them.

Rural credit delivery in India has been led by national full-service banks. Over the years, it has gradually

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become clear that the branch structure of the national full-service banks, in its present form is not well suited to processing small loans and priority sector loans from a cost, risk, as well as effectiveness perspective. Costs of operations (not including interest costs) tend to be as high as 30 per cent and non-performing assets are 10 per cent or more for the small loan segments. However, on account of low-transparency of bank balance sheets, the fact that these costs and risks are so high, is not immediately apparent and policy continues to require banks to not only meet high Priority Sector

Over the years, it has gradually become clear that the branch structure of the national full-service banks, in its present form is not well suited to processing small loans and priority sector loans from a cost, risk, as well as effectiveness perspective. Costs of operations (not including interest costs) tend to be as high as 30 per cent and non-performing assets are 10 per cent or more for the small loan segments. However, on account of low-transparency of bank balance sheets, the fact that these costs and risks are so high is not immediately apparent and policy continues to require banks to not only meet high Priority Sector Lending (PSL) targets, but to do so directly on their balance sheets using traditional outreach strategies.

Lending (PSL) targets, but to do so directly on their balance sheets using traditional outreach strategies. Global and Indian best-practice suggests that the only way for national full-service banks to effectively run such operations is through the creation of specialised verticals within the bank or dedicated subsidiaries that are focussed exclusively on these tasks and operate with a decision-making structure that transfers credit decision making to staff that directly interact with the borrowers and do not centralise it. Or, alternately, they need to partner with much more effective independent institutions such as Regional Banks and RBI-regulated Non-Bank Finance Companies (NBFCs) in order to meet their lending goals without putting their own balance sheets and profitability at risk. There are good examples of such structures within India as well as globally. To ensure that large quantities of low quality and high cost assets do not build up on the balance sheets of nationally important banks and that, they have a constant incentive to manage risks and costs actively, there is a great deal of focus on increased transparency of balance sheets through much more detailed segment level reporting and the public disclosure of stress test results at least on an annual basis.

Regional Banks in India, particularly those within the cooperative structure, have a number of advantages on all the three fronts of costs, risks, and effectiveness of outreach, but have historically suffered from both governance problems as well as an inability to successfully manage regional level systematic risks such as rainfall shocks and the transformations in the nature of the regional economy. The Indian cooperative structure has, over the years, experienced a great deal of failure on account of both these issues. Due to concerted efforts of the Government, the National Bank for Agriculture and Rural Development (NABARD), and the RBI, these issues are in the process of being addressed at least for those cooperative institutions that have survived, but the structural issues mentioned earlier are far more complex and will need the development of new capabilities within the Regional Banks and NABARD as well as the development of new risk management products such as catastrophic insurance and securitisation[4]. There are already a large number of regional / local banks that are currently in operation and it would be best to focus on continuing to strengthen them instead of attempting to create a large number of new Regional Banks which are bound to experience very similar problems until durable solutions to their risk management problem are developed.

Like the Regional Banks, specialised RBI-regulated NBFCs too have a number of advantages on the cost, risk and effectiveness fronts. The strength of this design is that, for the most part,

...unlike in the case of Regional Banks, at all times there are highly qualified and specialised lenders that are constantly overseeing their functioning and cutting them off from access to fresh lines of credit in case of poor performance. However, poorly developed debt-capital markets combined with a strong regulatory preference for direct origination of priority sector assets by banks and concerns with applicability of state moneylending laws, have historically served to keep the size of this sector small.

they are not able to take public deposits and have to necessarily borrow from wholesale sources such as capital markets and banks. This ensures that, unlike in the case of Regional Banks, at all times, there are highly qualified and specialised lenders that are constantly overseeing their functioning and cutting them off from access to fresh lines of credit in case of poor performance. However, poorly developed debt-capital markets combined with a strong regulatory preference for direct origination of priority sector assets by banks, and concerns with applicability of state moneylending laws, have historically served to keep the size of this sector small. Incorporating these institutions within the framework of banks as specialised Wholesale Banks, which do not have the ability to take retail deposits, would have the effect of removing several of these impediments to their orderly growth, without necessarily altering their core character and also simultaneously enhancing systemic stability.

While the rigid and mechanical manner in which credit delivery channels are currently required to operate, is the principal impediment in the orderly growth of rural credit, there are a few other critical areas in which changes could have a strong beneficial impact on the quality, quantity, and pricing of rural credit and on the performance of the various credit channels.

As mentioned earlier, one of the core problems of the Indian banking sector is its small size relative to the needs of a developing economy like India. The impact of this small size on the amount of lending that can take place is exacerbated by the fact that a large proportion of the modest resources mobilised by the banks are being pre-empted by the Government by requiring banks to invest in government bonds and providing food credit. The capital markets of India have acquired sufficient depth for both of these needs to be met exclusively by non-bank sources and a large amount of resources for rural and other forms of lending can be freed up from bank balance sheets if these pre-emptions were taken away. Additionally, banks, particularly government owned banks, are required to price their farm loans at very low prescribed rates of interest and the Government offers additional interest rate subsidies. This results in a massive distortion of the farm credit system resulting in a denial of credit to small farmers and land-less labourers; a desire on the part of banks to only offer minimal amounts of credit to this sector despite a large unmet demand and very low levels of innovation. It would be far better if the banks were free to price their farm loans based on their risk models and any Government benefits such as interest subventions and debt waivers were transferred directly to the farmers without channelling it through the credit system. In order to address issues relating to Moral Hazard and to allow high performing rural borrowers to signal their credit worthiness and obtain both lower cost and higher quantum of credit, there is a need to mandate universal reporting to credit bureaus of all loans by all originating entities, including for SHG loans, and Kisan Credit Card and General Credit Card facilities, just as has been done successfully for RBI-regulated Micro Finance Institutions.

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The uniform manner in which priority sector lending mandates are required to be met is another area of concern since it discourages banks from building core competencies in specific sectors or regions. An Adjusted Priority Sector Lending (APSL) mechanism in which, additional weightage is given to lending to the more difficult sectors and districts, by allowing a specific bank to focus only on one or more sectors or regions of its choosing, could help redress this problem while ensuring that the banking system as a whole delivers on the overall priority sector lending goals. In such a scheme the district level multipliers could be based on the CRISIL Inclusix, which is a neutrally determined district level financial inclusion index, and the sectoral weights could be based on the level of underachievement of a particular sector for the system as a whole. Against an unweighted PSL target of 40 per cent, banks would then be required to meet an equivalent weighted APSL target of 50 per cent. To address the problem of timing mismatches between the requirements of credit and its supply, the PSL credit target of 40 per cent (or the APSL target of 50 per cent) should be required to be met at every quarterly balance sheet reporting date and not just at the end of March. There is also a case to examine and eliminate PSL policy bias against consumption smoothing in general and for landless labourers in particular.

...it will become important to revisit the very definition of priority sector and to use metrics such as regional and sector credit to GDP ratios and the growth elasticity of credit to determine the weights that will be used to determine APSL targets. However, for this to happen, among other things, there will be a need for the Planning Commission to start to publish official GDP series for each district in the country and for key sectors within each district and for the RBI to make available comparable credit data so that these analyses can be accurately carried out.

In the longer run, as the relative importance of various sectors for poverty alleviation and enhancement of growth changes, it will become important to revisit the very definition of priority sector and to use metrics such as regional and sector credit to

GDP ratios and the growth elasticity of credit to determine the weights that will be used to determine APSL targets. However, for this to happen, among other things, there will be a need for the Planning Commission to start to publish official GDP series for each district in the country and for key sectors within each district and for the RBI to make available comparable credit data so that these analyses can be accurately carried out.

For a number of reasons related both to the achievement of PSL targets as well as active management of bank balance sheets, it is essential to develop robust markets for the active transfer of assets, liabilities and risks between financial markets participants. Such markets will facilitate the sale and purchase, of PSL (and other) assets between all types of entities, in a manner that is based purely on quality and is agnostic to institutional differences. Currently, the absence of such markets has resulted in banks paying high penalties for non-achievement of PSL targets; in banks struggling to originate PSL assets directly even though they are aware that from a cost and risk perspective they are not the most efficient originator; and in banks holding high sectoral or regional concentrations all the way to maturity despite the risks that such concentrations pose to their stability. The existence of such risk-transfer markets will facilitate the development of multiple specialist originators (banks and non-banks) and partnerships between these specialists to enable the development of a credit infrastructure that reaches out to every last rural household and enterprise in an effective, low cost and low risk manner. In order to achieve this, it would be very important to restore the tax-exempt status for securitisation of vehicles, given their critical role in efficient risk transmission; removal of the requirement that the all-inclusive interest charged to ultimate-borrower by originating entity must not exceed Base Rate of the purchasing bank plus 8 per cent per annum; and allowing banks to treat assets as held-to-maturity based on declared intent irrespective of the documentation of such assets as loans or bonds or their acquisition in primary or secondary markets. In order to facilitate this, specialised Institutions such as NABARD, the National Housing Bank (NHB), and the Small Industries Development Bank of India (SIDBI) will also need to move towards becoming much more market oriented in their support to their constituents. For example, NABARD can help to improve the financial health of better performing cooperative banks by providing fairly priced second-loss deficiency guarantees instead of balance sheet based refinance.

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Endnotes

1 All India Debt and Investment Survey (2002) and Sarangi (2010).

2 Thorat, Y.S.P. “Report of the Working Group on Outreach of Institutional Finance, Cooperatives, and Risk Management.” Submitted to the Planning Commission, Government of India, 2011.

3 Sarangi, Umesh Chandra. “Report of the Task Force on Credit Related Issues of Farmers.” Submitted to the Ministry of Agriculture, Government of India, 2010.

4 In the US such a role is performed by the Federal Agricultural Mortgage Corporation, commonly known as Farmer Mac (www.farmermac.com). ❑

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Pension Sanction and Payment Tracking System Launched on Pilot Basis

The Department of Pension & Pensioners’ Welfare has launched a web based Pension Sanction and Payment Tracking System “ BHAVISHYA” which provides for on-line tracking of sanction and payment processes by the individual as well as the administrative authorities. The new proposed system will capture information relating to the pensioner’s personal and service data including contact details like mobile number and e-mail etc. It will also have electronic forms required to be submitted to pension sanctioning authority. The system will keep retiring employees informed of the progress of pension sanction process through SMS/E-mail in future. The application will help in monitoring the delays which take place in sanction of pension and retirement benefits to a retiring Government Servant.

The software has been launched on a pilot basis in fifteen Ministries/Departments of the Government viz. Ministries of Statistics & Programme Implementation, Steel, Urban Development and Textiles, Home, Health, Family Welfare, Commerce; Departments of Electronics & Information Technology, Ayush, Industrial Policy & Promotion, Personnel & Training, Administrative Reforms & Public Grievances, Pension & Pensioners Welfare and Planning Commission.