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Improving Access to Finance for India's Rural Poor

PRIYA BASU

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Priya Basu



THE WORLD BANK
Washington, D.C.

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Foreword

A growing body of research—some of it by the World Bank—shows that well-developed and inclusive financial systems are associated with more-rapid growth and better income distribution. Finance helps the poor catch up with the rest of the economy as it grows. Finance also helps extend the range of individuals, households, and firms that can get a foothold in the modern economy, and it can reduce damaging concentrations of economic power. Largely thanks to microfinance, there is now a growing appreciation of the “empowerment” dimension of finance, of the extent to which it can give ordinary people and the poor access to opportunity and the ability to escape ossified social structures. It is perhaps symbolic of this evolutionary thinking that “building inclusive financial systems that work for the poor” became the mantra of the United Nations International Year of Microcredit 2005.

But building more-inclusive financial systems requires us first to get a handle on how well financial systems across countries are directly serving the poor and others at the margins. Which segments are underserved or excluded from the financial system, and why? What are the binding constraints faced by these underserved and/or excluded segments in accessing financial services (savings, money transfer, credit, insurance, etc.) from different types of providers? Which types of direct access to financial services have the greatest impact on reducing poverty and lifting growth rates in deprived districts and regions? How does financial sector access affect the efficiency of micro- and small-scale enterprises? What kinds of organizational and product strategies can help banks to “downscale” in order to reach underserved segments, and help microfinance scale up its outreach while achieving financial viability?

Here we are confronted with a scarcity of data, and even of consensus on what ought to be measured. Despite the existence of numerous extensive financial databases, our knowledge in most countries of the degree to which effective and low-cost financial services reach low- and middle-income households, small enterprises, and other less-privileged segments of society is very limited.

To fill this gap, development partners have begun a new push to collect country-level data on financial access. A wave of data collection exercises—supported by the World Bank, the Department for International Development, and others—is well under way. As part of this effort, household surveys specializing in financial sector access issues have been carried out by the World Bank and Finmark in several

countries. Additionally, the World Bank's "Investment Climate" surveys have sought to explore questions of financial sector access by the surveyed companies, and our "Doing Business" surveys have covered expert assessments of certain elements of the relevant institutional environment. The World Bank has also collected quantitative information from major financial service providers and regulators.

In India, the World Bank has recently championed an initiative on understanding and improving financial access, in partnership with the National Council of Applied Economic Research (India) and a group of experts, including researchers and practitioners. The initiative, led by Priya Basu, Lead Economist in the Bank's Finance and Private Sector Unit, South Asia Region, has included a household survey specializing in financial sector access issues—the first to be conducted among the countries of South Asia—and several analytical papers to further investigate the problems and challenges in financial access and to evaluate the success, scalability, and financial sustainability of recent approaches and innovations.

This volume presents the key findings of the India survey and the accompanying papers and distills the main lessons and policy messages. The survey included some important innovations over similar surveys conducted in other countries. For instance, the India survey is the first among the country-level household surveys to document measures of rent seeking and corruption in financial access. It also covers questions on a broader range of financial services—savings, money transfer, credit, trade finance, and insurance across the full spectrum of the financial system—formal, semi-formal (microfinance), and informal. It contains detailed questions on the income and expenditure profile of the surveyed households in an attempt to correlate this with their level and nature of financial access.

This volume makes an important contribution to the growing body of literature on measuring financial access, and to our understanding of what is holding back financial access for so many households and micro-enterprises across rural India. Based on the analysis, it charts an agenda for improving access to finance for India's rural poor. We hope this work will help researchers as they struggle for new ways to benchmark financial access, financial sector practitioners as they try to increase outreach to those at the "bottom of the pyramid," and policy makers as they strive to create a more-inclusive financial system, which is so critical to spreading economic opportunity and fighting poverty.

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Major contributors to the report were Leora Klapper, Niraj Verma, and Ulrich Hess of the World Bank; and Pradeep Srivastava and Rajesh Shukla of the National Council of Applied Economic Research (NCAER), India.

The report draws on a Rural Finance Access Survey (RFAS) for India, designed and undertaken jointly by the World Bank and NCAER. It also draws on the following background papers: (a) "Microfinance: Analytical Issues for India" by Jonathan Morduch and Stuart Rutherford; (b) "Scaling up Microfinance in India" by Priya Basu and Pradeep Srivastava; (c) "Microfinance in India: Banyan Tree and Bonsai" by Vijay Mahajan and Bharti Ramola Gupta; (d) "Review of Rural Finance Institutions in India" by Ramesh Deshpande and Niraj Verma; (e) "The Use of New Products, Processes and Technology in the Delivery of Rural Finance in India" by Ulrich Hess and Leora Klapper; (f) "Informal Finance in Rural India" by Jock Anderson and Niraj Verma; and (g) "Agricultural Commodity Markets in India: Policy Issues for Growth" by Susan Thomas. Connie Bernard, Dina Umali-Deininger, and James Hanson provided helpful comments.

The report incorporates suggestions from representatives of the Government of India, Reserve Bank of India, National Bank for Agriculture and Rural Development, Small Industries Development Bank of India, and commercial banks, as well as microfinance practitioners and other key stakeholders who attended a workshop in New Delhi in February 2004, at which an earlier draft of the report was presented and discussed.

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Abbreviations and Acronyms

AICI	Agriculture Insurance Company of India
AIDIS	All-India Debt and Investment Survey
AP	Andhra Pradesh
APEC	Asia Pacific Economic Cooperation Secretariat
APMAS	Mahila Abhivruddhi Society, Andhra Pradesh
APR	Annual percentage ratio
ATM	Automated teller machine
BAAC	Bank for Agriculture & Agricultural Cooperatives
BFS	Board for Financial Supervision
BI	Bank Indonesia
BKD	Badan Kredit Desa
BoS	Board for Supervision
BRI	Bank Rakyat Indonesia
CD	Credit deposit
CEO	Chief executive officer
CRISIL	The Credit Rating Information Services of India Ltd
CRR	Cash Reserve Ratio
CRAR	Capital to Risk Weighted Asset Ratio
DCCB	District central cooperative bank
DFI	Development financial institution
DRT	Debt Recovery Tribunal
ECB	External commercial borrowing
FA	Fishermen's Associations
FECRECOOP	Federation of Saving and Loan Cooperatives
FWWB	Friends of Women's World Banking
GDP	Gross domestic product
GoI	Government of India
HLL	Hindustan Lever Limited
IASP	Integrated Agricultural Service Provider

ICICI	Industrial Credit and Investment Corporation of India
ICT	Information and communication technology
IFC	International Finance Corporation
IFS	International Financial Statistics
KBS LAB	Krishna Bhima Samruddhi Local Area Bank
KCC	Kisan Credit Card
LIC	Life Insurance Corporation of India
LKDP	Rural Fund and Credit Institutions (Indonesia)
MACS	Mutually Aided Cooperative Societies
M-CRIL	Micro-Credit Ratings International Limited
MFI	Microfinance institution
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-bank finance company
NCAER	National Council of Applied Economic Research
NGO	Non-governmental organization
NPL	Non-performing loan
NSSO	National Sample Survey Organization
PACS	Primary Agriculture Credit Societies
PCO	Public Call Office
PKSF	Palli Karma-Sahayak Foundation
PLR	Prime lending rate
PRADAN	Professional Assistance for Development Action
PSB	Public sector bank
RBI	Reserve Bank of India
RFAS	Rural Finance Access Survey
RFIs	Rural finance institutions
RIDF	Rural Infrastructure Development Fund
RMK	Rashtriya Mahila Kosh
ROA	Return on Assets
RPCD	Rural Planning and Credit Department
RRB	Regional rural bank
SEBI	Securities and Exchange Board of India
SEWA	Self-Employed Women's Association

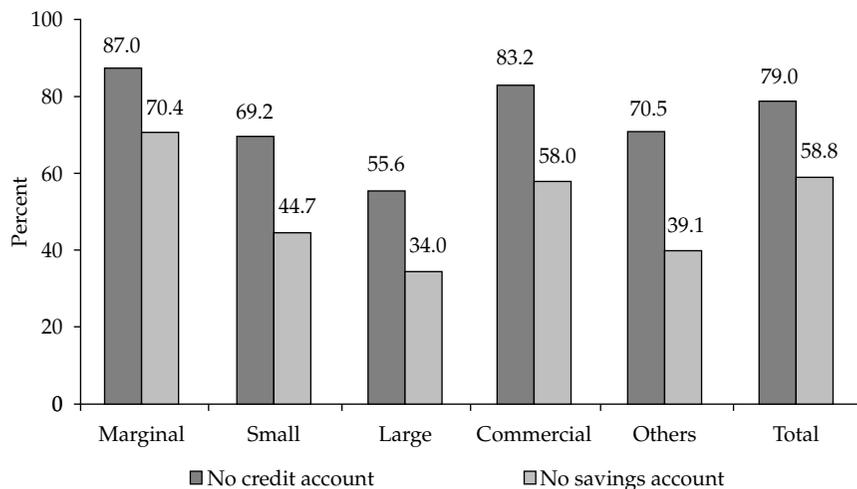
SFMC	SIDBI Foundation for Micro-Credit
SGSY	Swarnajayanti Gram Swarozgar Yojana
SHG	Self-Help Group
SHPI	Self-Help Promoting Institution
SIDBI	Small Industries Development Bank of India
SKS	Swayam Krishi Sangam
SLR	Statutory Liquidity Ratio
StCB	State-level cooperative banks
STD	Subscriber Trunk Dialing
UP	Uttar Pradesh
UTI	Unit Trust of India
US\$1.00	Rupees (Rs) 43.00 (May 31, 2005)
VSSU	Vivekananda Seva Kendra O Sishu Uddyan

Executive Summary

Since the country's early national plans of the 1950s, successive governments in independent India have emphasized the link between improving access to finance and reducing poverty. This stance by the Indian state has had influence globally.¹ The need to improve financial access for India's poor, the overwhelming majority of whom are concentrated in rural areas,² motivated the nationalization of commercial banks in the late 1960s, and an aggressive drive through the 1970s and 1980s to expand rural banking. These actions were coupled with policies making it mandatory for banks to provide subsidized credit to rural households. The 1990s saw the partial deregulation of interest rates, a gradual reduction in the government's stake in commercial banks, and increased competition in the banking sector. But political compulsions have all along dictated the persistence of government intervention in rural finance. Government still dominates rural finance institutions. "Directed" credit and subsidies—albeit lower than before—continue to distort risk-return signals in rural finance.

Access to finance for the rural poor has improved somewhat over the past decades, with public sector commercial banks being the dominant providers of formal rural finance. The Indian government's policies dictating branch expansion of public sector commercial banks in rural areas, particularly in the 1970s and 1980s, certainly helped banking outreach. Today, India has over 32,000 rural branches of commercial banks (mostly public sector commercial banks) and regional rural banks (RRBs), some 14,000 cooperative bank branches, 98,000 Primary Agricultural Credit Societies (PACS), thousands of mutual fund sellers, several non-bank finance companies (NBFCs), and a large post office network with 154,000 outlets that are required to focus on deposit mobilization and money transfers.³ Not surprisingly, India compares favorably with other developing countries in terms of the average population served per bank branch, and the average geographical area served per branch.

But the vast majority of India's rural poor still does not have access to formal finance. The World Bank (WB)–National Council of Applied Economic Research (NCAER) Rural Finance Access Survey (hereafter RFAS 2003) prepared as a background to this report, indicates that rural banks serve primarily the needs of richer rural borrowers: some 66 percent of large farmers have a deposit account; 44 percent have access to credit. Meanwhile, the rural poor face severe difficulties accessing

Figure ES.1 Low Access to Formal Finance

Note: **Marginal** farming households = landholding < 1 acre; **small** = 1 to 4 acres; **large** farms = > 4 acres; **commercial** households = with or without land but with income from non-farm sources exceeding half of total household income; **others** = mixed households with land and non-farm commercial incomes but the latter being less than half of their total household income.

Source: RFAS 2003.

savings and credit from the formal sector (Figure ES.1). Some 87 percent of the poorest households surveyed (marginal farmers) do not have access to credit, and 71 percent do not have access to savings from a formal source. Access to formal credit is particularly a problem for the poor when trying to meet unforeseen expenditure, and difficulty in accessing formal finance has resulted in a heavy reliance among poorer rural households on informal finance—mostly moneylenders and shopkeepers. Around 44 percent of the households surveyed by RFAS 2003 report having borrowed informally at least once in the preceding 12 months; the interest charged on informal loans averages 48 percent per year. Access to other financial services, such as insurance, also remains limited among the rural poor, even though many in this segment would like access to insurance—over 82 percent of households surveyed in RFAS 2003, had no insurance, and practically none of the poorest households surveyed had insurance.

Recent years have witnessed the growth of new microfinance approaches designed to serve poorer households. These often involve partnerships between government, non-governmental organizations (NGOs), and banks. But these approaches have not yet shown significant results. Informal sector lenders retain a strong presence in rural India.

What Explains Inadequate Access to Finance for India's Rural Poor?

The lack of access to adequate finance on reasonable terms for India's rural poor may be attributed to a combination of factors that affect both banks and their clients.

Why Banks Don't Want to Serve the Rural Poor

Serving the rural poor is a high-risk, high-cost proposition for banks: First, there is the uncertainty—about the repayment capacity of poor rural borrowers, with their irregular/volatile income streams and expenditure patterns. In the absence of credit information, this drives up default risk. Such problems are exacerbated by the borrower's lack of collateral, and/or difficulties in contract design and enforcement.

Second, the transaction costs of rural lending in India are high, mainly due to small loan sizes, the high frequency of transactions, the large geographical spread, the heterogeneity of borrowers, and widespread illiteracy. For private sector banks, their lack of a rural branch network is an additional problem.

Third, the government's policies have made things worse from the banks' perspective, creating a "financial climate" not conducive to lending in general and rural banking in particular:

- High fiscal deficits and statutory pre-emptions imposed on banks crowd out credit to the private sector; another persisting distortion that has failed to generate the desired results is the "priority sector" lending target;
- Persisting interest rate restrictions—"floors" on short-term deposit rates and lending rates, "caps" on small loans—all these impose an "implicit tax" on banks;
- Government's domination of and interference in rural banks, particularly RRBs and cooperative banks, further distort bankers' incentives; inefficiencies arising from weak governance, poor management, weak regulatory standards, and lack of supervision have meant that many of these banks are in deep financial distress. They are thus no longer able to perform their task of financial intermediation;
- Bankers' risk aversion to lending is exacerbated by a pervasive culture of suspicion of bankers, whose lending decisions are often subject to stringent scrutiny by Parliament, the Central Bureau of Investigation, etcetera.

Why Small Rural Borrowers Find Rural Banks Unattractive

First, rural banks do not provide flexible products and services to meet the income and expenditure patterns of small rural borrowers. Second, the transaction costs of dealing with formal banks are high. Procedures for opening an account or seeking a loan are cumbersome and costly (with high rejection rates), and, as indicated by RFAS 2003, clients often have to pay hefty bribes (ranging from 10 to 20 percent of the loan amount) to access loans. This makes the ultimate cost to borrowers very high (despite interest “caps”). It takes, on average, thirty-three weeks for a loan to be approved by a commercial bank.⁴ Third, banks demand collateral, which poor rural borrowers lack. Land remains the predominant form of collateral. But, poor households very often do not have clear titles to their land, and in any case, this collateral is seldom executed, so it is just another cost with little benefit in practice.

New Approaches and Products to Improve Rural Access to Finance in India

In recent years, several new approaches and products have evolved to provide finance to India’s rural poor.

SHG-Bank Linkage Program

Most notable among recent approaches to improve access to finance for the rural poor is the “Self-Help Groups (SHGs)–Bank Linkage” model, championed by the National Bank for Agriculture and Rural Development (NABARD). The growth of SHG–Bank linkage—from just 500 SHGs linked to banks in the early 1990s to over 1 million at present—has been truly remarkable. Data from RFAS 2003 show that SHG–Bank linkage appears to have targeted poorer segments of the rural population in an effective manner (Basu and Srivastava, 2005), reducing the vulnerability of clients. But outreach, volume of lending, and average loan size remain limited. With an outreach of about 12 million women and their households linked to banks through group savings accounts and an estimated 2 million to 4 million women with outstanding credit from banks, SHG–Bank linkage has a long way to go before it can really improve matters. The key challenges facing the initiative are: (a) Inadequate attention to group quality could jeopardize longer-term credibility and sustainability. (b) Capacity constraints and the cost of group formation.⁵ (c) State-owned banks have been lending to SHGs at interest rates of between 9 percent and 12 percent per year. Recent studies indicate, however, that the all-inclusive costs are, in fact much higher, and could range anywhere from 15 percent to 28 percent per year.⁶

Unless banks charge interest rates that enable them to recover costs, the model's financial viability and longer-term sustainability may be jeopardized.

Microfinance Institutions

In recent years, other institutional structures for microfinance have emerged: notably, independent specialized microfinance institutions (MFIs). The Small Industries Development Bank of India (SIDBI) has been the largest lender to these emerging MFIs, though Friends of Women's World Banking India (FWWB) as well as the National Women's Fund (which translates in Hindi as Rashtriya Mahila Kosh or RMK) have also played an important role. The outreach of Indian MFIs, however, is modest in comparison to SHG-Bank linkage, and also in comparison to MFIs elsewhere in the world. In March 2004 the Indian MFIs sector as a whole had a total outreach of less than 2 million borrowers. This limited outreach and scale of Indian MFIs reflects, at least in part, the absence of an enabling policy alongside a legal and regulatory framework. This hinders the ability of MFIs to mobilize member deposits, equity, and raise debt from external sources. MFIs are also constrained by the lack of adequate capacity and skills in financial control and management, management information systems (MIS), new product design, etc. Further, since most MFIs in India lend to SHGs, this means that MFIs in India are constrained by many of the factors that have held back the outreach and scale of SHG-Bank linkage. In particular, capacity, time, and cost issues related to group formation have posed constraints.

Partnerships between Private Banks, Microfinanciers, and Service Providers

Encouraged by early results, several new private sector banks, most notably ICICI Bank, but also UTI Bank, HDFC Bank, and some others, are actively seeking exposure in the microfinance sector. These banks have been lending to MFIs. While their current exposure to microfinance is too small to make a difference to their overall portfolio, some of these newer banks are pursuing innovative approaches to microfinance—as a potential business and not merely as a social or priority sector lending obligation. Key innovations include a pilot scheme by ICICI Bank that uses NGOs or MFIs, traders, or local brokers (who are close to the farmer by the nature of their business) as intermediaries/"service providers" for originating, managing, and collecting loans to groups of small and marginal farmers. Banks are also experimenting with an approach now termed the "Integrated Agricultural Service Provider" (IASP) approach, whereby the bank identifies

an IASP—one that has a good relationship with farmers and which provides genuine and timely information through extension services—and enters into a tripartite agreement with the IASP and the output buyer. This reduces transaction costs and the risk exposure of all parties, and, therefore, presents a potentially low-cost way of serving the rural poor engaged in marginal or small farming.

The Kisan Credit Card

Another recent approach to providing agricultural credit, including to small farmers, is the Kisan Credit Card (KCC), launched in 1998–99. By March 31, 2003 some 31.6 million KCCs had been issued by commercial banks, RRBs, and cooperative banks. Though these are not credit cards, KCCs present a number of advantages to borrowers and lenders, namely by reducing both borrowers' transaction costs as well as delays in accessing and renewing crop loans. But the success of the KCC scheme has been uneven. For instance, only 6 percent of households surveyed by RFAS 2003 report having a KCC, and access to a KCC appears to be higher among the larger farmers (20 percent of surveyed large farmers, as compared to a figure of just 2 percent for marginal farmers).

Agricultural Risk Management Products for Farmers

A potential means of reducing default risk in rural finance which has recently caught the attention of the Government of India (GoI) is the establishment of a "warehouse receipts system." This involves farmers using their crops as collateral for post-harvest financing. For the warehouse receipts system to work effectively, receipts need to be recognized as legal instruments. Also, the grades and quality standards of the commodities need to be defined centrally, warehouse operation standards need to be developed, and effective supervision established.

Weather-index insurance can be a good way for farmers to hedge businesses against imponderable weather risks and can be a cheaper substitute for crop insurance. The insurance is index-based and, therefore, transparent as well as free of moral hazard and adverse selection—which makes the product cheaper. In addition, insurance payouts are timely and immediate. Although such products have not yet taken off in India on a larger scale, BASIX, an MFI, through its Krishna Bhima Samruddhi Local Area Bank (KBS LAB), recently piloted a weather-indexed crop-insurance product developed by ICICI Lombard. ICICI Lombard (in conjunction with ICICI Bank) also offered excess-rain policies to around 5,000 wheat farmers in Uttar Pradesh (UP). In conjunction with BASIX they offered these policies also to 150 soya farmers in Madhya Pradesh (MP), in 2003/2004. More recently, the company has worked with the Government of Rajasthan to pilot weather insurance for orange

farmers in the state, while also extending weather-risk insurance for a rural-finance portfolio of BASIX. The latter is interesting in that it captures, with one deal, all the farmers—big, small and marginal—who are part of BASIX's agriculture portfolio.

The Policy Agenda

Improving access to finance for India's rural poor, to meet their diverse financial needs (savings, credit, insurance, etc.) through flexible products at competitive prices presents a formidable challenge in a country as vast and varied as India. But the opportunities, too, are plentiful. In the near term microfinance can, at minimum, serve as a quick way to deliver finance. But the medium term strategy to scale up access to finance for the poor should be to "graduate" microfinance clients to formal finance institutions where they can access standard "individual" loans, possibly on a fully commercial basis. An immediate problem arises in that there are no obvious lenders for microfinance customers to graduate to—none, yet, are close to offering the reliability, convenience, continuity, and flexibility required by low-income customers. Nor is the notion of graduation explicitly built into the design of microfinance in India. If the idea of graduation there becomes a serious one, efforts to promote microfinance should go hand in hand with efforts to make the formal sector better at "banking the poor," and both government and private sector can play a critical role in this context.

Making the Formal Financial Sector Better at Banking the Rural Poor

An immediate challenge is for formal sector institutions to introduce products and services that are not only reliable and continuously available, but that are also flexible and convenient. They need in addition to introduce measures that allow for low-cost ways of reaching the rural poor. Here, microfinance can offer useful lessons to formal banks. Over the medium term, key reforms in government policy are required to improve the overall incentive framework, as well as the regulatory and legal system within which rural banks operate, so as to promote greater efficiency and competition in rural finance.

Low-Cost Ways of Reaching the Rural Poor through the Formal Sector

India's vast network of rural banks potentially presents a tremendous advantage: it is one on which the country could capitalize to deliver finance to the poor. Currently, most banks operating in rural areas—

the majority of which are state owned—do not seem tailored to effectively meet the needs of the rural poor. The responsibility for introducing more flexible products and services that better match the needs of the rural poor rests with bankers. But government, given its domination of rural finance institutions, also has an important role to play in spearheading change. In this context, microfinance offers a number of lessons for formal banks.

Introducing flexible products. Small rural clients prefer to borrow frequently and repay in small installments; banks could usefully explore the possibility of offering new and more flexible loan products, such as those offered by microfinance. Increased use by insurance companies of the large and deep branch presence of the postal branch network, as well as the commercial bank network, for channeling insurance products, backed by trained staff, could help lower transaction costs and improve access to insurance.⁷

The need for composite financial services. While small rural borrowers seek savings and lending services, they also seek insurance (life, health, crop); bank branches in rural areas would do well to explore opportunities that offer composite financial services. They have begun to do this in urban areas already; some microfinanciers have begun to offer such composite services in both rural and urban areas.

Simplification of procedures to open a bank account, and access credit. This could go a long way in encouraging the poor to bank with the formal sector, by reducing clients' transaction costs. The KCC experiment is a move in the right direction, but it needs to be scaled up and accompanied by other procedural changes.

Better staffing policies and doorstep banking. The high recovery rates of microfinance are associated with staffing policies that allow recruiting staff from the local area who understand clients' needs, and a focus on doorstep banking. Public sector banks operating in rural areas currently do not have the flexibility to recruit staff locally, but antiquated staffing policies could be revised. Doorstep banking is costly, but the gains from better recovery and cost savings via hiring local staff in rural branches could well outweigh the higher transaction costs of doorstep banking.

Use of technology. Banks can use technology to drive down their transaction costs—for example, through the introduction of smart cards and biometrics.

Improving the Incentive Regime and Promoting Competition

Interest rates. One obvious area could be for government to rethink its policy of setting interest rate “caps” on rural lending rates and “floors” on deposit rates. As noted above, caps and floors have the opposite effect of what is intended—poor borrowers are cut off from access and

end up paying higher interest rates to informal lenders. Meanwhile, banks face an implicit tax (cost) that is not insignificant.

Revisiting the policy on “priority sector” lending. Government should consider revising its policy on priority-sector lending requirements imposed on banks which, in any case, are not fully observed and often circumvented through such means as subscription by banks to NABARD and SIDBI bonds.⁸ One option that would allow the most competitive lender to emerge in rural areas and minimize distortions is for government to make the priority lending obligation “tradable.” The most competitive lender would then be paid by less-well-placed banks to effectively take on their priority lending requirements for a price. Creating such a market for priority lending requirements would benefit both banks and the rural poor, who would be able to access finance from the most efficient and competitive institution.

Entry of new private banks in rural finance. Some private banks, such as ICICI Bank, have shown a growing interest in entering India’s rural finance sector—and have introduced innovative approaches and financial products to reach the rural poor. Government needs to do what it takes to create an environment that makes it possible and profitable for private banks to enter the rural finance market. This requires liberalizing interest rates (see above) so that lending to small rural clients can become a more profitable business for banks. It also requires revising branch licensing policies (private banks may be interested in buying up the branch networks of government-owned rural banks). And it requires strengthening the supervision of rural banks so as to weed out the good from the bad banks and create further space for new, private-sector entrants. The entry of private banks could have a good demonstration effect on public-sector banks—showing them how to reduce transaction costs in rural banking and how to make rural banking profitable.

Restructuring RRBs and rural cooperative banks. Restructuring RRBs and rural cooperative banks poses a major challenge. Various government-appointed task forces and committees have highlighted what needs to be done to deal with weaker RRBs and cooperative banks; the challenge really is to build the consensus for reforms and actually implement the changes. As a first step, the regulation and supervision of these banks urgently needs to be strengthened. Prudential regulation standards related to capital adequacy, asset classification, income recognition, and provisioning need to be upgraded and introduced in a phased manner, and the supervisory enforcement improved. Weaknesses in regulatory standards, poor enforcement, and regulatory forbearance have undermined market discipline and contributed to the deep financial distress that characterizes many RRBs and cooperatives.

Better regulation and supervision would pave the way for the restructuring of these banks. It would help weed out the weaker banks (undercapitalized banks, and those that are insolvent) from those that are adequately capitalized. The proper enforcement of prudential norms would mean that weaker banks are forced to address their problems through such means as mergers and closures. This needs to be accompanied by operational restructuring, involving improvements in governance to reduce state interference; better management; staffing policies that allow banks to employ local staff familiar with the community (and thereby better able to address client needs); the introduction of new products, such as loans with flexible repayment terms; and better services, such as doorstep banking, that can improve services to rural clients while minimizing risk. In introducing new products and services for the rural poor, lessons could be drawn from microfinance.

Beyond these measures, government can play an active role in other areas to facilitate increased efficiency of rural finance markets. Better laws and regulations governing financial transactions, a judiciary that enforces contracts, the demarcation of property and improvements in land titling, better credit information, and an enhanced regulatory, supervisory and legal framework to support the development of price-insurance products, price-derivatives instruments, and commodities-futures markets can go a long way in helping India's rural poor access finance on better terms.

Scaling Up Microfinance

Efforts to make the formal sector better at banking the poor should be accompanied, in the near term, with measures to scale up microfinance. This will require attention in the following areas:

An enabling policy, legal, and regulatory environment for microfinance. An enabling framework is already in place for SHG-Bank linkage, and scaling up the model would require government to ensure that the existing framework is maintained. This would require ensuring that the model continues to have a champion with a clear leadership role—a task which NABARD has assumed with exemplary diligence by introducing policies and measures to encourage banks to lend to SHGs. This also requires the authorities to maintain a “hands-off” regulatory policy towards SHG-Bank linkage. For MFIs, government could play an important role in establishing an enabling policy, legal, and regulatory framework. While the success of individual MFIs is largely attributable to visionary leaders, this is clearly not enough to mainstream the cause of MFIs. Advocates of MFIs argue that the immediate measures needed include the following: (a) reducing minimum start-up capital requirements to facilitate the transformation of MFIs into NBFCs so that they

can mobilize savings from their members; (b) encouraging multiple sources of equity for MFIs; and (c) developing a set of prudential norms that are more appropriate to institutions serving the poor, and setting up supervision mechanisms around such norms. Better policy coordination among the various government ministries/ departments/ agencies that cover MFI issues would also help greatly.

Better group quality, and the importance of financial sustainability. Scaling up microfinance in India requires attention to the quality and sustainability of groups, their promoters, and lenders (such as banks or MFIs). A strong focus on the quality of SHGs by their NGO promoters was a key factor in the success of SHG–Bank linkage in its pilot phase. But in recent years growing concerns have emerged on group quality as well as the ability of partner banks to properly assess, monitor, and manage risk on their SHG portfolios. Going forward, if SHG–Bank linkage is to be scaled up, NABARD and its partners face an important challenge in ensuring that high quality groups are created and maintained. In particular, the success and sustainability of SHG–Bank linkage depends crucially upon a clear strategy on who will promote new groups, and how they should be funded. Equally, efforts need to focus on ensuring that banks price their loans to SHGs at rates that cover their costs and ensure the financial sustainability of SHG banking. Banks also need to focus more on monitoring and managing SHG lending risk. Since most Indian MFIs also lend to groups, issues related to group quality have a bearing on the success of the MFI model as well.

Appropriate products and services, and good staffing. How products are designed, how staff are compensated, what messages are delivered from headquarters, and who is recruited onto staff, all have an important bearing on the success of microfinance. Technical support to rural finance and microfinance practitioners in these areas is required.

The need for greater inclusiveness and competition in the microfinance sector. The inclusiveness of SHG–Bank linkage, which has involved a partnership between government, NGOs, and a range of rural banks (commercial banks, RRBs, cooperative banks) has already generated a strong payoff. Further gains in terms of outreach and financial sustainability may be made by involving private-sector banks and MFIs in SHG banking. Recent experiments indicate good prospects for scaling up models that are variations of SHG banking, and involve MFIs as intermediaries between SHGs and private sector banks (who want to enter the market but do not have the branch network). Equally, there is space for independent, specialized MFIs in the Indian microfinance market that could provide the necessary competition to SHG–Bank linkage in the area of savings and credit provision, and also complement the services provided by SHG–Bank linkage. Evidence from elsewhere in Asia, and particularly from Bangladesh and Indonesia, suggests that

good, reliable, responsive, long-term MFIs for the poor can go a long way in improving access to finance (Morduch and Rutherford, 2003).

Recent studies also indicate the key role that can be played by MFIs that provide composite services—given the wide array of financial transactions (both borrowing and lending, often simultaneously, and at all levels of income) that characterizes the financial life of the poor (RFAS 2003 supports this conclusion). The poor are constantly borrowing, lending, saving, withdrawing, using, and losing money through contingencies and calamities. They need someone to help them with all these transactions. Composite-service providers are preferable in as much as they reduce the number of agencies with which poor households must deal, thus reducing transaction costs. Moreover, if a composite agency has a good internal MIS, it can use the savings history of a household as a “collateral” for loans. Similarly, if the same agency provides insurance for lives or livelihoods, it will be more willing to give a loan. From the MFIs’ point of view, transaction costs come down as the same delivery system can be used with only the additional costs of training, software, and some staff.

Overcoming geographic concentration in microfinance. Another issue of concern is that microfinance in India continues to be skewed in its geographical distribution, with a concentration in Southern India. The underlying causes for this include the general malaise in the economy of the central, eastern, and north-eastern states, with very little resultant demand for credit among the subsistence poor, and the absence (for historical reasons) of good quality NGOs willing to initiate microfinance programs in these states (Mahajan and Ramola 2003). Expanding the reach of microfinance to these areas is not a challenge that can be met overnight. Investments are required in areas such as watershed development, small-scale irrigation, livestock upgradation and forest regeneration. Unfortunately, none of these are amenable to the “small, short, and unsecured” nature of microcredit loans. These require long-term, lumpy public investments. However, once made, they unlock the potential for enhancing the livelihoods of millions of poor people, moving them up from subsistence production to surplus production and thereby increasing the demand for credit.

Attention to the demand-side. While the importance of microfinance in consumption-smoothing should not be underestimated, its success in building up poor peoples’ assets over the medium term depends very much on efforts directed at providing assistance in skills-development, technology, and marketing—all critical to ensuring that investments made by poor households reap returns and contribute to a sustained increase in incomes and improvements in rural livelihoods.

Notes

1. The focus on poverty and finance was articulated most famously in the Reserve Bank of India (RBI) report on the All-India Rural Credit Survey of 1951–52. See RBI 1954.

2. Of the estimated 260 million Indians (or 26 percent of the population) who live in poverty, some 193 million (or 74 percent) live in rural areas. Another 180 million rural people are “near poor.” A majority of these households comprise marginal or small farmers, and the poorest households are landless.

3. The total number of bank branches (rural and urban) is 66,500. The bulk of these branches belong to public sector commercial banks.

4. High transaction costs of dealing with formal banks translate into a low frequency of transactions. According to the RFAS 2003, more than 60 percent of households with bank accounts report accessing their accounts at a frequency of less than once a month (62.3 percent of households with accounts in banks access their accounts less than once a month, while the same percentage among households with accounts in RRBs is 70.8).

5. The estimated cost of creating and sustaining new and high quality SHGs is controversial, with NABARD claiming that it is as low as Rs1,000 (US\$23) per group and NGOs saying it takes as much Rs 12,000 (US\$279). The Ministry of Rural Development, Government of India has established a norm of Rs10,000 (US\$232) per group, which experts claim is realistic.

6. Fifteen percent is in fact what private banks like ICICI Bank charge when they lend to SHGs.

7. RFAS 2003 data showed that post office branches had the closest proximity (2 kms on average) to rural clients, compared to branches of commercial banks, RRBs, and cooperatives (5 kms on average).

8. This is expected to change in light of the recent policy that makes investments in bonds issued by certain institutions ineligible for classification under priority-sector lending.

1

Introduction

“Access to financial markets is important for poor people. Like all economic agents, low-income households and microenterprises can benefit from credit, savings, and insurance services. Such services help to manage risk and to smooth consumption . . . and allow people to take advantage of profitable business opportunities and increase their earnings potential.

But financial markets, because of their special features, often serve poor people badly . . . Since poor people often have insufficient traditional forms of collateral (such as physical assets) to offer, they are often excluded from traditional financial markets . . . transaction costs are often high relative to the small loans typically demanded by poor people. And in areas where population density is low, physical access to banking services can be very difficult . . .”—World Bank, *World Development Report 2000–2001*

Finance is an extraordinarily effective tool in spreading economic opportunity and fighting poverty. To understand why access to finance is so important for poverty reduction, we begin with two examples. The first example illustrates how the poor may be totally incapacitated when they do not have access to finance, while the second shows how a few dollars of financing can help poor people climb out of poverty, giving them the freedom to earn an independent and fulfilling livelihood.

The Stool Maker of Jobra Village¹

There is perhaps no greater authority on how to make finance available to the poor than Muhammad Yunus, the founder of the Grameen Bank. In his autobiography, Yunus described how he came to understand the importance of finance for the poor when he was a professor of economics in a Bangladeshi university. Appalled by the consequences of a recent famine on the poor, he wandered out of the sheltered walls of his university to the neighboring village, Jobra, to find out how the poor made a living. He started up a conversation with a young mother, Sufiya Begum, who was making bamboo stools. He learned that Sufiya needed 22 cents to buy raw material for the stools. Because she did not have any money, she borrowed it from middlemen and was forced to sell the stools back to them as repayment for the loan. That left her with a profit of only 2 cents. Yunus was appalled:

“I watched as she set to work again, her small brown hands plaiting the strands of bamboo as they had every day for months and years on end. . . .

How would her children break the cycle of poverty she had started? How could they go to school when the income Sufiya earned was barely enough to feed her, let alone shelter her family and clothe them properly?"

Because Sufiya did not have 22 cents, she was forced into the clutches of the middlemen. The middlemen made her accept a measly pittance of 2 cents for a hard day's labor. Finance would liberate her from the middlemen and enable her to sell directly to customers. But the middlemen would not let her have finance, for then they would lose their hold over her. For want of 22 cents, Sufiya's labor was captive.

Such paucity of finance, which is all too often the normal state of affairs for the poor in much of the world, is rendered even more stark when one contrasts it with the extraordinary impact of just a few dollars of finance on the lives of the poor. To see this, we move to an example in southern India, where microfinance—the provision of tiny amounts of finance to people with even tinier assets—helped lift a woman and her family out of poverty.

The Fisherwoman from Rajpally

Putlibai came from a fishing community in Rajpally, which lies in an impoverished region of southern India. Her family eked out a living through fishing in the reservoir. Her husband and two sons went out in the pre-dawn darkness and cast their nets. They brought in their daily catch in the morning. Then Putlibai, along with her daughter and mother-in-law, cleaned and processed the fish in time for Putlibai to catch the morning bus to various local town markets each day. Putlibai sold the fish, and the family's net earnings were about \$2/week, just enough to barely subsist.

Putlibai knew that a few extra fishing nets could go a long way in improving her livelihood—but she did not have the money to buy the nets. She could not borrow from the bank; she had heard that others from her community had been turned away by the bank, after several visits, and besides, she did not have any assets to pledge as collateral to the bank. The local moneylender charged exorbitant rates of interest (5 percent per month), and Putlibai had friends who were never able to get out of the moneylender's clutches.

Then, in 1998, Swayam Krishi Sangam (SKS), a microfinancier, established a center (*sangam*) in Rajpally. The center comprised of four joint liability groups who undertook to mutually guarantee each other's debt obligations; each group had five women as its members. All groups assembled together once a week for small financial transactions. This included savings of 10 cents/week per member that was collected by the loan office of SKS. Collateral free loans were given to all members in the center within 3–6 weeks of initiating the savings activity subject to approval of a small application from the borrower explaining how the funds would be deployed in productive activities. The loans could be up to a maximum of \$50 for the first cycle and had to be repaid in 50 equal weekly installments, carrying an interest rate of 15 percent flat per annum.

Like everyone else, Putlibai, who was one of the first to join, saved 10 cents/week. She took a loan of \$35 after four weeks of the start of the center to buy more fishing nets. While she previously had only eight nets and was able to catch approximately 6 kilos of fish per day, she and her husband now tripled their daily catch and the family's weekly income increased to \$6/week. Encouraged by this success, Putlibai took a second year loan of \$100 for even more nets and further increased the family's earnings to \$10/week. By her third year, she had gained tremendous confidence and took a \$150 loan and the daily catch is now about 50 kilos per day. Putlibai can no longer sell all the fish the same day and she uses a nearby cold storage plant to store unsold fish for the next day. Her family's weekly net income averages around \$15/week, a 750 percent increase from three years ago. This year, Putlibai is planning to take a loan for even more nets and is considering employing people to help with both fishing and selling.

Putlibai's entrepreneurial success has inspired other families to take up fishing. Today, eight other SKS members in Rajpally have taken loans for fishing nets and the entire community has benefited through increased economic activity. This is a particularly inspiring story because Putlibai was one of the poorest members when SKS started and she was not very respected. Now she is held in high esteem by the entire center and the entire village.

Broader access to finance helps an economy produce more, and distribute it fairly.² Both consumers and producers benefit because their welfare and productivity are raised.³ Without access to credit, one avenue of opportunity—self employment—is shut off. As a result, the poor are doubly damned—not only because they lose an option but also because their bargaining power, when they work for those who have resources, is weakened. In the examples above, while both Sufiya and Putlibai had talents and ideas, the difference was that Putlibai was able to obtain the resources necessary to carry out her ideas. This gave her individual choice and economic freedom, dignity, and the ability to contribute to the wealth of her community.

Indeed, access to credit allows all those with talent to obtain the resources necessary to carry out their ideas, and society is the richer for it. Better access to other financial services, such as savings, remittance service and insurance,⁴ also means that individuals can insure themselves against periods of low income or unexpected fluctuations in income, and maintain their consumption standards via the accumulation of financial savings.⁵ For example, for rural farmers savings constitute insurance, protecting them against periods of drought or crop failure. Savings also provide a vehicle for future expenditure needs, whether expected (for example for special family occasions, or for the purchase of significant assets such as a home) or unexpected. Access to finance could also have longer-term welfare implications, permitting

people to borrow when young—for example for education or for other physical or human capital—and then repay and save for retirement when older.⁶

In India, since the early national plans, successive governments have emphasized the link between improving access to finance and reducing poverty,⁷ a viewpoint which has been globally influential.⁸ The need to improve financial access for India's poor motivated the establishment of a vast network of rural cooperative credit banks in the 1950s, followed by a drive to nationalize commercial banks, launched in 1969. This created thousands of new bank branches in rural areas across the country. The strategy during the 1970s and 1980s gave the leading role to nationalized (public sector) commercial banks. These were charged with loosening the grip of traditional informal-sector moneylenders, sought to be brought about through the use of targeted low-priced loans. The 1990s saw the partial deregulation of interest rates, increased competition in the banking sector, and new microfinance approaches that combine the safety and reliability of formal finance with the convenience and flexibility of informal finance. Access to finance for the rural poor has improved somewhat over the past decades. But the vast majority of India's rural poor still do not have access to either formal finance or microfinance. Informal-sector lenders thus retain a strong presence in rural India.

Why focus on the rural poor? The overwhelming majority of poor people in India are concentrated in rural areas. Of the estimated 260 million Indians (or 26 percent of the population) who live in poverty, some 193 million (or 74 percent) live in rural areas.⁹ Based on an internationally comparable poverty estimate of a dollar a day, the number of rural poor in India is estimated at around 270 million. Another 180 million rural people are “near poor.”

India's Rural Finance Landscape

What Are the Financial Needs of the Rural Poor?

India's rural poor are overwhelmingly dependent on agriculture as their primary source of income; the majority are marginal or small farmers, and the poorest households are landless. The financial needs of India's rural poor reflect the volatile, uncertain, and irregular income streams and expenditure patterns of these households. The recently completed World Bank-NCAER Rural Finance Access Survey of 2003 (henceforth referred to as RFAS 2003) indicates that while rural families are predominantly multiple-income households, their two main sources of income include the sale of agricultural products and wage labor.¹⁰ Irregular employment is the most important source of income from

wage labor. For households with more than one source of income, agricultural income is the most important secondary source, with sales of farm produce and dairy products being the most prominent. Clearly, rural households depend on one or both of two types of income: seasonal (post-harvest sale) or highly irregular, due to irregular or part-time wage labor, with the dependence on the latter being inversely proportional to the size of land holdings. The typical expenditure profile of the households is also of small, daily, or irregular expenses incurred throughout the month. Moreover, the overwhelming majority of rural households report having to deal with at least one unusual expense each year, which they are forced to finance either from cash at home or through informal loans from family, friends, or moneylenders.

Research shows that poor people value financial services and want these to be reliable, convenient, continuous, and flexible.¹¹ They understand that financial services help them spend at one time the income they have earned at other times. And because those incomes tend to be small, irregular, and unreliable, they need the full armory of intermediating modes—saving up for future spending, taking advances against future savings, and building cash reserves that can be called on at any time. The poor need a wide range of financial services—from small advances to tide over consumption needs to loans for investment purposes to long-term savings that help them manage life-cycle needs.¹²

Who Are the Rural Finance Service Providers?

India has a range of rural financial service providers, including formal-sector financial institutions at one end of the spectrum, informal providers (mostly moneylenders) at the other end, and between these two extremes a number of semi-formal/microfinance providers.

Formal providers. In terms of their sheer size and spread of operations, formal-sector financial institutions dominate the rural finance landscape:

- Commercial banks, mostly public sector banks (but also some private-sector banks) and regional rural banks (RRBs) together have more than 32,000 rural branches.
- India also has a vast network of rural cooperative banks, with a three-tiered structure at the state, district, and village levels. There are some 14,000 branches of rural cooperative banks and more than 98,000 grassroots retail outlets of Primary Agricultural Credit Societies (PACS), which are used by the cooperative system as channels for fund flows.
- The post office system adds to the physical service point network of the country with more than 154,000 post office branches handling more than 110 million money orders and administering 114 million savings accounts.¹³

- Recent developments have led to other interlinkages between the formal—both public- and private sector banks—and semi-formal sector initiatives, particularly in the context of SHG–Bank linkage, as well as through lending by SIDBI and commercial banks to MFIs. Moreover, a few private-sector commercial banks, such as ICICI Bank, have tried innovative ways of incorporating lessons from microfinance into their operations, and have made inroads in using microfinance methodologies to deliver rural financial services. These innovations are detailed later.

Informal providers. Informal financiers include a range of actors—landlords, local shopkeepers, traders, professional moneylenders, etc. While there are no definite estimates of the number of informal-sector providers, these are spread very widely across the country. Survey data indicate that poor rural households rely heavily on informal finance to meet a range of financing needs: from consumption and emergency financing to investment loans. Around 44 percent of the households surveyed by RFAS 2003 report having borrowed informally at least once in the preceding twelve months; the interest charged on informal loans averages 48 percent per annum. Not surprisingly, informal borrowing is very important for the poorest (marginal and commercial categories), which are most deprived of formal finance.

With a few notable exceptions (such as West Bengal, where land reforms are the most advanced in the country), village moneylenders and other types of informal financiers have been around for as long as villages have existed. Informal financiers have the advantage of knowing their client better than most formal institutions, such as banks. They are better able to enforce contracts and provide flexible products.

* * *

Improving access to finance for India's rural poor, to meet their diverse financial needs (savings, credit, insurance, etc.) through flexible products at competitive prices presents a formidable challenge in a country as vast and varied as India. But the opportunities are plentiful, and government has an important role to play in creating space and a flexible architecture for scale-up. The present report is organized as follows: drawing on RFAS 2003, Chapter 2 reviews the current level and pattern of access to finance for India's rural households, with a focus on the poor. It highlights inadequacies in rural access to finance. Chapter 3 takes a closer look at what explains the lack of financial access for India's rural poor. Chapter 4 examines recent approaches in India to improve access to finance for the rural poor, focusing particularly on low-cost delivery models that have involved linkages between the formal and informal sector, based on principles of microfinance. It

evaluates successes and failures, and identifies the main challenges ahead in improving outreach and sustainability. The concluding section provides some suggestions on what needs to be done to scale up access to finance for India's rural poor.

Notes

1. See Rajan and Zingales 2003.
2. For a producer, access to credit for fixed or working capital enables an increase in production possibilities which can have far-reaching implications not only for the producer but for patterns of employment, occupational choice, and even economy-wide productivity and growth. Financing constraints have been shown to feature prominently among the constraints of small- and medium-size enterprises in some investigations: Hallberg 2001. Yet other studies indicate that firms find difficulty of access to financial markets the major obstacle to the expansion of their business activities, ahead of factors such as macro instability, taxes, and street crime: Galindo 2001.
3. Intermediation enables inter-temporal choices in consumption and investment for the individual, allows the determination of the cost of capital and hence helps guide investment to its most productive use, and permits the social reallocation of savings from low to high productivity uses—thus raising social welfare.
4. Official estimates show that international remittances to India amounted to US\$8.4 billion in 2003. The total volume of remittances would be much higher once credible estimates, as yet unavailable, for international remittances through unofficial channels and domestic remittances are added. Within the latter, domestic migrant labor income remittances play an important role for rural household income.
5. The role of savings and borrowing in protecting consumption against unexpected shocks, first discussed by Milton Friedman 1957 in the “permanent income hypothesis,” has since been extensively tested empirically, as discussed in Bond and Townsend 1996.
6. The “life cycle” hypothesis as an explanation for savings and borrowing behavior, is discussed in Ando, Modigliani and Brumberg in a series of articles in the 1950s and 1960s. See Mayer 1972, and Romer 1996 for overviews.
7. The focus on poverty and finance was articulated most famously in the All-India Rural Credit Survey of 1951–52. See RBI 1954.
8. For a good discussion on the link between finance and poverty see Rajan and Zingales 2003. For a discussion on the microeconomic underpinnings of the welfare implications of improved access to financial intermediation, see World Bank 2003a.
9. This is based on the Planning Commission of India's definition of poverty as the level of per capita consumer expenditure sufficient to provide an average daily intake of 2,400 calories per person in rural areas and 2,100 calories per person in urban areas, plus a small allocation for basic non-food items.
10. The findings of this survey are discussed in detail in the next chapter.
11. See Morduch and Rutherford 2003.

12. For a discussion of ways that low-income households cope with risk, see Morduch 1999a.

13. While the postal system is heavily subsidized, it nevertheless adds to the service branch outreach of the country and provides a valuable and trusted place for small investors to deposit their savings. The potential linkages with the postal network to deliver increased and more efficient financial services is discussed in a World Bank study. See World Bank 2002.

14. NABARD is owned by the RBI and the Government of India and was established by an act of Parliament in 1982 as the apex bank for rural finance.

Access to Rural Finance in India: The Evidence

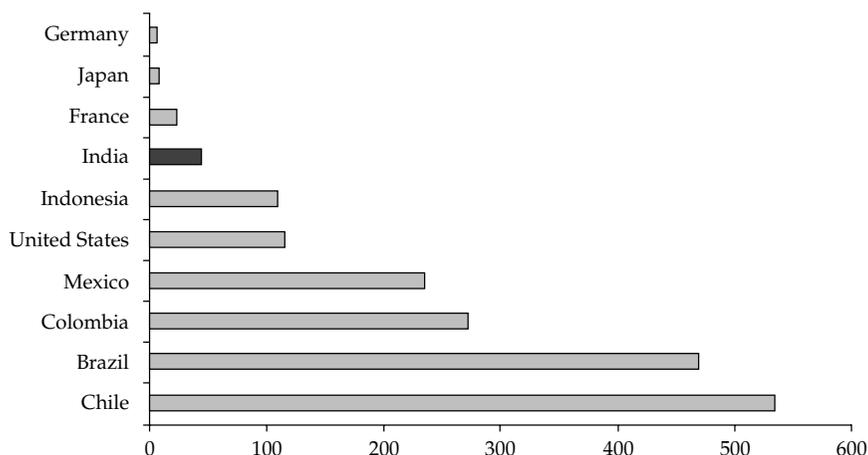
India has a financial system which runs deep. This is attributable in large part to the country's vast network of banks and other financial institutions, including thousands of branches of rural banks. Financial assets in India amount to about US\$1,034 billion, in nominal terms, compared to US\$235 billion in Indonesia, US\$656 billion in Mexico, or US\$775 billion in Brazil. This is despite India's significantly lower per capita income. The share of financial assets in GDP in India is about 173 percent, compared to 104 percent in Mexico, 112 percent in Indonesia, and 157 percent in Brazil. (See Appendix 1 for a structural overview of India's financial sector.)

Supply-Side Indicators of Access to Finance

Financial depth is attributable in large part to India's vast network of financial institutions, including rural finance institutions. The 1970s and 1980s saw a rapid expansion of India's financial system into rural areas. Following Indira Gandhi's bank nationalization drive (launched in 1969), commercial banks were required to open rural branches. Between 1973 and 1985 bank branches in rural areas grew at an average of 15.2 percent each year, about double the growth rate of branches in semi-urban (6.4 percent), urban (7.8 percent) and metropolitan (7.5 percent) areas. Rural branches grew from 1,833 in 1969 to 30,186 in 1985, an increase of 1,547 percent (by comparison, the increase over the same period for semi-urban, urban, and metropolitan areas was only 194,315, an increase of 220 percent). Rural branches continued to expand in the 1980s, to 35,000 by 1991, declining slightly to 32,400 in 2001. Today, India has over 32,000 rural branches of commercial banks and RRBs, some 14,000 cooperative bank branches, 98,000 PACS, not to speak of thousands of mutual fund sellers, several NBFCs, and a large post office network with 154,000 outlets that are required to focus on deposit mobilization and money transfers.¹

Not surprisingly, India compares favorably with other developing countries in terms of the distribution of financial services. The average population served per commercial bank branch in India was around

Figure 2.1 International Comparisons of Area Covered per Branch (square kilometers)



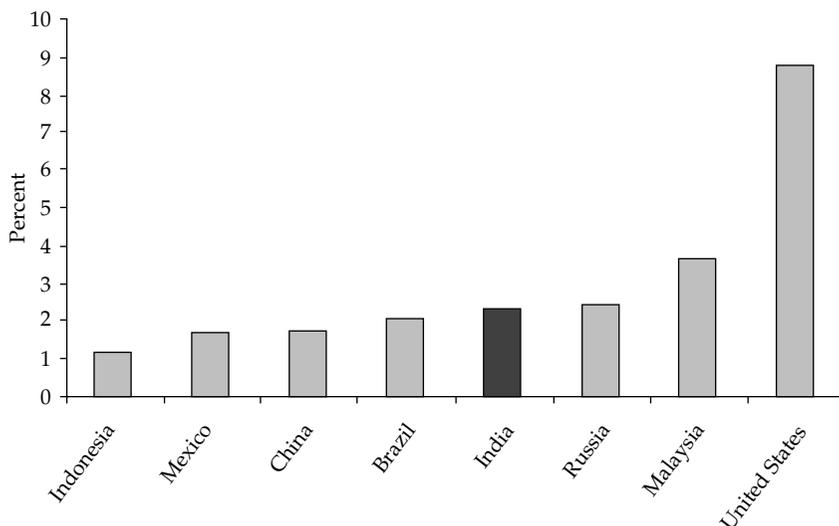
Source: World Bank 2003a.

15,000 in 2002, and including the branches of rural cooperative banks, at 12,800, close to levels in Indonesia and Mexico. Also in terms of the average area served per branch, India compares favorably with other countries, indicating a high degree of physical branch presence, which has been improving over time (Figure 2.1).

India's performance with respect to insurance penetration is also better than countries like Brazil and China. Measured by insurance premium as a percentage of GDP, insurance penetration in India in 2000 was close to 2.5 percent, compared to a little over 1 percent in Indonesia, under 2 percent in China and Mexico, and a little over 2 percent in Brazil (Figure 2.2).

Improvements in rural finance notwithstanding, the supply of formal finance appears to be biased against the rural population. On average, a rural bank branch in India serves almost three times the number of people served by a non-rural branch (Table 2.1). The volume of deposits and credit in rural areas is also much lower than in urban areas. Per capita deposits in rural areas stood at Rs2,150 (US\$47) or around 10 percent of national per capita GDP in 2001, compared to Rs33,780 (US\$740) or around 160 percent of per capita GDP in the same year for urban areas. Credit per person in rural areas stood at Rs900 (US\$20) or around 4 percent of national per capita GDP versus a figure of Rs20,600 (US\$450) for urban areas, which is around 100 percent of national per capita GDP. The number of credit accounts in rural areas relative to the total rural population amounts to only 3.4 percent against a ratio nearly three times higher for urban areas.

Figure 2.2 Insurance Penetration Across Countries in 2000
(premium/GDP)



Source: Insurance Regulatory and Development Authority 2002.

Rural-urban differentials in insurance are even larger than the differentials for credit or savings. While general insurance agencies have a directive to source 5 percent of their gross premium within three years of operations from rural areas (2 percent in the first year), the actual levels for most companies at present are much lower. In terms of premium from rural areas, for FY 2002–03 the share was 8.3 percent reducing to only 1.4 percent on excluding the share of Life Insurance Corporation of India (LIC), thus indicating that most insurance agencies are well below required levels of rural exposure.

Table 2.1 Coverage of Bank Branches

Year	Average population served per bank branch		Average area per branch	
	Overall	Rural	Non-rural	(Sq kms)
1972	40,241	91,151	12,389	232.4
1981	19,137	29,685	8,820	88.7
1991	14,054	17,858	8,700	52.6
2001	15,515	22,841	8,461	47.8
2001*	12,806	NA	NA	39.5

Note: *Including cooperative bank branches.

Sources: RBI, *Basic Statistical Returns* 2002, and *Handbook of Statistics* 2003; NABARD; Census 2001.

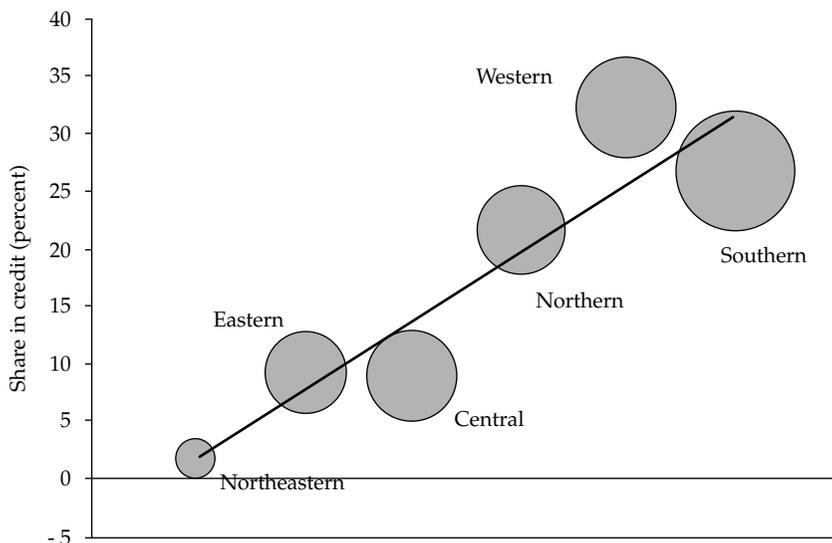
The quality and choice of products and services provided by rural bank branches are generally lower than their urban counterparts. Rural branches are typically not computerized, and do not offer technology banking through ATMs or credit and debit card products. Moreover, while urban bank branches have increasingly started turning into one-stop-shops for all financial services (insurance and mutual funds in addition to banking products), and also provide add-on services in terms of payments of net and phone banking, payment of utility bills, cell phones, etc., rural branches are unable to offer a comparable services/product mix.

Large regional differences exist in the distribution of financial services, both in terms of the volume of transactions and branch density, with clients in India's economically weaker regions having a disproportionately lower level of financial access. The spread of branches appears to be closely associated with regional shares in population: the eastern and central regions have larger shares in population and therefore, despite their low share in income, occupy the second and third positions in terms of share in branches. However, the presence of branches alone does not ensure access to finance; as expected, income is a key determinant to financial access. Regional differences in the volume of financial services (volume of credit and deposits) are largely explained by regional income differentials.² India's lesser developed and low-income eastern, central, and north-eastern regions account for 54 percent of the population and 40.5 percent of total branches, but only 20 percent of outstanding credit and 29 percent of deposits (Table 2.2 and Figures 2.3–2.7).³

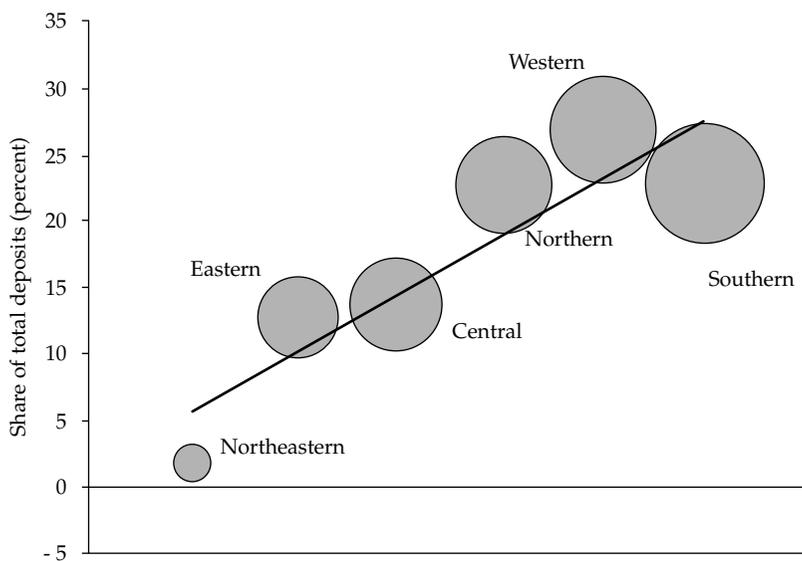
Table 2.2 Regional Differences in Financial Services

<i>Region</i>	<i>Share in all India GDP</i>	<i>Share in population</i>	<i>Regional per capita GDP/national per capita GDP</i>	<i>Share in all India credit</i>	<i>Share in all India deposits</i>	<i>Share in all India bank branches</i>
Northern	18%	13.8%	1.28	21.5%	22.9%	16.1%
Northeastern	3%	3.7%	0.76	1.5%	1.6%	2.5%
Eastern	14%	23.6%	0.58	9.2%	12.9%	17.7%
Central	17%	26.6%	0.64	8.9%	13.6%	20.3%
Western	22%	15.5%	1.39	32.2%	26.4%	15.6%
Southern	28%	16.9%	1.63	26.6%	22.6%	27.4%
Total	100%	100%	1.00	100%	100%	100%

Source: RBI, *Basic Statistical Returns* 2002; RBI, *Handbook of Statistics* 2003; Census 2001.

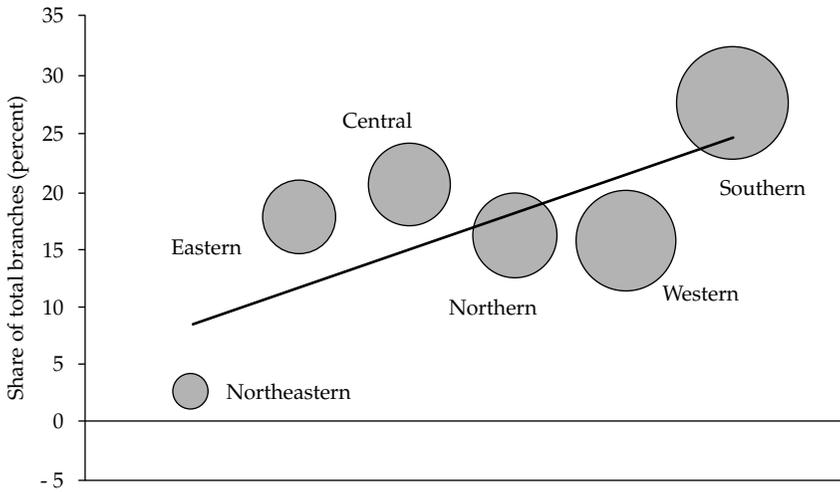
Figure 2.3 Credit Distribution by Regional Income

Source: RBI, *Basic Statistical Returns 2002*, and *Handbook of Statistics 2003*.

Figure 2.4 Deposit Distribution by Regional Income

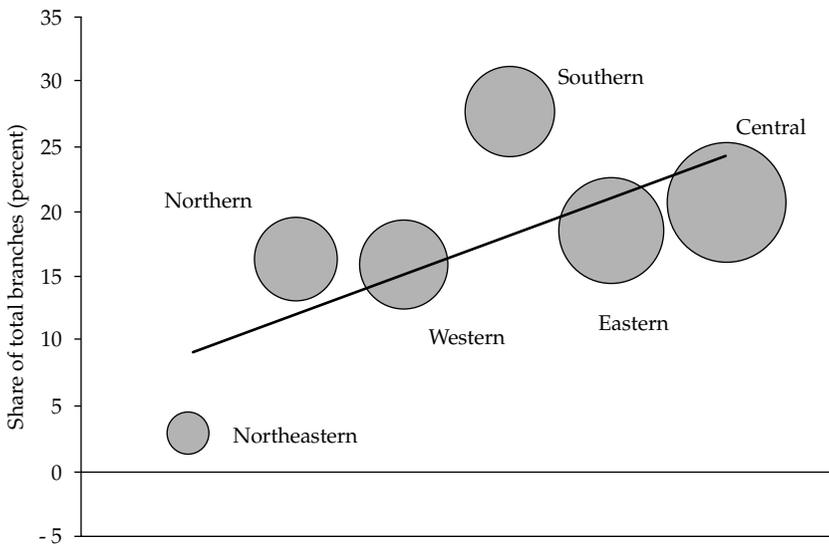
Source: RBI, *Basic Statistical Returns 2002*, and *Handbook of Statistics 2003*.

Figure 2.5 Branch Distribution by Regional Income

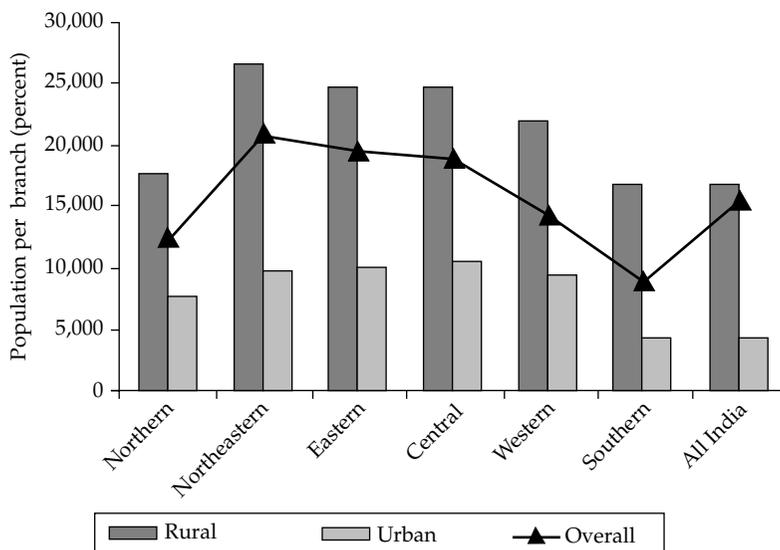


Source: RBI, *Basic Statistical Returns 2002*, and *Handbook of Statistics 2003*.

Figure 2.6 Branch Distribution by Regional Population



Source: RBI, *Basic Statistical Returns 2002*, and *Handbook of Statistics 2003*.

Figure 2.7 Population per Branch Across Regions, 2002

Source: RBI, *Basic Statistical Returns 2002*.

Access to Rural Finance: Evidence from the Demand Side

Developments in India's financial sector, particularly after the late 1960s, resulted in substantial achievements which enhanced access to credit in rural areas. The share of rural credit in total credit increased from 4.6 percent in 1972 to 10.1 percent in 2001; the share of rural deposits in total deposits increased from 8.5 percent in 1972 to almost 15 percent by 2001. The growth of rural banking in absolute terms and relative to GDP has also been significant (Table 2.3).

Table 2.3 Rural Banking: Trends Over Time

Indicator	Year	Rural	Non-rural
Deposits (Rs million)	1972	5,396.9	78,199.6
	2001	1,394,313.6	8,100,019.3
Credit (Rs million)	1972	2,572.7	53,565.4
	2001	544,312.5	4,840,025.4
Deposits to GDP (percent)	1972	1.1	16.0
	2001	6.6	38.5
Credit to GDP (percent)	1972	0.5	10.9
	2001	2.6	23.0

Source: RBI.

Table 2.4 Share of Rural Household Debt by Source of Credit, All India, 1951–91
(percent)

Year	Banks	Cooperatives	Government	Total instnl.	Relative/friends	Money-lenders	Others
1951	1.1	4.6	3.1	8.8	14.4	68.6	8.2
1961	0.3	10.4	6.6	17.3	5.8	60.9	16
1971	2.4	20.1	6.7	29.2	13.8	36.9	20.1
1981	28.6	28.6	4	61.2	9	16.9	12.9
1991	29	18.6	5.7	53.3	6.7	15.7	24.3

Note: Others includes non-institutional sources, other than friends and relatives and money-lenders, e.g. traders, agriculturist money lender, landlord, etc.

Source: All India Rural Credit Survey, RBI; All India Debt and Investment Surveys (AIDIS), NSSO.

Shortly after independence in 1947, the first survey of rural indebtedness (All India Rural Credit Survey) prepared by the RBI documented that moneylenders and other informal lenders met more than 90 percent of rural credit needs. The share of banks in particular was only about 1 percent in total rural household debt. This ratio remained low until 1971, when it was 2.4 percent, although the share of formal sources of credit in rural areas increased steadily to 29 percent due to the rising share of cooperatives. Following bank nationalization, the share of banks in rural household debt increased to about 29 percent in 1981 and 1991 while the share of formal or institutional sources in total debt reached 61.2 percent before declining in 1991. Correspondingly, the share of moneylenders declined steadily over these four decades (Table 2.4).

While no official survey of rural access has been conducted since 1991, the World Bank-NCAER RFAS 2003—this covered 6,000 households in the two states of AP and UP—allows for some analysis of trends between 1991 and 2003. See Appendix 2 for details on the RFAS 2003 methodology and sampling.⁴ Relative to the findings of the AIDIS 1991, the incidence of indebtedness (i.e. proportion of households with debt outstanding to a formal finance institution) had further increased by 2003, indicating greater access and the ability to borrow.⁵ Under the assumption that households “prefer” formal borrowing and were earlier rationed due to inadequate supply of such debt, the increase in formal indebtedness could be viewed as an improvement (Table 2.5).

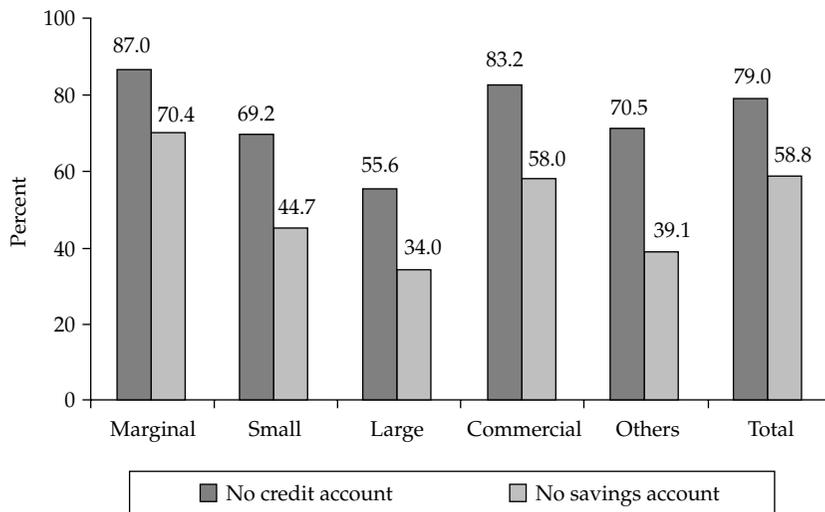
India’s poor households, which are concentrated in rural areas,⁶ continue to have very little access to formal finance. RFAS 2003 indicates that 70 percent of marginal/landless farmers do not have a bank account; 87 percent have no access to credit from a formal

Table 2.5 Summary Comparison of AIDIS 1991 and RFAS 2003

<i>Indicator</i>	<i>All India formal</i>	<i>UP formal</i>	<i>AP formal</i>
Percentage of households indebted			
AIDIS 1991	15.6	12.5	16.5
RFAS 2003		19.4	24.0
Average debt per household			
AIDIS 1991	1221.0	1521.0	1691.6
RFAS 2003		6376.0	4313.0

Source: RBI 1989; National Sample Survey Organization (NSSO), Report No. 420; RFAS 2003.

source (Figure 2.8).⁷ As a result, they are forced to rely on informal finance, mainly from moneylenders who charge exorbitant rates of interest: the RFAS 2003 finds that 48 percent of marginal/landless farmers have borrowed from an informal source at least once in the previous twelve months, at rates averaging 48 percent per year.

Figure 2.8 Low Access to Formal Finance, RFAS 2003

Note: **Marginal** farming households = landholding <1acre; **small** = 1 to 4 acres; **large** farms = >4 acres; **commercial** households = with or without land but with income from non-farm sources exceeding half of total household income; **others** = mixed households with land and non-farm commercial incomes but the latter being less than half of their total household income.

Source: RFAS 2003.

Access to Savings/Deposit Accounts

Over half of all rural households (59 percent) do *not* have an account with a formal financial institution (Table 2.6). What's more, among those with no accounts, 97.5 percent of households report never having applied. Almost two-thirds of households without an account do not perceive the need for deposit account services, while another fifth report not being aware that they could open an account. The biggest reason for not having an account appears to be a perceived "lack of need."

While around 41 percent of rural households have an account with a formal financial institution, wide differences exist between the access of large and small farmers, and between those who had other sources of income, and "pure" farmers. By far the most deprived segment in terms of access to an account are the "marginal" farming households, followed by the "commercial" category (households that rely on non-farm sources for more than half of their income). Over 70 percent of marginal farmers have no bank account (Table 2.6).

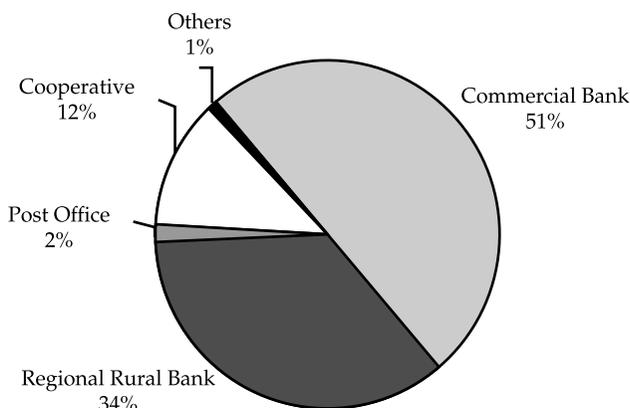
The bulk of rural accounts are in commercial banks, which have one and a half times the number of rural accounts compared to the dedicated RRBs (Figure 2.9). The cooperative sector only has a small fraction of account holders (12 percent). The post office system, despite a very wide network of branches and close proximity to rural clients (refer below to the discussion on transaction costs at the end of Chapter 3), surprisingly accounted for an even smaller percentage of account holders (2 percent), perhaps indicating the latent potential for tapping the large and widespread postal network for provision of deposit services.⁸ While multiple accounts with formal financial institutions are relatively rare, the survey indicates that rural households do not

Table 2.6: Access to Deposit Accounts in Financial Institutions, by Household Category
(percent)

<i>Indicator</i>	<i>Marginal</i>	<i>Small</i>	<i>Large</i>	<i>Commercial</i>	<i>Others</i>	<i>Total</i>
With account	29.6	55.3	66.05	41.96	60.88	41.16
Without account	70.4	44.7	33.95	58.04	39.12	58.84

Note: **Marginal** farming households = landholding <1 acre; **small** = 1 to 4 acres; **large** farms = >4 acres; **commercial** households = with or without land but with income from non-farm sources exceeding half of total household income; **others** = mixed households with land and non-farm commercial incomes but the latter being less than half of their total household income.

Source: RFAS 2003

Figure 2.9 Distribution of Accounts

Source: RFAS 2003.

expect to have all their financial service needs met by just one provider, or by just one type of provider, and that they are used to multiple informal providers.

Households' preference for commercial banks (over other types of formal financial institutions) does not appear to be related to physical distance (the mean distance to RRBs and cooperatives is lower than to commercial banks). In general, frequency of visits to formal financial institutions is low, with the main reason for infrequent visits being the high costs related to travel time/transport. The most important reason for having an account is for safekeeping of monetary assets: over 72 percent of households with an account report safekeeping as the primary use of the account.

Payments Services—Limited Use, High Cash Economy

Even those households which do report having bank accounts appear to have little use for payments and checking services. Moreover, there is limited transactions demand because most transactions are cash-based. Some 48 percent of households in our survey report receiving their incomes in the form of cash and 93 percent report cash at home as the main mode of financing usual household expenses. And even in the case of payment services, such as remittances, cash dominates: 82 percent of households report cash as the main mode of remittance, as opposed to 15 percent who report checks/drafts and 1.7 percent who report postal money orders as modes of remittance.

It follows that a substantial segment (over half) of rural households may have no use for the type of depository or payment services offered by formal financial institutions, which may be explained by: (a) their low levels of financial assets and flows; (b) an environment characterized by the preponderance of cash transactions. Households with accounts tend to use them in a limited way, accessing them with low frequency and with little use of checks (the primary use of deposit accounts is for safekeeping, with little role for payment services). Households without accounts are presumably too poor to have any excess savings to safeguard.

Access to Credit

There is some indication of an increase in “indebtedness” among rural households over the past decade. However, this can also mean increased access to credit, and as such may be a step forward. According to AIDIS 1991, just 16 percent of rural households had a formal loan outstanding. Based on the World Bank RFAS 2003, the corresponding number was 21 percent.

Some 79 percent of rural households do not have access to a formal loan, and once again access is particularly a problem for marginal farmers and commercial households (Table 2.7). Furthermore, some 97 percent of households without a formal loan report not having applied for a loan in the past three years; the main reason reported for not applying is “lack of need,” and the second most important reason is “complicated procedures—an indication, perhaps, of the fact that, based on the experience of others, they know they don’t stand a chance of receiving a loan.

Table 2.7 Access to Credit from Financial Institutions, by Household Category

(percent)

<i>Indicator</i>	<i>Marginal</i>	<i>Small</i>	<i>Large</i>	<i>Commercial</i>	<i>Others</i>	<i>Total</i>
With formal loan						
outstanding	12.97	30.79	44.36	16.78	29.47	21.01
Without formal loan	87.03	69.21	55.64	83.22	70.53	78.99

Note: **Marginal** farming households = landholding <1 acre; **small** = 1 to 4 acres; **large** farms = >4 acres; **commercial** households = with or without land but with income from non-farm sources exceeding half of total household income; **others** = mixed households with land and non-farm commercial incomes but the latter being less than half of their total household income.

Source: RFAS 2003.

Access to formal credit is particularly a problem for meeting unforeseen expenditures—family sources and the local moneylender dominate. Over 90 percent of households report financing unusual expenses from cash at home, while the second most important source of financing such expenses was reportedly informal loans from family, friends, or moneylenders. Newer sources, such as the recently introduced Kisan Credit Cards (KCC), are still statistically insignificant.

Use of bank credit for investments depends on the type of investment—bank loans are most frequently used for land acquisition/improvement, and perhaps machinery and vehicles, while the purchase of livestock (which cannot be collateralized easily) is typically financed from informal sources. About 4 percent to 6 percent of loans from banks and RRBs respectively are used for purposes of working capital.⁹ Among households who have a formal loan outstanding, commercial banks are the main source, at interest rates of 12.5 percent per annum (Figure 2.10).

There is limited evidence of credit rationing for formal credit on the basis of amounts applied for, approved, and received, with commercial banks showing the best record (loan amount received as a percentage of amount applied is 92 percent), followed by RRBs (88 percent) and government schemes (87 percent). However, on the basis of applications rejected, rationing appears to be high.

Figure 2.10 Credit Outstanding by Source

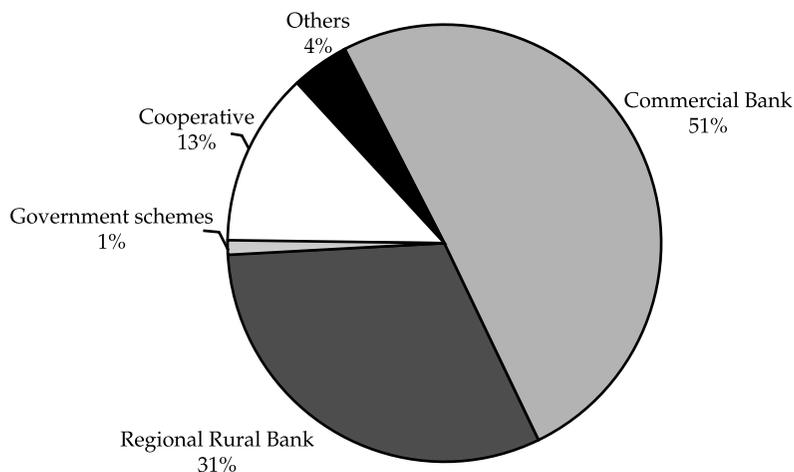


Table 2.8 Aspects of Formal Borrowing and Its Costs

<i>Indicator</i>	<i>Bank</i>	<i>RRB</i>	<i>Coops</i>	<i>Schemes</i>	<i>Others</i>
Interest rate (median) % p.a.	12.5	11	11	14	14
Loan amount received as % of amount applied	91.8	88.2	83.5	86.6	93.9
Percentage of households reporting bribes	26.8	27.0	9.7	27.27	23.21
Bribe as % of amount approved	10.1	18.2	19.9	42.3	8.3
Time taken to process a loan application (weeks)	33	28.5	24	8.9	14.3

Source: RFAS 2003.

Longer processing times for loans, together with bribes, could result in higher effective costs to borrowers and consequent credit rationing. It takes, on average, thirty-three weeks for a loan to be approved by a commercial bank.

On average, some 27 percent (and 48 percent in UP) of sample households who borrowed from an RRB report having to pay a bribe to get the loan (and this figure is 48 percent in the case of UP), a little under 27 percent of households who borrowed from a commercial banks paid a bribe, and 10 percent of households who borrowed from a credit cooperative paid a bribe. The bribe amounts vary from between 10 percent of the loan amount (in the case of banks) to 20 percent (in the case of cooperatives). In all cases, UP's performance is much lower than the average, indicating deeper problems in the integrity and internal controls of formal financial institutions in UP (Table 2.8).

The majority of loans extended by commercial banks, RRBs, and cooperatives are collateralized, with 89 percent of households who borrowed from RRBs, and 87 percent of households who borrowed from commercial banks, reporting that they had to provide collateral. Land remains the predominant form of collateral. The value of collateral required as a proportion of the loan, however, remains relatively low in the case of banks and RRBs, at under 10 percent, but high in the case of government schemes (Table 2.9).

Table 2.9: Collateral

<i>Indicator</i>	<i>Bank</i>	<i>RRB</i>	<i>Coops</i>	<i>Schemes</i>	<i>Others</i>
Collateral required (% of loans)	87.0	89.3	72.9	58.3	83.1
Value of collateral as % of loan	9.1	9.5	11.0	26.8	24.3

Source: RFAS 2003.

Credit is mostly used as stated; however, diversion is more likely in the case of short-term (working capital) loans. It may follow that the same households that report the lack of need for depository/payment services may also comprise a substantial proportion of households *without* repayment capacity for any kind of credit from banks or other formal financial institutions. These households may comprehensively lie outside the ambit of the formal financial sector.

Access to Insurance

Access to insurance remains limited: over 82 percent of households surveyed report not having any insurance, 3 percent report not knowing what insurance is, and 15 percent report having insurance. Life insurance is by far the most predominant insurance product available and the demand for this product appears to far exceed its supply: while 13 percent of households have access to life insurance, some 73 percent report that this would be their preferred insurance product. Demand for crop insurance is also relatively high: while only 0.2 percent of households report having crop insurance, some 18 percent express a preference for this product over other types of insurance (Table 2.10).

The Importance of Informal Finance

Around 44 percent of the households surveyed report having borrowed informally at least once in the previous twelve months; the interest charged on informal loans averages 48 percent per annum. Not surprisingly, informal borrowing is very important for the poorest (marginal and commercial categories), who are the most deprived of formal finance, but it is also important for small farmers (Table 2.11).

The main source of informal borrowing is moneylenders (some 56 percent of households who report having borrowed informally in the past twelve months used moneylenders); microfinance (through SHGs or NGOs) plays a modest role at present (Table 2.12). The strong growth

Table 2.10 Distribution of Insurance, by Percentage of Households

<i>Type of insurance</i>	<i>Existing</i>	<i>Preference</i>
Life	13.2	72.86
Health	0.37	5.48
Fire	0.03	0.26
Theft	1.01	0.74
Crop	0.2	18.98
Other	0.13	1.68

Source: RFAS 2003.

Table 2.11 Incidence and Size of Informal Borrowing, by Household Category

<i>Indicator</i>	<i>Marginal</i>	<i>Small</i>	<i>Large</i>	<i>Commercial</i>	<i>Others</i>	<i>Total</i>
Borrowed in past 12 months (% households)	48.24	39.84	35.9	39.07	42.82	44.06
Loans currently outstanding (% households)	44.58	34.79	31.45	36.13	39.9	40.07
Average debt/borrower (Rs.)	9152	12523	18572	13075	17885	11136
Average debt/household (Rs.)	4332	4834	6373	5007	7495	4790

Source: RFAS 2003.

of microfinance in AP in recent years is reflected in the survey findings—28 percent of households in AP are SHG members, compared to 8 percent for UP; in terms of credit from sources other than the formal sector institutions, 11.5 percent of AP households borrowed from SHGs over the last year, compared to 3 percent for UP.

The largest uses of informal loans are for meeting “family emergencies” and “social expenditures” arising from events such as births, marriages, and deaths (Table 2.13). Flexible repayment of informal loans, their shorter duration (as compared to formal loans), and the frequency with which they can be accessed appear to be significant features that make such loans more attractive to the poor.

Some perceived advantages of informal loans over formal loans are as follows: (a) contractual flexibility, flexibility in repayment terms/schedules; (b) lower discrepancies between loan amounts sought and received; (c) less reliance on collateral: only 16.5 percent of households report providing collateral against the loan.

Table 2.12 Source of Last Informal Loan, by Percentage of Households

SHG/NGOs	2.89
Landlord	7.76
Moneylender	55.87
Friends/Relatives	31.36
Others	2.12

Source: RFAS 2003.

Table 2.13 Uses of Last Informal Loan, by Percentage of Households

Invest in land, building	13.33
Purchase in machinery/equipment	2.36
Purchase livestock	5.83
Purchase inputs	3.92
Family emergency	28.76
Illness of livestock animals	1.44
Social expenditure	18.54
Routine household expenditures	11.61
Repay other loans/debt	1.12
Others	13.08

Source: RFAS 2003.

But among those who report providing collateral for informal loans, the overwhelming collateral cited is “self labor”—evidence of interlinked credit contracts spanning credit and labor. Almost all cases reporting self labor as collateral are landless/marginal farmers. They are too poor to offer any assets as collateral, and hence most vulnerable to harsh contracts linking their labor to loans.

Notes

1. The total number of bank branches (rural and urban) is 66,500. The bulk of these branches are of public sector commercial banks.

2. The only outlier is the western region, which has the highest volume of financial services though only the second highest contribution to GDP and relatively low share in total branches. This indicates more a developed financial institutions network in this region, which has traditionally been the hub of business and trading activity in India.

3. The size of the circle in Figures 2.5 to 2.8 represents the share (or size) of GDP of the region, whereas in Figure 2.10 the size of the circle represents the regional share in the country's population.

4. The survey covers 6,000 households in two states, Andhra Pradesh, AP (known to be a leader in the provision of rural finance) and Uttar Pradesh, UP (a laggard). While the original intention was to contrast the findings of AP with UP, in the event, with a few exceptions, such as access to microfinance, the findings from the two states converged on most indicators—possibly because access to finance in rural AP has been negatively affected by increased poverty resulting from years of consecutive drought. Therefore, the results were aggregated and presented as averages. A background paper on the Survey findings presents the separate results for AP and UP.

5. Higher incidence of debt can be interpreted in different ways. It could signify greater access and ability to borrow but it could also denote greater distress leading to higher demand for debt.

6. Of the estimated 260 million Indians (or 26 percent of the population) who live in poverty, some 193 million (or 74 percent) live in rural areas. Another 180 million rural people are “near poor.” A majority of these households are marginal or small farmers, and the poorest households are landless.

7. The RFAS 2003 covers 6,000 rural households. The last such survey, the AIDIS, was undertaken in 1991.

8. The low share of the post office system in RFAS 2003, could however, be attributed partly to a lack of association amongst respondents of post offices as “financial service providers,” which is the terminology that the survey used.

9. Loans for working capital are relatively few, since the sample consists primarily of cultivating households with only a small fraction of small and microenterprises. Even within the latter, the majority are engaged in trading and other service activities.

What Constrains Access to Finance for India's Rural Poor?

A combination of factors—affecting both banks and their clients—contribute to reducing the supply of finance for the poor, driving up costs and hampering access.

Why Banks Are Reluctant to Lend to Rural Clients

From the perspective of rural banks, serving the rural poor is a high-risk, high-cost proposition.

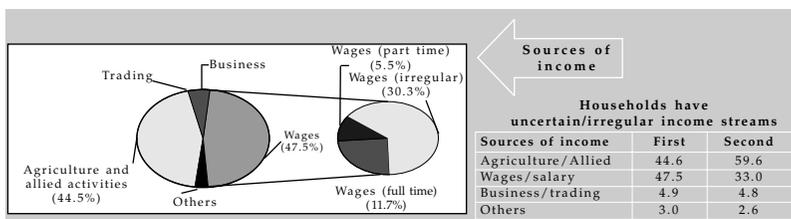
Uncertainty and Default Risk

Lending to some segments, especially to the very poor, is surrounded by uncertainty about repayment. The rural poor tend to have irregular/volatile income streams and expenditure patterns (Box 3.1). They also tend to be highly exposed to systemic risks—such as crop failures or a fall in commodity prices—and therefore may face real difficulties servicing loans. So, banks have legitimate concerns while dealing with the rural poor and tend to perceive such loans as risky.

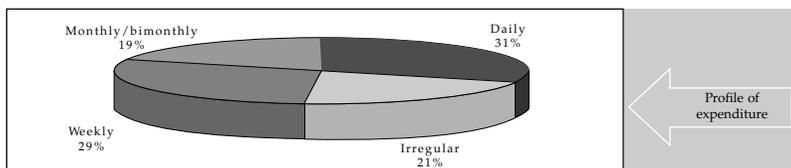
One of the main sources of risk faced by rural financiers in their dealings with prospective rural clients is a fall in commodity prices below production-cost levels, and this risk becomes all the more significant in the absence of efficient price discovery and credible national commodity-prices. Market-based tools to insure against commodity price volatility (e.g. futures and options) already exist and are widely used in high-income countries, but they are not prevalent in India. Why? First, the minimum size of contracts traded on organized exchanges far exceeds the annual value of production of individual small- and medium-sized producers. Second, small producers, as well as many market intermediaries, lack knowledge of such market-based

Box 3.1 Income and Expenditure Patterns of India's Rural Poor

Rural households have irregular and volatile income streams. Irregular wage labor and the sale of agricultural products are the two main sources of income for rural households. The poorest rural households (landless and marginal farmers) are particularly dependent on irregular wage employment: about two-thirds of marginal farming households surveyed rely on wage labor as their primary source of income (in contrast, only 9 percent of large farming households rely on wage labor for primary income and none of these households rely on irregular wage labor), while 29 percent rely on selling farm produce. Rural households also have irregular expenditure patterns. Over half the households surveyed report the bulk of their expenditures as being either daily or irregular. The typical expenditure profile of rural households surveyed is that of small, daily or



irregular expenses, incurred all through the month. Furthermore, some 99 percent of households report having incurred at least one unusual expen-



diture over the past six months, with the most frequent reasons for the latest unusual expenditure reported as medical or social purposes (related to births, marriages, etc.)

Source: RFAS 2003.

price insurance instruments and an understanding of how to use them. Third, the sellers of such instruments, generally international trading firms, are often unwilling to engage with a new and unfamiliar customer base of small-scale producers, characterized by high transaction costs, credit issues, and performance risk.

Lack of Credit Information

Problems caused by uncertainty are exacerbated by the lack of reliable information on the past credit history of borrowers. There are a number of sources of credit information in India, but none of these focuses on small rural borrowers. Credit information on such borrowers is difficult to obtain because the majority of the rural poor rely on moneylenders and other informal lenders, and it is not in the interest of such lenders to pass on a borrower's good credit repayment record to other providers of finance. The unavailability of credit information has reduced the volume of lending in India; because performance risk measures are unavailable, the current risk-management practice of banks is to control loan amounts. Better credit information could directly increase the amount of financing available to rural borrowers.

The Tyranny of Collateral

One way in which a financier can reduce the risk of losing his money to uncertainty is by requiring collateral—valuable assets that the financier can keep in case the borrower defaults. Collateral reduces the problem of uncertainty, since the lender can theoretically recover some, or all, of his loan in the event of non-payment. It also reduces information asymmetries—it is often easier to value physical assets than to value character. Moreover, the borrower will find it costly to put valuable collateral if she intends to decamp with the proceeds of the loan, because she will lose the collateral. Thus, the collateral requirement can also help weed out rogues from honest borrowers, leaving only those bona fide applicants who fully intend to repay the loan. The potential loss of her collateral also makes the borrower think twice before investing in risky ventures. Collateral's twin effects, of keeping rogues from applying for loans and reducing the borrower's incentive to take undue risks, make it a valuable device in encouraging lending. The potential financier sees lower risk in collateralized lending, while the borrower benefits from the consequent lower interest rate the financier charges.

One problem in all this, of course, is that the rural poor typically do not have collateral, so they lose out once again. Most of India's rural poor, for instance, have no fixed collateral or only small plots of land that most often cannot be mortgaged. Identification of alternative collateral is costly and cumbersome. So, only those with assets can borrow! Another problem is that collateral can only provide security to lenders in an environment where households have proper titles to their assets, and where the legal system makes it relatively straightforward for lenders to enforce contracts and repossess collateral; the legal system

in India makes collateral registration, and its repossession by the financier, a long and arduous process.

Transaction Costs

The transaction costs of rural lending in India are high, mainly due to small loan sizes, high frequency of transactions, large geographical spread, the heterogeneity of borrowers, and widespread illiteracy. For private-sector banks, the lack of a rural branch network is an additional problem. Given the extent of rural poverty in India, the value of financial services required tends to be small. The small size of rural loans, resulting in a high due-diligence cost per loan, exacerbated by the heterogeneity of borrowers, make it difficult for formal financiers to cover costs. The geographical spread of customers in rural India, and their widespread illiteracy, further drive up administrative costs after the loan is granted. Borrower supervision costs are high, as are compliance costs for customers. Financiers thus have to achieve a delicate trade-off between minimizing the loan default rate and minimizing administrative/collection costs. For example, microfinanciers are able to offset the high maintenance costs of their loans with low default rates, whereas low supervision costs over rural loans are generally associated with high default rates. Furthermore, limited or no price discovery (only local-price benchmarks, no national grades and prices for agricultural commodities, very limited dissemination of prices—brokers have information monopoly) makes credit-risk assessment of rural borrowers more difficult, and credit information on such borrowers is non-existent.

Weak Legal Framework and Enforcement Issues

Government has not been able to develop and enforce a legal and regulatory framework conducive to rural finance, so that contract design, contract renegotiation, and contract enforcement remain weak, making it even more difficult for financiers to provide borrowers with the right incentives for repayment. While the enactment of the securitization and asset reconstruction law (2002) has helped improve the legal framework for recovering bad loans by facilitating out-of-court settlements on non-performing loans and instituting alternative methods of dispute resolution between creditors and debtors, the law does not cover small loans. Land titling and registration systems are weak, and the use and transfer of land is difficult under the current framework. Many states do not permit leasing of land, while in some states the lease creates long-term irrevocable rights for the lessee to the

disadvantage of the lessor. All this encourages unrecorded and unofficial year-to-year oral leases, which prevent the lessor from getting a good lease value, and the lessee from putting the land to best use.

Government Policy

Government policy has created a financial climate not conducive to lending in general, and to rural banking in particular. High fiscal deficits, the government's domination of rural finance institutions, persisting weaknesses in the regulatory and legal framework, and a set of policies toward the sector that have been designed to gain political patronage have resulted in the distortion of risk/return signals and inefficiencies in the delivery of rural finance services. An outcome of these realities has been a dilution of the credit-creating role of rural banks.

First, high fiscal deficits have led to government's appropriation of a large share of financial savings for itself, preempting credit to the private sector. At the same time, government's deficit financing policies have provided bankers with opportunities to deploy bank resources in Government securities, which are not only safe but also have yielded high profits for banks in a declining interest rate environment.¹ While it is true that statutory preemptions—Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR)—imposed on banks have been gradually reduced in recent years, they remain high by international standards.² That banks prefer to deploy resources in government securities rather than lending to the private sector is evident from the data: at end March 2004, investments in Government securities accounted for 41.3 percent of net demand and time liabilities of commercial banks, much higher than the mandated SLR of 25 percent. Bank credit to the private sector is thus modest, at best, and the bulk of it takes the form of relatively safe, mortgage-backed lending, other types of consumer loans to high-income individuals, and loans to top-end corporates.

Directed lending norms that require commercial banks to allocate 40 percent of their lending to the "priority sector" (including agriculture) have not generated the intended results, as most banks get around this requirement by subscribing to other eligible instruments, including bonds issued by NABARD and SIDBI.³

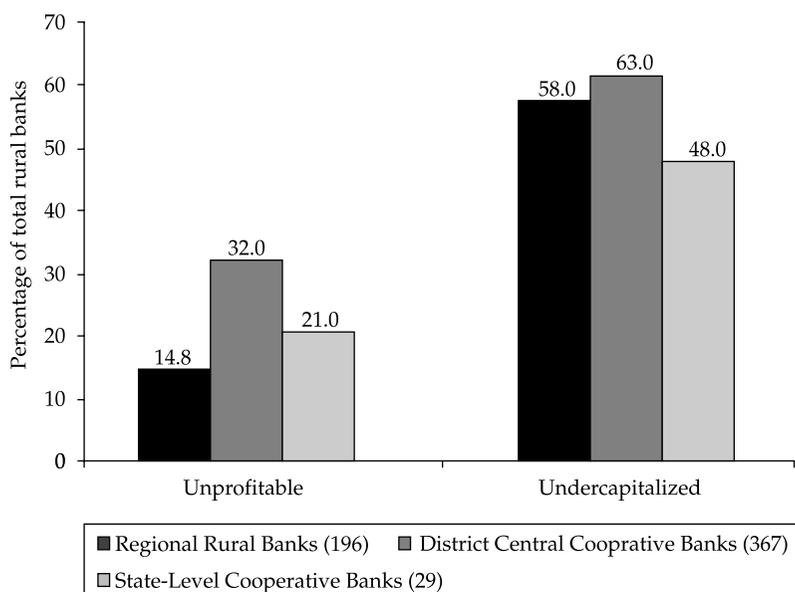
Second, interest rate policies reduce the attractiveness of lending to small, rural clients. Banks' borrowing costs are kept high by "floors" on short-term deposit rates,⁴ while government policy dictates that lending rates on small loans (Rs200,000 or below) in the rural sector be "capped" at the prime lending rate (PLR), which banks are free to set. These restrictions impose an "implicit tax" on banks: Assuming a differential of 200 and 400 basis points between PLR and market interest rates, the loss in the income of rural banks from lower lending rates is estimated at \$550 million to \$1.1 billion; this implies that the net profit

of the banking sector may be as much as 15 percent to 30 percent lower than what it could have been. Naturally, this reduces the attractiveness of rural lending, particularly to smaller clients, with the unintended consequence of “rationing” credit to poor rural households.⁵ Thus, the access of poor borrowers to formal loans is effectively cut off, and they end up borrowing at much higher rates from the informal sector.

Third, RBI's credit planning policy, whereby each rural branch is given a set of defined villages (typically 15 to 20 villages) within which it can operate, (“service area” approach) has restricted competition in rural banking. Further, bank branches are unable to optimize branch infrastructure, and the entry of new, non-service-area bank branches, including private-sector bank branches, in the “service area” is impeded since this requires a “no-objection certificate” from the service-area branch, which is often not easily forthcoming.⁶

Fourth, government's domination of/interference in rural banks (Box 3.2) has further distorted bankers' incentives and generated deep inefficiencies in rural finance institutions. Of the 196 RRBs in the country, some 15 percent were loss-making and 58 percent were estimated to be undercapitalized for the financial year ending March 2002 (Figures 3.1–3.2).⁷ RRBs' operating costs relative to average assets are high at about 3 percent, compared to less than 2 percent for leading

Figure 3.1 Status of Rural Banks in India



Note: Figures in parentheses in key represent total numbers of rural banks.

Source: RBI reports and NABARD statistics.

commercial banks. And staff productivity is low—business/staff is Rs9 million, which is less than half that of the larger public-sector banks and between a sixth to a tenth that of the levels in leading private-sector banks. Asset quality is poor, with non-performing loans (NPLs) at 16.5 percent of total loans (Figure 3.3). And while the profitability of these banks, reported at 1.2 percent of average assets, appears good, the earnings forecast for these banks is particularly susceptible to market and interest-rate risks. (See Appendix 3 for a review of India's retail rural finance institutions; Appendix 4 provides an overview of the main apex-level institutions involved in rural finance.)

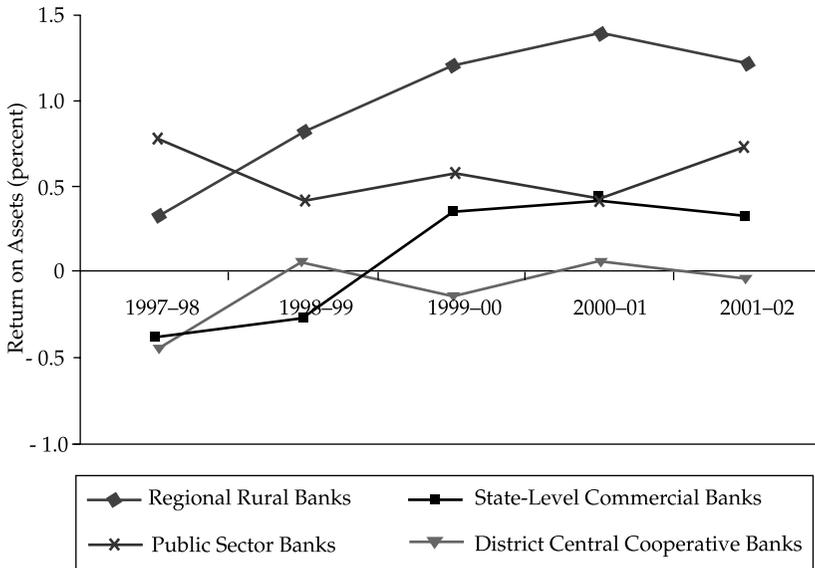
Box 3.2 Rural Banking—Government's Omnipresence

Public sector (i.e., majority government-owned) banks account for about 73 percent of commercial bank assets in India. Some 95 percent of commercial bank branches in rural areas are of public sector banks. And these account for 93 percent of total rural credit outstanding. The boards of public sector banks have majority representation from the government/RBI. However, with banking reforms and increasing number of public sector banks being listed in the capital markets (twelve of the larger public sector banks are listed), governance standards have improved significantly in conformity with the requirements of the capital markets regulator, Securities and Exchange Board of India (SEBI).

RRBs are also majority government owned. The ownership structure of these banks is as follows: GoI owns 50 percent of the capital of an RRB, the "sponsoring" public sector commercial bank owns 35 percent (except for two RRBs that have a private sector bank "sponsoring" the 35 percent commercial bank stake), and the state government accounts for the remaining 15 percent of the capital. Four of nine board members are government appointees; in addition RBI and NABARD have one nominee each and the sponsor banks (which are mostly public sector banks) have three representatives.

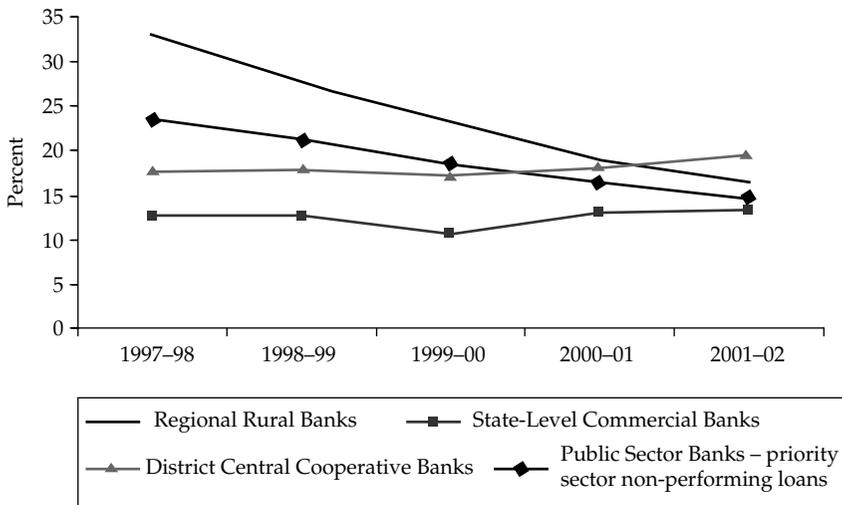
Rural cooperatives—for the state-level cooperative banks (StCBs) government ownership is around 10 percent, while it is around 15 percent for the district central cooperative banks (DCCBs); nonetheless, through the powers assigned to the Registrar of Cooperatives, control of the state government tends to be pervasive. State governments, through the Registrar of Cooperatives, have considerable powers and can supersede elected boards. As of end-March 2001, the elected boards of 75 of the 367 district cooperative banks had been superseded. The state government also retains the rights to appoint senior management—the CEOs of StCBs are often government officials (rather than professionals) and those for the DCCBs are either government or StCB officials.

Figure 3.2 RFIs: Profitability (Return on Assets)



Source: RRB/Coop., NABARD (RoAvg Assets); RBI: PSB data.

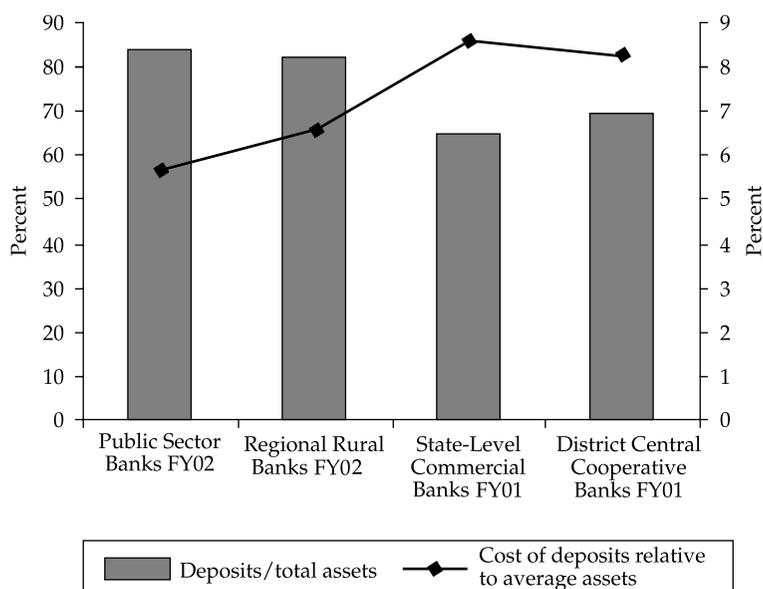
Figure 3.3 Credit Outstanding by Source



Source: RBI reports and NABARD statistics.

The rural cooperative banking sector is in an even deeper state of distress.⁸ Some 32 percent of DCCBs and 22 percent of the StCBs are unprofitable and over two-thirds of the DCCBs and just under half of the StCBs are undercapitalized (Appendix 3 provides more details; Figures 3.1⁹ and 3.2¹⁰). Asset quality is quite poor (Figure 3.3¹¹) with the StCBs reporting an NPL ratio of 13.4 percent, and the DCCBs reporting an NPL ratio of close to 20 percent. While the DCCBs have a reasonable operating cost ratio of a little over 2 percent, staff productivity at Rs12 million is weak (the StCBs' performance on these indicators is better but is really not comparable to retail banks since the former are structured as apex institutions). Further, the weighted average cost of funds for the cooperative banks—8.3 percent and 8.6 percent for StCBs and DCCBs, respectively (Figure 3.4)—is very high and leads to compressed financial margins. Overall, the combined effects of moral suasion from the government to keep lending interest rates low, poor asset quality, low ability to enforce recoveries, and high cost of funds have led to the present tenuous position of the balance sheets of rural cooperative banks.

Figure 3.4 Deposits of Rural Finance Institutions—Costs and Significance



Source: RBI reports and NABARD statistics.

Government ownership/control also means that RRBs and rural cooperatives have to operate in line with government diktat and are not able to take decisions independently. Some examples of this include: forced rescheduling of agricultural loans and “coerced” lending to unviable government-owned/controlled commodity cooperatives (especially, the sugar and textile cooperative sectors); state governments’ use of cooperative banks as channels for the delivery of various government schemes; debt or interest waiver schemes; and elected boards being superseded.¹² Rural debt or interest-waiver schemes announced by state governments also create adverse incentives for farmers, who do not service the debt in a timely manner with the expectation that, at some point, a waiver will be granted. All these factors hinder the proper management and operation of rural banks and reduce the attractiveness of rural lending for these banks.

Fifth, problems of regulatory architecture, particularly the unclear and/or overlapping mandates of various regulatory agencies responsible for the regulation and supervision of rural banks, cooperatives, etc., has led to inefficiencies. While the RBI is the overall regulator of the rural finance sector, supervision of RRBs and rural cooperative banks is delegated to NABARD. But the state governments, through the Registrar of Cooperative Societies, also play a large role in the regulation of cooperative banks. State governments retain significant powers in rural cooperative banks, controlling all matters relating to registration, membership, election, financial assistance, loaning powers, business operations, loan recovery, and audit. This leads to cross-directives, inadequate levels of control by the central bank with respect to banking functions, and consequent weakening of the overall quality of regulation of cooperative banks. Appendixes 5a and 5b present international experience on the regulatory and supervisory architecture for rural banking, which provide some useful hints for India.

While regulatory standards in India have been progressively tightened for commercial banks and brought in line with best practices, this has not been the case for RRBs and rural cooperative banks. Prudential regulation standards related to capital adequacy have not been applied to RRBs and cooperative banks (there are no minimum capital adequacy ratios prescribed). Also, asset classification standards, and, related to this, regulation on income recognition and provisioning, need to be upgraded to match those for commercial banks. Given the weak regulatory standards, it is not surprising that eligibility norms from NABARD for availing refinance assistance remain lenient—cooperative banks that have eroded deposits less than 50 percent are eligible for refinance, as are RRBs that have a deposit erosion level of less than 30 percent.

NABARD, in its role as the apex development bank for rural finance has provided subsidized refinancing to commercial banks, RRBs, and cooperative banks. This could have led to some crowding out of market-based credit to rural areas and, importantly, reduced the incentive and pressure on rural banks to improve financial performance and move toward increased reliance on market-based funding. However, declining interest rates in the economy, meant that the incremental cost of funds for rural banks declined faster than for NABARD. The result of this is that NABARD's typical refinancing rates of between 6.25 and 6.75 percent per year are no longer subsidized and demand for refinancing has declined, especially from the more efficient rural banks.

Furthermore, poor enforcement of regulation, and the use of regulatory forbearance have undermined market discipline, allowing weak banks to continue operations. In the absence of prompt corrective action mechanisms, undercapitalized banks have been allowed to continue business. Appendix 6 provides lessons from international experience on dealing with troubled banks.

Why Do Small Rural Borrowers Find Rural Banks Unattractive?

From the perspective of small rural borrowers (the users), rural banks are unattractive for several reasons.

Absence of Flexible Products and Services

Rural banks do not provide flexible products and services to meet the income and expenditure patterns of small rural borrowers. As noted above, small rural borrowers have irregular/volatile income streams and expenditure needs, and therefore prefer to borrow frequently and repay in small installments. But most banks do not offer such products. Also, while small rural borrowers seek savings and lending products, they also seek insurance (life, health, crop), which banks do not generally offer.

Transaction Costs

The transaction costs of dealing with formal banks are high. In part, high transaction costs stem from distance to the nearest financial institutions. According to the RFAS 2003, the median distance to the nearest financial institution ranges from 2 kms (post office branches) to 5 kms (commercial banks, cooperative banks); the median time taken to travel to the nearest commercial bank, cooperative or RRB is thirty minutes (post offices are available at closer proximity). Procedures for opening an account or seeking a loan are cumbersome and

Table 3.1 Aspects of Formal Borrowing and Its Costs

<i>Indicator</i>	<i>Bank</i>	<i>RRB</i>	<i>Coops</i>	<i>Schemes</i>	<i>Others</i>
Interest rate (median) % p.a.	12.5	11	11	14	14
Loan amount received as % of amount applied	91.8	88.2	83.5	86.6	93.9
Percentage of households reporting bribes	26.8	27.0	9.7	27.27	23.21
Bribe as % of amount approved	10.1	18.2	19.9	42.3	8.3
Time taken to process a loan application (weeks)	33	28.5	24	8.9	14.3

Source: RFAS 2003.

costly (with high rejection rates). Government policy dictates that rural borrowers currently need to acquire a “no dues certificate” from every other lender in the village (as defined by local lenders) to the effect that they do not have a loan outstanding.

Furthermore, clients have to pay hefty bribes (ranging from 10 percent to 20 percent of the loan amount) to access loans, so that the ultimate cost to borrowers is very high (despite interest “caps”). On average, some 27 percent (and 48 percent in UP) of sample households in our survey who borrowed from an RRB report having to pay a bribe to get the loan, a little under 27 percent of households who borrowed from commercial banks paid a bribe, and 10 percent of households who borrowed from a credit cooperative paid a bribe. The bribe amounts appear to vary from anywhere between 10 percent of the loan amount (in the case of banks) to 20 percent (in the case of cooperatives). Moreover, longer processing times for loans, together with bribes, could result in higher effective costs to borrowers and consequent credit rationing. It takes, on average, thirty-three weeks for a loan to be approved by a commercial bank (Table 3.1).¹³

Collateral

A third factor that makes formal banks unattractive for rural borrowers is that banks demand collateral, which poor rural borrowers lack. Indeed, the majority of loans extended by commercial banks, RRBs, and cooperatives are collateralized, with 89 percent of households who borrowed from RRBs, and 87 percent of households who borrowed from commercial banks, reporting that they had to provide collateral (RFAS 2003). Land remains the predominant form of collateral. But since this collateral is seldom executed, it is just another cost, with little benefit in practice.

Notes

1. Indian bank managers have found that they can in fact make large profits from the trading of government securities (G-Secs) in an environment of declining interest rates (and bankers in India do not appear to have a full appreciation of the interest rate risk involved in such investment allocation decisions, viewing G-Secs as risk-free assets). Income on sale of investments has been rising steadily over the past five years, accounting for around 33 percent of operating profits in FY 2002–3. Simultaneously the share in total income of interest income on advances has fallen to levels below 40 percent. RBI, *Trend and Progress of Banking in India*, 2003–4.

2. SLR has declined from 38.5 percent in 1991 to 25 percent at present. Similarly the CRR has declined from 15 percent to 4.5 percent over the same period. However, the overall statutory pre-emption levels are higher than levels in other countries—South Africa (5 percent), Malaysia (15 percent), Singapore (18 percent), Sri Lanka (20 percent), USA (none).

3. More recently, and in order to encourage banks to lend directly to priority sectors, investments made by banks on or after April 1, 2005 in special bonds issued by certain institutions have been made ineligible for classification under priority-sector lending. But taking the example of agriculture, even when banks do lend directly to priority sectors, the benefits tend to be captured by the larger and more prosperous farmers, while marginal and small farmers continue to be excluded and dependent on moneylenders.

4. A floor/fixed rate of 3.5 percent is set for savings deposits.

5. Such difficulties can imply that sometimes, entire communities, and particularly the rural poor, may face limits on credit. Such theories of “credit rationing” have been discussed for example by Stiglitz and Weiss (1981), Williamson (1986). Besley (1994) and Murdoch (1999) have discussed this specifically in the case of communities such as small farmers and microfinance providers.

6. However, it may be noted that the RBI has recently decided to dispense with some of the more restrictive provisions of the service area approach, which is definitely a step in the right direction.

7. By regulation, capital adequacy standards have not been extended to RRBs or cooperative banks. However, even by the lenient requirement of Rs100,000 as minimum capital for cooperative banks, as the RBI Annual Policy Statement 2004 reports, at end-March 2004, as many as 143 out of 366 DCCBs and 7 out of 30 StCBs had not complied with even this requirement. Similarly 61 out of 196 RRBs had a networth lower than Rs10 million (March 2002).

8. Commercial banks’ rural operations are not analyzed separately as these are subsumed in their overall operations. However, as some indicators on asset quality indicate, their overall performance disaggregated for the rural operations may not be too different from that of RRBs and cooperative banks.

9. Given the politically sensitive nature of rural credit, with falling interest rates in recent years, announcements by successive governments, typically suggesting interest rate caps on agricultural credit, have not been uncommon. The last major announcement was made around a year ago and suggested a cap at 9 percent on farm loans less than Rs50,000 (around US\$1,200). While these

announcements do not get mandated by RBI policy, such moral suasion provides the wrong signals for rural banks and increases the chances that could lead to rural banks being forced to adopt such pricing—if they do so, the suggested rates would probably leave an inadequate, or even negative financial margin.

10. While many of the public sector commercial banks are now listed companies raising capital from the public and having independent and professional boards and are relatively free of the adverse impacts of government ownership, this is not the case with the RRBs and rural cooperatives.

11. For commercial banks, a proxy for rural asset quality has been taken as the NPL ratio on the priority sector advances of public sector banks; the public sector banks account for more than 90 percent of the outstanding advances in rural areas of commercial banks.

12. Most significantly, the Agriculture and Rural Debt Relief Scheme of 1989–90, but several other subsequent schemes, including, the *kharif* interest waiver in 2002–03.

13. High transaction costs of dealing with formal banks translate into a low frequency of transactions. According to the RFAS 2003, more than 60 percent of households with bank accounts report accessing their accounts at a frequency of less than once a month (62.3 percent of households with accounts in banks access their accounts less than once a month, while the same percentage among households with accounts in RRBs is 70.8).

Recent Efforts in India to Improve Rural Access to Finance: The Role of Formal–Informal Linkages and New Products

In light of the inefficiencies that characterize India's rural finance markets and the relative lack of success of formal rural finance institutions in delivering finance to the poor, NGOs, financial institutions, and government have made efforts, in partnership, to develop new financial delivery approaches. These approaches—or “microfinance” programs—have been designed to overcome some of the risks and costs associated with formal financing, and also to overcome the tyranny of collateral. They involve providing thrift, credit, and other financial services and products of very small amounts to the poor, with the aim of raising income levels and improving living standards.¹ They attempt to combine the safety and reliability of formal finance with the convenience and flexibility typically associated with informal finance. While some of these programs have been more successful than others, their limited outreach, scalability, and financial sustainability remain matters of concern.

SHG-Bank Linkage Approach: Linking Commercial Banks to Grassroots Borrowers

One approach to microfinance that has gained prominence in recent years is the Self-Help Group (SHG)–Bank linkage program, pioneered by a few NGOs such as MYRADA in Karnataka, and Professional Assistance for Development Action (PRADAN) in Rajasthan (and later in Tamil Nadu and Jharkhand), with strong support from NABARD, which has been instrumental in promoting this growth.² SHG–Bank linkage involves organizing the poor, usually 15 to 20 women, into self-help groups or SHGs, and inculcating in the group the habit of saving. The group is linked to a bank (usually the rural branch of a commercial bank, but also RRBs, cooperative banks, etc.), and the saved and borrowed funds are rotated through lending within the group. The SHGs thus save, borrow, and repay collectively. The lenders (banks) are often refinanced by NABARD at slightly subsidized rates, al-

though, in recent years, high recovery rates have encouraged some banks to lend to SHGs without NABARD refinancing. The SHGs are not formally registered.

The funds may be distributed either to one or more members of the group—who are personally responsible for repayment (generally, the group borrows at about 12 percent per annum)—or spent collectively by the group. The group is free to decide the interest rate charged to its members, but typically a member borrows from the group at about 24 percent per annum.³ The groups make their internal credit decisions, decide on the repayment period, and so on. Money is used for both consumption (health, marriages, etc.) and, over time, for individual and group investment products. After a loan is fully repaid, the group may borrow again, often a larger amount. Banks typically provide a loan equivalent to four times the group's savings but, as the group matures, and based on the group's track record, banks are ready to lend more; some of the RRBs visited reported making loans amounting to ten times the SHG's savings.

The success of the SHG-Bank linkage model depends critically on the tasks of promoting, nurturing, strengthening, and monitoring SHGs—tasks that are performed by Self-Help Promoting Institutions (SHPIs). Traditionally, grassroots-level NGOs have performed the tasks of promoting and monitoring SHGs. More recently, rural branches of commercial banks, cooperative banks, RRBs, NBFCs, and then link have all begun to play the role of SHPIs. But, recent evaluation studies reveal the comparatively better performance of SHGs promoted by NGOs (as opposed to the other SHPIs).

SHGs require a large amount of pre- and post-lending monitoring. Most lenders use "facilitators" (who may or may not earn a commission and/or bonus for group repayment and recruiting new groups). Facilitators may be local business people, health workers, government employees, teachers, etc. Before a loan is granted, the group must prove its ability to save over time, learn bookkeeping skills, and show their commitment to continue as a cohesive group. It often takes over a year before an established group can borrow. The facilitator is responsible for introducing the group to the bank, implementing savings patterns, and teaching basic accounting practices. (Although the facilitator may not accept money on behalf of the lender). After the loan is made, the facilitator attends monthly meetings (attendance is a good indicator of the continued success of the group) and enforces repayment.

Over the last ten years, SHG-Bank linkage has become the dominant mode of microfinance in India, and has been successful in encouraging significant savings and high repayment rates. The number of SHGs linked to banks has increased from just 500 in the early 1990s to over 700,000 by 2003 and has now crossed the 1 million mark. SHG-Bank linkage today reaches some 12 million women through

Table 4.1 Growth in Volumes of SHG–Bank Linkage

<i>By March 31</i>	<i>Number of SHGs linked to banks, cumulative nos.</i>	<i>Cumulative bank loans (Rs million)</i>
1999	32,995	571
2000	114,775	1,930
2001	263,825	4,809
2002	461,478	10,263
2003	717,306	20,487
2004	1,079,091	39,042

Source: NABARD.

deposit services, cumulatively providing over Rs39 billion (US\$906 million) as credit between 1992 and March 2004 (Table 4.1).

There appears to be widespread enthusiasm in India about the benefits of the SHG–Bank linkage approach, notably because: (a) it helps reduce transaction costs for the banks (their costs related to credit evaluation, loan monitoring, and decisions are reduced, since banks can rely on the SHPI to identify and promote groups and pass on loan-appropriation decisions to the group) as well as the borrowers (as the group itself provides constant watch and follow-up); (b) by using “peer pressure,” the approach increases the likelihood that individual group members will repay as well as that the group as a whole will not default (other group members effectively proxy for collateral); (c) loan default rates are very low, on average less than 1 percent; (d) it empowers rural women.

How Effective Has SHG–Bank Linkage Been in Targeting the Poor?

Although data available to us cannot answer this question directly, we can look at some indirect indicators on the relationship between SHGs and the poor using results of the RFAS 2003 for the states of AP and UP.⁴ First, the majority of the beneficiaries of SHG Bank Linkage are from among the poorer groups. RFAS 2003 indicates that nearly 54 percent of SHG members are from the poorest groups—landless and marginal farmers. However, significant differences exist across states. While 73 percent of SHG members in UP are from the poorest households—landless and marginal farmers—the corresponding proportion in AP is lower (43 percent). In AP though, almost a quarter of the poorest households belong to SHGs, but the proportion of households from richer categories that belong to SHGs is much higher (Table 4.2).

To explore further the success with which SHGs are targeting the poorest, we used RFAS 2003 data to examine the attributes of households that are SHG members. Our results indicate that SHG–Bank linkage is certainly quite effective in targeting poorer households (particularly in the two quintiles above the poorest households). The relationship between the

Table 4.2 SHG Membership by Type of Household

<i>Indicator</i>	<i>Marginal</i>	<i>Small</i>	<i>Medium</i>	<i>Large</i>	<i>Others</i>	<i>Total</i>
Andhra Pradesh						
SHG member (% households)	25.3	34.3	31.1	29	29.6	28.2
% of SHG members	43.3	14	11.4	11.4	19.9	100
Uttar Pradesh						
SHG member (% households)	10.3	5.4	5.3	4.1	6.7	8.2
% of SHG members	72.8	8.8	7.4	4.4	6.7	100

Note: **Marginal** = landholding <1 acre; **small** = 1–2 acres; **medium** = 2–4 acres; **large** = > 4 acres; **others** includes households with or without land but involved in commercial activities.

Source: RFAS 2003

poorest households and SHG membership is positive too, though not statistically significant. This only further underlines the challenges ahead in expanding the outreach of microfinance to the poorest (Box 4.1).

Box 4.1 How Successfully Has SHG–Bank Linkage Targeted the Poor?

RFAS 2003 data allow for the first time a statistical analysis of certain aspects of SHGs in India, which we have used to look at the reach of the SHG–Bank linkage model into the poorest households, who are predominantly those excluded from formal finance. We can explore further the success with which SHGs are targeting the poorest by examining the attributes of households that are SHG members, using data from AP. We model this in a “probit” framework, using as explanatory variables household’s relative income rank in terms of income quintiles (*poorest* are the bottom quintile, *qint 2* the next, and so on) and the number of SHGs available in the village (*shgnum*). Other explanatory variables available in the survey include the number of other households in the village that are related to the household (*relatvs*), since this could indicate the household’s access to informal finance.⁵ We also include as an explanatory variable whether or not it has an account with a formal financial institution (*bankac*), as a crude indicator for access to the household of formal finance. Finally, we also include a regional dummy for villages in coastal districts (*coastal*).

The estimated coefficients are reported in terms of the incremental impact on the probability of the household being an SHG member due to a small change in the explanatory variable. Thus, an increase in the number of SHGs in the village by 1 increases the probability of a household being in an SHG by 0.2 percent. Similarly, households in the second quintile have a 7.8 percent higher likelihood of being in SHGs compared to households in the richest quintile. Although the overall fit

Box continues on the following page .

Table 4.3 Probit Estimates of Likelihood of a Household's Being a Member of an SHG

<i>Variable</i>	<i>dF/dx</i>	<i>s.e.</i>	<i>Z</i>
Shgnum	0.002	0.001	2.27
Coastal	-0.045	0.017	-2.58
Poorest	0.039	0.030	1.32
Quint2	0.072	0.028	2.67
Quint3	0.102	0.034	3.13
Quint4	0.039	0.028	1.41
Bankac	-0.042	0.019	-2.23
relatvs	-0.007	0.002	-3.46
N=	2910	Pseudo R2 =	0.011
			1

of the regression is low, suggesting other variables (not available in the survey data) are also important, the coefficients of all variables included are statistically significant at 5 percent level of significance, except the poorest and quint 4. The three variables with statistically insignificant coefficients are poorest, quint 4, and expnd. This suggests that households in the two quintiles above the poorest households are more likely to be SHG members, while the poorest and those in the top two income quintiles are less likely to be in SHGs. Note though that the coefficient for poorest quintile is positive even if insignificant, and that the second quintile may still include households that are quite poor, even if not among the poorest (Table 4.3).

We can also use the RFAS 2003 data to answer a related question using villages and SHGs in AP, where SHGs were found in all villages: *Are poorer villages more likely to have a larger number of SHGs?* What explains inter-village variations in SHGs? One approach is to use the standard Poisson model for count data to analyze the number of SHGs in a given village. Specifically, let y_i denote the number of SHGs in village i and let y_i be distributed as a Poisson with mean μ_i , where $\mu_i = \exp(X_i \beta)$ and X_i is a vector of explanatory variables. However, a preliminary look at the data shows an overdispersion in number of SHGs relative to the Poisson, with the variance substantially higher than the mean. To account for the overdispersion, we use a negative binomial distribution that can be viewed as modifying the equation above to $\mu_i = \exp(X_i \beta + u_i)$, where u_i denotes some omitted variable(s) such that e^{u_i} follows a Gamma distribution with mean 1 and variance a . Larger values of a imply greater dispersion in the data.

Results of the negative binomial regression are provided below, using a number of explanatory variables related to poverty in the village—village average per capita income (avpcy), inequality in land holdings (giniland), and connectivity of the village measured by distance to nearest railway station and nearest metal road (rail & road, respectively).

Table 4.4 Negative Binomial Regression Estimates for SHGs in a Village, Andhra Pradesh

<i>Variable</i>	<i>Coef.</i>	<i>z</i>	<i>P>z</i>
Constant	5.96	3.98	0
Size	0.002	6.15	0
Illiterate	-0.04	-2.25	0.024
Primary	-0.07	-3.88	0
Avpcy	0.00	0.07	0.943
Giniland	-1.47	-0.94	0.348
NGO	-0.33	-1.60	0.11
Rail	0.01	1.43	0.154
Road	-0.06	-1.95	0.052
RRB	-0.03	-2.01	0.045
Coop	0.02	2.29	0.022
Alpha	0.22	0.06	3.49
N	59	Pseudo R ²	0.12

Likelihood ratio test of $\alpha=0$: $\chi^2(1) = 50.19$ Prob> $\chi^2 = 0.0000$. Robust estimates used for standard errors.

Poorer villages will have lower per capita incomes, while greater inequality for any given per capita income would indicate more poor people in the village. Villages farther away from access to rail and road, and hence markets, may be relatively poorer. The percentage of illiterate households in the village is also likely to be correlated with village poverty. In addition, we also include an index of educational attainment for villagers who are not illiterate in the form of a percentage with primary education. Other variables included are total village size in terms of number of households (size) and whether or not NGOs are active in the village (NGO). Finally, since rural institutions like RRBs and cooperatives can also assist with SHG formation, we also included their distance from the village (RRB and coop, respectively) (Table 4.4).

The results suggest the absence of a strong relationship between village-level indicators of poverty and number of SHGs. The size of the village is significant, indicating that the larger the village, the greater the number of SHGs found. Higher rates of illiteracy, presumed correlated to poorer villages, are associated with fewer SHGs in the village.⁶ Similarly, the negative sign for (distance to) metal road implies that villages in the interior, away from good roads, have fewer SHGs. Noticeably, neither village per capita income nor inequality within the village is significant, again underlining the weak link between poverty and the presence of SHGs. The coefficient for NGOs is negative but insignificant, implying no significant relationship between the presence of NGOs and the number of SHGs in the village.

Source: World Bank (2004); Basu and Srivastava (2005).

Impact on Vulnerability of Poor Households

Recent analyses indicate that access to loans under SHG–Bank linkage has contributed to the reduction in vulnerability of poor households.⁷ This reduction in vulnerability takes the form of:

- (1) *Improvement in asset position:* The program significantly improved the asset position (comprising livestock and consumer durables) of sample households. The average increase in assets was about 72 percent, from Rs6,843 to Rs11,793 in real terms (in one to three years). About 59 percent of households saw assets increase after groups were formed. Before the groups were formed, one in three households had no assets; after the groups were formed, that changed to one in six;
- (2) *Increase in savings:* The average savings per member more than tripled, from Rs460 before the group to Rs1,444 after;
- (3) *Changes in borrowing patterns and activities financed:* Average borrowing per household increased from Rs4,282 to Rs8,341. A shift was observed in the activities of SHGs, with a lower share of consumption and cultivation loans after the groups formed and a larger share of allied agricultural activities and small businesses;
- (4) *Increase in employment:* Employment per household went from an average of 318 days a year to 375 days. The proportion of employment generated through non-farm and off-farm activities increased;
- (5) *Increase in consumption expenditure:* consumption expenditure per household per month increased from Rs799 to Rs993. Per capita consumption increased from Rs197 per month to Rs249;
- (6) *Impact on income:* The average net income per household increased from Rs20,177 to Rs26,889. About 43 percent of the incremental income generated was from nonfarm activities;
- (7) *Impact on poverty:* About 234 households were below the poverty line before groups were formed, compared with 122 after;
- (8) *Social impact:* 89 percent of members reported that, as a result of the group's activities, they could meet officials from the government or from banks, while about 77 percent had never had that opportunity earlier. Changes were also reported regarding attitudes toward women.

Further work should be conducted on the performance of the program from the point of view of the financial institutions that provide the linkage. This would provide lessons on the costs and benefits associated with the SHG model, including which entity in the linkage covers what costs, what financial benefits banks get from the SHG program, potential adjustments and innovations banks have made to the SHG model, and incentives that motivate them to be involved in the

program and within microfinance in general. It would be particularly important to analyze private banks to draw on their experiences and assess their potential to play a larger role in microfinance in India.

Some Lessons from SHG–Bank Linkage

In large part, the success of SHG–Bank linkage may be attributable to the fact that it is well aligned with Indian history and circumstances, and capitalizes on the country's vast network of rural bank branches. The idea of local savings-and-loan clubs enjoying access to formal financial services by becoming corporate customers of banks is a good one and is practised in a small way in many countries. A well-run club can keep its reserves at the bank and take bulk loans which it can on-lend to its members at a premium, covering its costs and rewarding its savers in the process. In India, this practice seems particularly appropriate on two counts: first, the country has active NGOs that have been zealous in their efforts toward group formation; NGOs view SHGs as having many benefits (such as women's empowerment) beyond microfinance. Second, and perhaps even more important, SHG–Bank linkage seems particularly suited to India because the model capitalizes on the country's vast (and unique) network of rural banks that are otherwise unable to reach out to the poor. However, as the analysis above indicates, the SHG–Bank linkage program faces important challenges in expanding outreach and reaching the poorest quintiles of rural households.

Equally important, the success of SHG–Bank linkage underscores just how important a role skillfull leadership, good policy, and a conducive legal and regulatory framework can play. Indeed, the role of government in establishing the necessary policy and legal framework, and the leadership role assumed by NABARD in championing the movement, cannot be underestimated. Government recognized the potential of SHG banking very early on in the movement's history; NABARD was given the task of leading this effort and it took to the task with exemplary diligence. It involved NGOs, commercial banks, RRBs, and even cooperative banks in forming SHGs and then linking those up with nearby bank branches. Legal obstacles were removed and the RBI issued guidelines in 1992 to experiment with a pilot of 500 SHGs to link with banks. This pilot program as well the work of a number of NGOs was reviewed by a Working Group on Bank Lending to the Poor through NGOs and SHGs (1995) and detailed guidelines were drawn to encourage banks to use this method.

To encourage banks to lend to SHGs, NABARD made available subsidized refinancing to banks for their lending to SHGs, so that the groups could take bulk loans from banks that could be on-lent to group

members, who could use them to take up or expand microbusinesses. (More recently, such subsidized refinancing to banks has been phased out, as banks have begun to see SHG lending as a profitable and commercially viable business.) Further inducements for banks came in the form of allowing banks to count SHG lending toward their legal obligation to direct a fraction of their loans to the poor (“priority sector-lending” obligations). It seemed an ideal way to realize an old Indian dream—to make the vast network of rural banks key suppliers of loans to the poor.

*Key Concerns: Limited Outreach and Scale of Lending
and Issues in Financial Sustainability*

However, outreach remains limited in terms of the number of households served by SHG-Bank linkage, and the scale has been modest in terms of the volume of credit outstanding and average size of loans. The program has reached only about 12 million women directly (in a country where 460 million people live on less than \$1/day) in terms of savings accounts and an estimated 2 million–4 million women directly in terms of outstanding credit accounts. The outstandings of SHG-Bank linkage in March 2003 were around Rs10 billion, thus catering to 2.2 percent to 6.6 percent of the estimated demand and amounting to around 1.9 percent of rural outstanding bank credit. Loan amounts remain small. In 2003, SHG member households got an average of Rs1,766 as credit, after being in a group and meeting monthly for anywhere between 9 and 24 months. In 2002–03 only 22 percent of SHGs existing at the beginning of the year received loans during the course of the year—even assuming a two-year loan period, this means that more than half of the existing SHGs did not receive a loan during the year. And the program remains concentrated in South India, with nearly 75 percent of funds flowing to SHGs in the four southern states. The following factors could explain the constraints to scaling up the SHG-Bank linkage program:

A key constraint is the lack of capacity to promote and maintain groups to ensure quality. In the early phase of the SHG movement, the tasks of promoting, nurturing, and strengthening groups,⁸ were performed by grassroots NGOs. However, in NABARD's zeal to link SHGs to banks, and as SHG-Bank linkage has caught the attention of politicians who view the program as an easy vote-winner, quantitative targets on the number of groups to be promoted each year are overriding concerns as against the quality of groups promoted. Many of the recent groups have been promoted by institutions that either lack the required skills and local knowledge, or that are driven by short-term monetary incentives. Many groups

have come together on an ad hoc basis, only because they want a loan. Inadequate attention to group quality could threaten the longer-term credibility and viability of the entire program. Indeed, recent evidence suggests that the quality of groups is already beginning to suffer. A recent survey by the Mahila Abhviniddhi Society, Andhra Pradesh (APMAS) in 2002 indicated that only 17 percent of all groups were of adequate quality for bank linkage, and this in a state considered the leader in the movement. Thus, lack of good-quality SHG promoters, alongside the increasing use of non-traditional promoters of SHGs, affects the quality of group formation by such entities. While scale objectives may be attained in the short term through using non-traditional SHPIs, long-term sustainability and quality remain issues to be tackled.

A second problem relates to the cost of group formation, and the time taken. Promotion of good-quality groups requires an investment of both time and money. Someone has to incur the cost of promoting groups (organizing meetings, training the members). The estimate of this cost is controversial, with NABARD claiming it is as low as Rs1000 per group and NGOs saying it takes as much Rs12,000. The Ministry of Rural Development of the Government of India has established a norm of Rs10,000 per group, which experts claim is realistic. Thus, reaching NABARD's target of forming an additional one million groups by 2008 would require an estimated Rs10 billion. Where these funds will be sourced from remains unclear. Moreover, even after a group has been promoted, continuous efforts are needed to monitor it and strengthen its internal capacity to undertake administrative tasks (accounting, meeting minutes, correspondence, and negotiations with bankers) and commercial activities (business start-ups, marketing, and re-investment). Efforts are also needed to ensure the group remains financially sustainable and has the ability to weather personal losses (accidents, sickness, death) and natural disasters. Leading NGOs engaged in this activity indicate that it takes a minimum of three years of nurturing before a group is ready to be linked to a bank.

Third, issues concerning the model's financial sustainability in the face of pressures on banks to lend to SHGs at subsidized interest rates could constrain the further growth of SHG-Bank linkage. Banks have been lending to SHGs at interest rates of between 12 percent and 12.5 percent. Recently, two state-owned banks, State Bank of India and Andhra Bank, have announced their intention to lend at 9 percent per annum, viewing SHG lending as a highly profitable business. Recent studies, however, indicate that the all-inclusive costs of lending to SHGs are in fact much higher than what state-owned banks seem to think, and could range anywhere between 15 percent (which is what private banks like ICICI Bank charge when they lend to SHGs) and 28 percent. In a

study of five RRB branches, Sinha 2003 shows that the all-inclusive costs of lending to SHGs (taking into account the relatively high transaction costs of dealing with SHGs as well the costs of group formation, which banks are increasing beginning to bear) would translate into interest rates of anywhere between 22 percent and 28 percent per year, and in one case, where the RRB was located in a low density forested district, the costs translated into interest rates as high as 48 percent per year (M-CRIL 2003). The SHG portfolio is a small part of total bank lending, the portfolio quality is good, and it may be possible to cross-subsidize this. But unless banks charge interest rates to recover costs, the model's financial viability and longer-term sustainability may be jeopardized.

Microfinance Institutions

A second approach to microfinance involves delivery of finance to the poor through the creation of specialized microfinance institutions (MFIs). This effort has been led by the SIDBI Foundation for Micro-Credit (SFMC) and other apex lending institutions, including the RMK and FWWB. Much of the credit for the growth of the sector goes to these pioneering institutions. SFMC, as the largest player, led a number of innovations, including mainstreaming the microfinance sector, facilitating links to commercial banks and lenders, promoting better practices amongst MFIs through its capacity building program, and pioneering support to rating initiatives and new instruments (including the recently launched transformation loan/quasi-equity product). As a result of such initiatives the MFI sector has grown at a fast rate over the last six years or so. Some of these MFIs are based on the Grameen model. Others promote and establish financial links with SHGs. The MFIs offer some of the features of the informal sector, such as flexible products and customer-friendly practices—but at a higher interest rate than the formal sector—while bringing in some features of formal institutions—such as documented loan contracts, detailed books of accounts, MIS, staff, and some degree of supervision by a regulatory authority.⁹

Over the past decade, the number of MFIs in India has grown. However, with a few exceptions, most of these are very region-specific, small in size—the largest being SHARE Microfin Ltd (with a market share of about 16 percent), followed by Spandana (market share of 9 percent), and their collective outreach has been limited. In March 2004 the MFIs sector as a whole had outstandings of Rs5 billion (US\$116 million) reaching less than 2 million people.

One estimate indicates that the average loans disbursed by the top ten MFIs amounted to just Rs160 million per MFI. Another estimate, based on

sixty-nine rated MFIs (which are among India's top hundred MFIs), shows that these MFIs had about 6,500 borrowers and Rs23 million in loans outstanding per MFI (M-CRIL, 2004). In comparison, MFIs in Bangladesh are reported to reach more than 60 percent of the poor in the country, with the larger programs—such as Grameen Bank, BRAC, Proshika and ASA—all reaching well over 1 million clients each. Grameen Bank's loan portfolio alone exceeds that of the entire microfinance sector in India by a factor of two, whereas BRAC's and ASA's portfolios are more than one and a half times that of all MFIs in India.

In addition to the relatively small scale of their operations, Indian MFIs tend to be limited in their scope. For regulatory reasons, only a handful of MFIs, such as Vivekananda Seva Kendra O Sishu Uddyan or VSSU (West Bengal) offer savings as a service. Apart from promoting mutual savings among groups (SHG or Grameen type), a few NGO MFIs offer savings services by taking deposits from their members. Others have had to use Mutual Benefit Trusts or Mutually Aided Cooperative Societies (MACS). Only the SEWA Bank, Ahmedabad, and the BASIX Local Area Bank KBS LAB (in three districts of AP and Karnataka) offer savings as RBI regulated entities.

What Has Constrained the Outreach and Scale of MFIs?

The limited outreach and scale of Indian MFIs, relative to the MFI giants in Indonesia and Bangladesh, reflects, at least in part, the absence of an enabling policy, legal, and regulatory framework. MFIs suffer from the fact that their regulatory oversight is fragmented across many government agencies. MFIs are not allowed to mobilize deposits (even from their own members) unless they convert themselves into an NBFC. And even as NBFCs, an "investment grade" rating from corporate rating agencies is required for mobilizing deposits. This is difficult for most MFI-NBFCs. Based on past examples, on account of the typically geographically concentrated and non-collateralized portfolios that MFIs have, rating agencies, in almost all cases, have not assigned the required credit rating. The minimum start-up capital requirement for registering as an NBFC (Rs20 million or US\$465,000) is typically beyond the reach of most MFIs. Similarly, the minimum capital requirements for insurance companies (Rs1 billion, or US\$23 million) are high. MFIs have problems raising equity: NGOs are not allowed to invest in MFI equity because of the charitable status of NGOs under Sections 11 and 12 of the Indian Income Tax Act. Regulation on foreign direct investment (FDI) in MFIs dictates rather high minimum levels; foreign equity must be a minimum of 500,000 for FDI upto 51 percent, US\$5 million for FDI between 51 and 75 percent, and US\$50 million for FDI of 75 to 100 percent. (See Appendix 7.)

Second, the cost of funds for Indian MFIs is relatively high, and, unlike in Bangladesh and a number of other countries, the Indian MFI sector has not benefited from grants/subsidized funding. Unlike in, say, Bangladesh, where Palli Karma-Sahayak Foundation (PKSF) lends to MFIs at 4 to 6 percent per year (less than half the market interest rate), Indian MFIs, right from inception, tend to raise debt (from SIDBI, FWWB, or commercial banks) at market rates (between 11 and 13.5 percent per year). While, in many ways, this is a more sustainable way to grow, in practice the high cost of funds, combined with problems in accessing equity, has meant that achieving profitability and growth has been more difficult for Indian MFIs than their counterparts in countries like Bangladesh.

Third, the Indian MFI sector suffers from capacity and skills constraints, and inadequate support systems. As microfinance is a specialized activity, and given that many MFIs have evolved from NGOs that have otherwise been focusing on grant-based activities, staff tend to have stronger inclination toward social development issues and tend to possess limited skills in finance, accounting, and business management. Thus, sensitization to issues like internal controls. The importance of credit discipline amongst groups/members, MIS, financial control and management, financial analysis, business planning, systems development, new product design, and so on tend to be of relatively low quality. MFIs need considerable technical assistance to scale up skills in these aspects.

Fourth, most MFIs in India lend to SHGs. This means that MFIs in India are constrained by many of the factors that have held back the outreach and scale of SHG-Bank linkage. In particular, capacity, time, and cost issues related to group formation have posed constraints.

The “Service Provider” Model of Microfinance Piloted by Private Banks

In January 2000 the RBI allowed banks to lend to MFIs and treat this as part of their priority-sector lending. Since then, a number of banks have used this opportunity to lend to MFIs, mainly NGOs, and all banks now offer lines of credit to MFIs in addition to term loans. This enables MFIs to draw down the loan at the pace they build their portfolio, thereby reducing the effective interest payment. Banks appear to have had a positive experience with lending to MFIs, where transaction costs for banks are lower as compared to lending to SHGs, and the repayment rates are 98 percent and above. Encouraged by early results, the new private-sector banks, most notably ICICI Bank, but also UTI Bank and HDFC Bank, are actively seeking exposure in the microfinance sector. While their current exposure to

microfinance is too small to make a difference to their overall portfolio—even to their priority-sector lending portfolio—these new banks are pursuing new and innovative approaches to microfinance as a potential business, not merely as a social or priority-sector lending obligation.

The various approaches to microfinance launched in recent years by ICICI Bank to reach rural borrowers are noteworthy. One approach involves linking ICICI Bank's network of about 100 rural branches to SHGs; through this approach, ICICI Bank funds about 6,000 groups. To overcome the constraints faced by the lack of ICICI Bank's rural branch network, the bank uses local "promoters" to help organize groups. The interest rate on loans under this approach are about 18 percent and promoters are paid a salary that depends on recovery rates, size of loans, and so on.

Another approach piloted in areas where ICICI Bank does not have a physical presence involves the use of NGOs or MFIs, traders, or local brokers (who are close to the farmer by the nature of their business), as intermediaries/"service providers" for loans to small and marginal farmers.¹⁰ The tasks of loan appraisal, processing, management, and collection, are delegated to the NGO/MFI, but the loans are always on the books of the bank (ICICI Bank funds the borrower *directly* and the loan does not pass through the NGO/MFIs). ICICI Bank provides an initial loan to the NGO/MFI to develop SHGs, but then requires that the NGO/MFI repay the loan in a few years and become a "viable unit" through charging service fees to the groups directly. In general, ICICI Bank charges the group 12 percent, plus the service provider charges 6 percent, equalling to 18 percent. Another recent initiative taken by some private-sector banks and insurance agencies to overcome the lack of rural branch presence has been the use, for a fee, of the vast postal branch office network as a means to provide financial services. This includes channeling of insurance products and mutual funds and the use of postal branch office space for setting up automated teller machines (ATMs).

ICICI Bank, as well as other banks such as Oriental Bank of Commerce, are also experimenting with an approach now termed the "integrated agricultural service provider," or IASP, approach. One version of this approach that could perhaps be replicated on a wider basis is the ICICI Bank Farmer Service Center operating model (Mahindra Shubhlabh model). Under this model, ICICI has identified an IASP (Shubhlabh), that has a good relationship with the farmer and provides genuine and timely information through extension services. ICICI Bank enters into a tripartite agreement with the IASP and the output buyer. ICICI Bank provides credit to the farmers on the recommendation of the IASP, the farmer pledges his produce to the

output buyer at a market-based price, the IASP provides inputs to the farmer. Loan processing, disbursement, and collection are effectively done by the IASP, while the credit decision remains nominally with ICICI Bank. At the end of the season, the farmer supplies the crop to the output buyer and the output buyer deducts the loan amount from the sale proceeds and remits the loan to ICICI Bank in full settlement of the loan amount. The IASP receives a service fee for the loan processing and supervision services (1.5 percent on recovered loans). The model creates a symbiotic relationship between the input supplier, financier, and trader. This reduces transaction costs and the risk exposure of all parties and, therefore, presents a relatively low-cost way of serving farmers. It helps improve information collection, reduces credit risk, and increases access to rural financing. However, deepening these relationships to the marginal farmers, scaling up the pilots, and replicating them remain major challenges.

Other variations on this model include ICICI's trader farmer financing model (Rallis-HLL) in Haryana's Basmati-growing area, where Rallis, as an IASP, provides comprehensive field support with fortnightly checks and ensures pest control; and ICICI's farmer financing coupled with insurance model, being piloted in Tamil Nadu's cotton-growing area (Appachi), offers tailor-made insurance packages and bulk storage capacity to farmers in order to avoid crop contamination.

Whenever possible, the lender likes to avoid paying the farmer directly. A model being used by ICICI Bank is to pay the input supplier directly and pre-arrange with the trader to pre-pay the lender before paying the borrower. The borrower contracts to sell his crops at a market-based price—since, if a contract price was used and the market price was higher, the farmer would not deliver and default (and sell at the higher rate).

The Kisan Credit Card

A recent approach to providing credit to the agriculture sector, including small farmers, is the Kisan Credit Card (KCC), offered by commercial banks, RRBs, and cooperative banks. Since their introduction in 1998–99, some 31.6 million KCCs had been issued by March 31, 2003. Though these are not truly credit cards, KCCs present a number of advantages to borrowers and lenders. Borrowers appear to have found this scheme quite useful because of the ease with which they can access credit and renew loans on a yearly basis, once the initial screening has been done, the reduction in number of visits required to branches, the choice/freedom of purchase of inputs and operation of accounts at the designated branches. KCCs have substantially reduced the paperwork and delays associated with renewal of crop loans.

Branch staff also appear to have found the scheme helpful as it has reduced transaction costs. On the lines of KCC, banks have launched the Laghu Udhami Credit Cards for small entrepreneurs.

However, one concern is the uneven growth in the distribution of the KCC scheme (Box 4.2). For instance, in our sample of households from AP and UP, only 6 percent of households report having a KCC (RFAS 2003), and access to a KCC appears to be higher for the larger farmers: while some 20 percent of the large farmers report having a KCC, the corresponding figure for marginal farmers is just 2 percent. The reasons for this appear to include the following: (a) instructions from controlling offices sometimes reduce the flexibility of branch staff; (b) some farmers have been unable to avail of the facility due to lack of title to the land that they till; (c) many farmers possess land under oral lease arrangements, which are not recognized; (d) some farmers have not yet availed of the scheme because they are unaware of its benefits.

Box 4.2 Kisan Credit Cards: Making Inroads

In Teek village near Kurukshetra town in the agriculturally prosperous state of Haryana, more than 70 percent of the villagers had a KCC. Relative to all other avenues of institutional finance—primary agricultural cooperatives, banks (including RRBs), and land development banks—the KCC was revealed in discussions to be the most preferred channel of short-term finance (more so than informal finance from commission agents/*adhtias*, and shopkeepers, which were ranked second and third, respectively, and credit from cooperatives, ranked last). Users of KCCs reported that KCCs provided easy access to cash credit lines of fixed amounts based on land ownership (Rs10,000 per acre, subject to an upper limit of Rs100,000) and were free of the demands of officials who, otherwise, could get as much as 10 percent of the loan as pre-sanction bribes. Bankers too reported good repayment performance and low transaction costs in processing these loans.

The situation in Barabanki district of UP, however, was quite different. In Ghadhiya, a village of 230 households, only two people had managed to acquire KCCs, despite many more applications being made. Their relatively low level of physical connectivity and their location on the fringes of two administrative blocks, which make them a bureaucratic no-man's zone, partly explain the reason for the low access to services by formal institutions here.

The illustrations serve to highlight that while nationwide growth figures have been impressive, there is a long way to go before the full potential of KCCs is utilized.

The success of the KCC, and other similar facilities that could be introduced in the future, would seem to depend critically on the following factors: (a) extending the facility to rural non-farm activities; (b) efforts to update land records in a timely manner; (c) a relaxation by the RBI in the rules so as to accommodate oral lessees and sharecroppers; (d) greater flexibility to branch managers to be innovative in the use of the KCC facility to meet the totality of credit requirements of farm households; (e) greater flexibility to cardholders to make deposits and withdrawals; (f) uniformity in service-charge interest rates among various banks; (g) a reduction in documentation charges; and (h) efforts to better publicize the scheme.¹¹

Recent Innovations in Micro- and Weather Insurance

Micro-life and Accident Insurance

In a short period of three years since India's insurance sector was opened up to private investment, there have been a number of interesting innovations to provide insurance services to the rural poor. The poor most often cannot afford traditional insurance products that are linked with earnings. Some MFIs and banks are considering new, micro-insurance products designed specifically for rural and poor borrowers that they could cross-sell to small borrowers. SEWA Ahmedabad is by a long way the leader in developing and offering insurance products to its customers. SEWA provides insurance services managed through its Vimo SEWA affiliate, which works as a nodal agency for the LIC and a number of general insurance companies. Vimo SEWA is perhaps the nation's largest MFI insurer, covering over 100,000 women for life as well as risks related to houses and assets used in earning their livelihoods. It also offers health-insurance covering maternity. ICICI Bank has also facilitated a life-insurance trust self-funded by SHGs and pays out in the case of death of the participant or her spouse.

Weather Insurance

Another innovation has been in the area of weather insurance. In 2003 ICICI Lombard, a private-sector general insurance company, started offering drought cover policies via BASIX and excess-rain covers through ICICI Bank. Such contracts offer the distinct advantage of solving the delayed payment problem that is common with the government area-yield-based crop insurance programme. BASIX launched its first weather-insurance program in July 2003 through its KBS LAB in Mahbubnagar. Since local area banks are limited to operations in three

adjacent districts and therefore face limited natural portfolio diversification, this helped convince KBS that weather-insurance contracts for its borrowers could mitigate the natural default risk inherent in lending in drought-prone areas such as Mahbubnagar, a district that has experienced three consecutive droughts since 2000. KBS bought a bulk insurance policy from ICICI Lombard seeking to sell individual farmer policies for three categories of groundnut and castor farms: small, medium, and large. Informal interviews with farmers who bought the policies revealed that they are well aware of the rainfall-based index nature of the contracts and value the quick payout of the weather policy, which distinguishes it from their experience with the government crop-insurance scheme. ICICI Lombard also offered excess-rain policies to around 5,000 wheat farmers in UP (in conjunction with ICICI Bank), and to 150 soya farmers in Madhya Pradesh in 2003/2004 (in conjunction with BASIX). More recently, the company has worked with the government of Rajasthan to pilot weather insurance for orange farmers in the state while also extending weather-risk insurance for a rural finance portfolio of BASIX. The latter deal is interesting from the point of view that it captures, with one deal, all the farmers—big, small, and marginal—who are part of BASIX's agriculture portfolio. This approach is therefore potentially scalable even while having the ability to reach small, and marginal farmers on account of its use of a financial intermediary/microfinancier. However, cost (around 10 percent of the sum insured) remains an issue, even though, relative to the true costs of the government crop-insurance program (around 15 percent), the cost is lower. If the same or lower cost enabled with greater risk diversification can be viably sustained over time, the argument for moving toward such a product becomes stronger. Perhaps, as in traditional crop insurance, this could be backed by government subsidies, particularly since the early evidence seems to suggest that the subsidy required may be lower than for traditional crop insurance. Further, the other benefits of the use of an objective indicator (rainfall) to determine payouts and reduced time-lag between claim and payment (relative to traditional crop insurance) associated with this product strengthens the case for pursuing the development and scaling up of this innovation.

Composite Financial Service Providers

A variation of microfinance that has emerged in recent years is composite service provision, in other words a single microfinance institution provides an array of services, including credit, savings, insurance and so on. A recent set of studies sponsored by the Institute for Development Policy and Management, UK (Ruthven 2001; Patole

and Ruthven 2001), found that a wide array of financial transactions (both borrowing and lending, often simultaneously, and at all levels of income) characterized the financial life of the poor. The aggregate financial transactions were between 113 percent to 167 percent of the income levels of the very poor and the poor, respectively, in rural Allahabad; and 149 percent to 135 percent in urban Delhi slums. RFAS 2003 also supports this conclusion. The poor are constantly borrowing, lending, saving, withdrawing, using, and losing money through contingencies and calamities. They need someone to help them with all these transactions.

Composite service providers are preferable from the viewpoint of reducing the number of agencies with whom a poor household must deal, thus reducing transaction costs. Moreover, if a composite agency has a good internal MIS, it can use the savings history of a household as a "collateral" for loans. Similarly, if the same agency provides insurance for lives or livelihoods, it will be more willing to give a loan. From the MFIs' point of view, transaction costs come down as the same delivery system can be used with the addition of training, software, and some staff.

There are now some examples, albeit few, of composite financial service providers in India, mostly among MFIs. The three top MFIs in India are all trying to offer a composite set of services to their customers, in spite of a fragmented and unsupportive regulatory framework. Some examples are given below.

SEWA Ahmedabad provides a combination of savings and credit through its Sri Mahila SEWA Urban Cooperative Bank and insurance services managed through its Vimo SEWA affiliate, which front-ends for the LIC and a number of general insurance companies.

The BASIX group's KBS LAB, is able to provide all the services—savings (including daily deposits collected from the doorstep of its borrowers); credit (for a range of purposes from crop loans to non-farm activities and to SHGs); and crop insurance (to farmers under the KCC/Rashtriya Krishi Bima Yojana as well as a weather-indexed crop product developed by ICICI Lombard, and piloted last year). BASIX retails life insurance on behalf of AVIVA Life Insurance Company and provides livestock insurance to its borrowers through the Royal Sundaram General Insurance Company.

Portfolio Securitization

Portfolio securitization of the micro-loan portfolios of MFIs is an innovative approach, recently piloted in India by ICICI Bank and SHARE, a microfinancier. ICICI Bank has just completed two such deals in AP. In the larger one, it has paid US\$4.3 million for a portfolio of 42,500 small loans from SHARE. SHARE will be responsible for

collecting the loans. The securitization is not asset-backed; rather, ICICI Bank will have as collateral a “first loss” guarantee of an 8 percent deposit from the total from Grameen Foundation.

The approach has many advantages: ICICI Bank manages to reach borrowers it could never otherwise have approached, and palm off most of the administration to SHARE. This also helps it meet its government-set target of directing 40 percent of its loans to “priority sectors,” including 18 percent to farmers. SHARE secures a new source of funds, off SHARE’s balance sheet, at a cost that is 3 to 4 percentage points cheaper than it pays for a bank loan. This will help SHARE meet its aim of increasing the number of borrowers from under 300,000 now to 1 million. The deal also helps create a new asset class for which there is demand among the more liquid investors.

While such securitizations can be done for the better MFIs, for which credit ratings are available, scaling up would pose a serious challenge given the paucity of reliable, independent information on the bulk of the MFIs and their loan portfolios. Also, at present, there is no secondary market for securities, but ICICI Bank is talking to CRISIL, a credit-rating agency, about the prospects for its rating the paper, and is hoping that over time other banks will enter the market too.

Price-Insurance and Risk-Management Products for Farmers

Commodity Price Insurance

Fluctuations in commodity prices are a major source of risk in rural finance. Market-based tools to insure against commodity-price volatility (e.g. futures and options) can help reduce the risk of default by marginal and small farmers, and hence improve the terms on which they can access finance. Such tools already exist and are widely used in high-income countries. Risk-management service providers, such as grain elevators and oilseed crushing plants, provide farmers with access to risk-management tools using purchasing contracts. As a result, the demands of individual farmers for insurance are aggregated into contracts of a commercially viable size, thereby enabling even farmers who produce a relatively small quantity of a commodity to indirectly purchase insurance. In developing countries like India, small farmers and market intermediaries tend to lack knowledge of such market-based price insurance instruments and an understanding of how to use them. Also, the sellers of such instruments, generally international trading firms, are often unwilling to engage with a new and unfamiliar customer base of small-scale farmers, characterized by high transac-

tion costs, credit issues, and performance risk. One illustration of an innovation that was tried recently relates to the Indian Coffee Board and three commercial banks that designed a comprehensive pilot for retailing New York traded coffee "put options" to protect farmers against adverse price movements (this was designed with significant contributions from the Commodity Risk Management Group of the World Bank). However, fewer-than-expected coffee farmers pre-registered for this scheme and therefore it was not launched in 2004. The set-up of this pilot was driven by regulatory constraints, as banks are not allowed to deal with derivatives. This continues to constrain the growth of such price-risk management products.

The development of commodities futures markets can help efficient price discovery and go a long way in reducing risks related to a fall in commodity prices below production-cost levels. In particular, micro-futures can help marginal and small farmers hedge against commodity price fluctuations.

Establishing Warehouse Receipt Systems

Another means of reducing the default risk in rural finance may be through establishing "warehouse receipt systems." This involves farmers using their crops as collateral for post-harvest financing. The basic idea is as follows: The warehouses store the produce for a fee and deliver a receipt to the farmer, and the receipt becomes immediately enforceable (similar to checks). For the warehouse receipt system to work effectively, receipts would need to be recognized as legal instruments. Also, the grades and quality standards of the commodities would need to be defined centrally, warehouse operation standards would need to be developed, and effective supervision established. The Government of India has been examining this issue; a recent taskforce set up by the Ministry of Finance highlighted the following measures required to develop a warehouse receipt system: (a) creation of a central warehouse registry and a central regulatory authority; (b) making warehouse receipts a negotiable instrument; (c) allowing for the full transferability of warehouse receipts; and (d) the introduction of nationally recognized grades and qualities for commodities.

The Strategic Use of Information and Communication Technology

A leading agri-commodity market player in India, information and communication technology (ICT), has pioneered "e-choupal," an

initiative involving the use of desktop computers with an internet connection, with revolutionary implications for more than 4,000 villages. The e-choupal is operated as a commercial venture by a local farmer who earns a commission from the sales that take place through the e-choupal internet connection. Farmers use the e-choupal to check prices for agricultural produce at the nearest *mandi* (market), or in international commodity markets, as well as trade commodities. Better market information enables farmers to obtain better prices. The e-choupal is also a mode to seek technical advice, obtain weather forecasts, and order agricultural inputs—or indeed a range of other commodities. These e-choupals also provide potential avenues for lenders, agricultural commodity traders, and farmers to interact in a relatively seamless manner, with low transaction costs and improved (credit and market) information. With rapid expansion plans that aim to cover a fifth of India's villages in the future, ITC's e-choupals are a great illustration of the powers of information technology.

The strategic use of information and communication technology is critical to addressing the transaction-cost problem in rural finance. Some experiments in this direction have been made, notably by BASIX, to use to give out very small loans (below Rs1,000) and collect repayments using smart cards readable at devices placed in Subscriber Trunk Dialing (STD) Public Call Office (PCOs). Though the initial experiment has not been successful, due to a combination of technical and financial reasons, it certainly established that there is a market for "nano-credit" (loans below Rs5000) which can be profitably and efficiently served using sophisticated ICT.

Notes

1. While microfinance typically covers the poor in rural, semi-urban, and urban areas, the focus here is on the rural poor.
2. Guidelines from the RBI were issued in 1992, to experiment with a pilot of 500 SHGs linked with banks. This pilot program as well the work of a number of NGOs was reviewed by a Working Group on Bank Lending to the Poor through NGOs and SHGs (1995) and detailed guidelines were drawn to encourage banks to use this method. NABARD was given the task of leading this effort and it took to the task with exemplary diligence. It involved NGOs, commercial banks, regional rural banks, and even cooperative banks in forming SHGs and then linking these up with nearby bank branches.
3. In contrast, moneylenders would charge annual interest rates ranging from 36–120 percent per year. The average interest rate charged by moneylenders is 48 percent.
4. The RFAS 2003 targeted roughly 60 villages in each state, though the actual number of villages sampled was higher in UP. Data from RFAS 2003, which was a household survey, include responses from those who were members of SHGs, as well as village-level data. Based on the latter, a total of

736 SHGs were in operation in the villages covered by RFAS 2003, with the overwhelming majority in AP, as would be expected. Not only does AP have a preponderance of SHGs, these groups overwhelmingly comprised women only. Women's groups accounted for 95 percent of all SHGs in the state. By contrast, in UP, groups comprising only men, and mixed groups, were also well represented.

5. Friends and family are a major source of informal borrowings.

6. However, this would also be consistent with the notion that greater illiteracy makes more difficult the formation of SHGs.

7. See, for example, Puhazhendhi and Satyasai (2000), and World Bank (2003).

8. These tasks include inculcating in the groups a culture of savings and repayment, teaching them bookkeeping skills, strengthening their internal capacity to undertake administrative tasks (accounting, meeting minutes, correspondence, and negotiations with bankers) and commercial activities (business start-ups, marketing, and re-investment), ensuring the groups remain financially sustainable and have the ability to weather personal losses (accidents, sickness, death), and natural disasters, etc.

9. M-CRIL's 2004 Micro Finance Review presents the annual percentage ratio (APR) of rated Indian MFIs as 24.3 percent. There are signs that with competition and growing efficiency in operations, interest rates of MFIs can reduce over time; Spandana, a leading MFI in AP, among the largest in the country, reduced its lending rate from 18 to 20 percent per year (flat) to 12 to 15 percent per year (flat) and has plans to reduce it further on account of operational efficiency gains with growing scale of operations; ASA, a leading MFI in Tamil Nadu, also reduced its interest rate from a high 24 percent per year (flat) to 15 to 16 percent per year (flat), this being close to the rates that SHGs themselves charge each other for internal lending. Other examples can be found particularly from these two states, where the degree of competition between MFIs is strongest.

10. The ICICI Bank has launched a pilot effort for this jointly with Cashpor Micro Credit, specially set up for this purpose by Cashpor Financial and Technical Services Ltd, in Chandauli District, UP.

11. This report does not examine, in detail, the effectiveness of various government-sponsored rural finance schemes such as Swarnajayanti Gram Swarozgar Yojana (SGSY). These are being examined in a companion volume.

Meeting the Challenge of Scaling Up Access to Finance for India's Rural Poor: The Policy Agenda

Improving access to finance for India's rural poor, to meet their diverse financial needs (savings, credit, insurance against unexpected events) presents a formidable challenge in a country as vast and varied as India. But the opportunities, too, are plentiful. In the near term, microfinance can, at a minimum, serve as a quick way to deliver finance. But the medium-term strategy to scale up access to finance for the poor should be to graduate microfinance clients to formal finance institutions where they can access standard individual loans, possibly on a fully commercial basis. An immediate problem arises in that there are no obvious lenders for microfinance customers to graduate to—none yet are close to offering the reliability, convenience, continuity, and flexibility required by low-income customers. Nor is the notion of graduation built explicitly into the design of microfinance in India. In Indonesia, in contrast, Bank Rakyat Indonesia (BRI) has worked closely with (and in fact supervises) the Badan Kredit Desa (BKD) network, which has for some been a feeder to BRI. Even so, there is relatively little graduation overall from the BKDs to BRI, partly because BRI is only now developing products that work well for smallest-scale clients. In Bangladesh, the pretext of graduation has been universally abandoned for lack of an appealing next step—and for the desire of NGOs to continue working with clients with whom they have developed relationships over many years. If the idea of graduation is a serious one in India, efforts to promote microfinance should go hand in hand with efforts to make the formal sector better at “banking the poor,” and both government and private sector can play a critical role in this context.

Making the Formal Financial Sector Better at Banking the Rural Poor

An immediate challenge is for formal-sector institutions to introduce products and services that are not only reliable and available on a

continuous basis, but are also flexible and convenient; and also to introduce measures that allow for low-cost ways of reaching the rural poor. Here, microfinance can offer some useful lessons to formal banks. Over the medium term, key reforms in government policy are required to improve the overall incentive framework, and the regulatory and legal system within which rural banks operate, so as to promote greater efficiency and competition in rural finance.

Low-Cost Ways of Reaching the Rural Poor through the Formal Sector

India's vast network of rural banks potentially presents a tremendous advantage, and one on which the country could capitalize in delivering finance for the poor. Currently, most banks operating in rural areas, the majority of which are state-owned, do not seem to be tailored to meet the needs of the rural poor in an efficient and effective manner. The responsibility for introducing more flexible products and services that better match the needs of the rural poor rests with bankers. But government, given its domination of rural finance institutions, also has an important role to play in spearheading change. In this context, microfinance offers a number of lessons for formal banks.

Introducing flexible and easily accessible products. Small rural clients prefer to borrow frequently, and repay in small installments; banks could usefully explore the possibility of offering new and more flexible loan products, like those offered by microfinance. Increased use by insurance companies, of the large and deep branch presence of the postal branch network (as well as the commercial bank network) for channeling insurance products, backed by adequate training of staff, could help lower transaction costs and improve access to insurance.¹

The need for composite financial services. While small rural borrowers seek savings and lending services, they also seek insurance (life, health, crop); bank branches in rural areas would do well to explore opportunities to offer composite financial services, as they have begun to do in urban areas, and as some microfinanciers have begun to offer in rural and urban areas. The need for remittance services is also gaining increasing importance particularly on account of the large volume of international remittances (US\$8.4 billion through official channels in 2003) coming to India. Lowering transaction costs and increasing the availability of such services through increased bank and postal branch coverage will help generate new business while also weaning away customers from using informal channels for remittances.

Simplification of procedures to open a bank account, access credit. These could go a long way in encouraging the poor to bank with the formal sector, by reducing clients' transaction costs. The KCC experiment is

a move in the right direction, but it needs to be scaled up and accompanied by other procedural changes.

Better staffing policies and doorstep banking. The high recovery rates of microfinance are associated with staffing policies that allow recruiting staff from the local area who understand clients' needs, and a focus on doorstep banking. State-owned banks operating in rural areas currently do not have the flexibility to recruit staff locally, but staffing policies could be revisited. Doorstep banking is costly, but the gains from better recovery and cost savings from hiring local staff in rural branches could well outweigh the higher transaction costs of doorstep banking.

Use of technology. Banks can use technology to drive down their transaction costs, for example through the introduction of smart cards and biometrics.

Improving the Incentive Regime and Promoting Competition

Interest rates. One obvious area could be for government to review its policy of setting interest rate caps on rural lending rates and floors on the deposit rates. As noted above, this has the opposite effect of what is intended—poor borrowers are cut off from access and end up paying higher interest rates to informal lenders. Meanwhile, banks face an implicit tax (cost) that is not insignificant. Also, as indicated by RFAS 2003, the “store of value” reason for holding accounts dominates the transaction needs of rural households; most transactions are cash-based. This suggests that deposit mobilization may be relatively inelastic to interest rates (however, further study is needed), which could mean that there is scope for more attractive spreads for commercial banks—if interest rates were further deregulated. The success of countries such as Indonesia and Philippines, which have no interest rate controls but have succeeded in making deep inroads in rural areas, is noteworthy.

Moral suasion by governments on interest rates on farm loans and periodic announcements of interest (and principle) waivers by state governments must be avoided. With regard to the former, announcements by government on interest-rate ceilings, even if with compensatory subsidies to banks, dis-incentivize rural bankers, hamper the credit culture that could otherwise have been established, and lead to the expectation among farmers that low interest rates will continue forever. Similarly, interest waivers announced by government create disincentives for farmers to service debt. Clearly, such measures have an adverse impact on the financial system, and alternatives such as direct farm-protection measures, including increasing the outreach of agricultural-risk mitigation, need to be given serious consideration by governments at both the central and state levels. Moreover, to the

extent that such announcements are generally linked to disaster situations, disaster relief and rehabilitation measures need to form part of the government's response—these can be politically viable and financially more prudent and effective than seeking to waive interest.²

Revisiting the policy on “priority sector” lending. Government should also consider revising its policy on priority-sector lending requirements imposed on banks. One option, that would allow the most competitive lender to emerge in rural areas and minimize distortions, is for government to make the priority lending obligation tradable. The most competitive lender would then be paid by less-well-placed banks to effectively take on their priority-lending requirements for a price. Creating such a market for priority-lending requirements would benefit both banks and the rural poor, who would be able to access finance from the most efficient and competitive institution.

Entry of new private banks in rural finance. Some private banks such as ICICI Bank have shown a growing interest in entering India's rural finance sector—and have introduced innovative approaches and financial products to reach the rural poor. Government needs to do what it takes to create an environment that would make it possible and profitable for interested private banks to enter the rural finance market.³ For one thing, interest rates would need to be fully liberalized so that lending to small, rural clients can become a more profitable business for banks. Branch-licensing policies and procedures also need to be revisited (private banks may be interested in buying up the branch networks of government-owned rural banks). And supervision of rural banks would need to be strengthened to ensure financial discipline/reduce moral hazard problems while also fostering an enabling environment for financial intermediaries (see below). The entry of private banks could have a good demonstration effect for public-sector banks on how to reduce transaction costs in rural banking, and how to make rural banking profitable. It would also create more competition that would help weed out the bad banks from the good and create further space for new, private-sector entrants. To this end, measures to support innovations by private-sector banks and consolidate and disseminate lessons from such pilots would help in leveraging adequately on their initiatives.

RRBs and rural cooperative banks. Dealing with the RRBs and rural cooperative banks poses a major challenge. Various government-appointed task forces and committees have highlighted in detail what needs to be done to deal with the weaker RRBs and cooperative banks; the challenge really is to build consensus for reforms and implement the changes (Appendix 8).⁴ As a first step, the regulation and supervision of these banks need to be urgently strengthened. Prudential

regulation standards related to capital adequacy and asset classification (and related to the latter, regulation on income recognition and provisioning) need to be upgraded and introduced in a phased manner, and supervisory enforcement improved. Weaknesses in regulatory standards, poor enforcement, and regulatory forbearance have undermined market discipline and contributed to the deep financial distress that characterizes many RRBs and rural cooperative banks. Improved prudential standards need to go along with a clearer demarcation and prioritization of functions to address the conflict of interest in apex institutions' (RBI and NABARD) regulatory, supervisory, refinancing, and development functions.⁵

Better regulation and supervision would pave the way for the restructuring of these banks. It would help distinguish between adequately capitalized banks and weaker banks (undercapitalized banks, and those that are insolvent). The proper enforcement of prudential norms would mean that weaker banks are forced to address their problems through such means as mergers or closures.⁶

Better regulation and supervision need to be accompanied by operational restructuring, involving improvements in governance to reduce state interference. Especially for rural cooperative banks, the duality of control needs to be addressed—all banking functions need to vest clearly with the central bank rather than be shared with the state government. These functions include policies on interest rate and loans, reserve and appropriation, remission of debts, branch licensing, powers to appoint auditors and supersede the board, powers to appoint CEOs, better management, strong policies on loan sanctions (without any pressure by government) including measures to check related-party lending, and clear portfolio risk-management strategies. Staffing policies that allow banks to employ local staff familiar with the community and thereby address the needs of their clients are necessary, as is the introduction of new products such as loans with flexible repayment terms, and better services such as doorstep banking that can help meet the needs of rural clients more effectively and minimize risk. In introducing new products and services for the rural poor, lessons could be drawn from microfinance.

Better regulation and supervision also need to go hand in hand with strengthening the refinancing eligibility norms for rural banks used by NABARD, and the due diligence underlying lending to rural finance. With regard to the former, relatively lenient conditions used at present provide wrong signals to rural banks and thereby reduce the incentive to improve financial performance while also potentially crowding out private-sector financial institutions.⁷ The quality of due diligence is particularly relevant to the practice of lending against state government guarantees—this includes NABARD refinancing to state-level

cooperative banks and state governments but also lending by state-level cooperative banks to other commodity cooperative sectors against a state guarantee. Often, given the comfort of a state guarantee, such lending may not be backed by adequate due diligence on the part of the lender, and therefore, while retaining a standard asset on its books on account of the government guarantee, this could ultimately create a fiscal liability for the state if the underlying asset financed by the intermediary is not a viable project. Such lending could include NABARD's exposures under the Rural Infrastructure Development Fund, its lending to long-term cooperative banks (many of which have eroded their capital base), and the lending (often "directed" by state governments) by state cooperative banks to unviable and bankrupt government-owned sugar (and other commodity) cooperatives backed by state guarantees.⁸

Beyond these measures, government can play an active role in many other areas to facilitate the increased efficiency of rural finance markets and increased competition that would help financiers make credit available more efficiently to rural borrowers, both large and small. Better laws and regulations governing financial transactions, a judiciary that can enforce contracts, the demarcation of property, better credit information, and improved price discovery in rural markets, could go a long way in addressing market constraints. Specifically, these would include the measures discussed below.

Improving contract enforcement, the legal framework and land titling. To encourage banks and other private creditors to lend in rural areas, the government needs to strengthen the legal framework for recovering smaller NPLs. While the recent enactment of the securitization and asset reconstruction law (2002) has helped improve the legal framework for recovering bad loans by facilitating out-of-court settlements on NPLs and instituting alternative methods of dispute resolution between creditors and debtors, the law does not cover small loans. Extending the law to small loans would greatly facilitate loan recovery on rural loans, thereby reducing the default risk faced by rural finance institutions. Land titling and registration systems should also be strengthened, restrictions on the use and transfer of land removed, and enforcement mechanisms improved so as to facilitate the use of land as collateral. At present, some 90 percent of land parcels in India are reportedly subject to disputes over ownership which take decades to settle in court. While these are complex issues, a start could be made by efforts to improve the titling and registration process through the automation of land records. Land laws need to be modified to facilitate the development of a free and fair land-lease market. Indeed, many states do not permit leasing of land, while in some states the lease creates long-term irrevocable rights for the lessee to the disadvantage of the

lessor. All this encourages unrecorded and unofficial year-to-year oral leases, which prevent the lessor from getting a good lease value and the lessee from putting the land to best use.

Better credit information would directly increase the amount of financing for rural borrowers by reducing transaction costs and costs related to default risk. A way forward may be for NABARD to consider collecting credit information on micro-borrowers, both groups and individuals. A first step could be to require the 2,500 NABARD-affiliated financial institutions to provide default information to a central registry. For example, in many rural areas NABARD arranges for farmers to meet informally and share default information among themselves. It would be helpful if this information—historically and across regions—were kept electronically and made easily accessible. One constraint is the unique identification of borrowers. However, the current system—including name, father's name, and address—is considered accurate in over 95 percent of cases. In addition, as national IDs become more common, NABARD could require that every borrower have an ID (as is the case in Sri Lanka). A similar initiative could be undertaken with SIDBI and other apex microfinance lenders. A useful reference would be the South African credit bureau that also covers the microfinance sector, using the apex micro finance council as a channel to collate information on micro-borrowers.

Better price discovery, crop insurance, and commodity price insurance to reduce default risk. One of the main sources of default risk faced by rural financiers is a fall in commodity prices below production-cost levels. The development of commodities futures markets could be a way of improving price discovery and hence reducing risk. This would require changes to the regulatory and legal framework. Specifically, government and RBI need to re-examine the entire set of forward markets regulations and Section 8 of the banking law. At present, the regulatory framework for forward markets seems to conflict with the rapidly liberalizing futures market regulations. One aspect of this conflict is the interpretation of Section 8 of the banking law. Currently, the law does not allow a bank to buy commodity price derivatives, even if the bank does not take any exposure by retailing the derivative as price insurance to commodity producers. Banks should be allowed to trade derivatives as long as speculation and exposure to price movements are limited and well supervised. A variant product is "micro futures," which are smaller denominated futures products marketed to smaller businesses or independent farms. Contract sizes on futures contracts are often too large to accommodate small holders' needs. Smaller micro futures on principal crops and weather measures in major cities could be retailed through brokers and banks and marketed to retail buyers.

This instrument could help marginal and small farmers hedge against commodity price fluctuations.

Access to price insurance and price derivative instruments would also help commodity producers and traders access finance on better terms. But this would require the Indian authorities to redefine the regulatory framework governing the use of commodity price derivatives. Appropriate supervision would need to be put in place to curtail the speculative use of these instruments and limit exposure to more sophisticated structures with margin requirements. The supervisor would need to distinguish between simple straightforward hedging instruments, such as “put” options and futures, and more complicated and hard-to-track swaps, “collars,” “swaptions,” and so on.

An important tool in agricultural risk mitigation could be weather-based insurance products. The main precondition for the scaling up of weather insurance is the timely and full availability of weather data, preferably online. Currently, weather stations in India are often not automated and data are not available online. In addition, the use of weather derivatives is subject to tight restrictions; essentially they are not part of the recognized set of financial instruments. To encourage the use of these instruments, government would have to: (a) ensure that those who would like to pilot weather-based insurance products are provided with full access to historical and current weather data (which do seem to exist but are not readily available at present); (b) make available these data online (on the basis of specific agreements); and (c) introduce weather derivatives as a tradable instrument.

Recent innovations in agricultural risk mitigation have opened the doors for innovations to reduce default risk in rural finance while also providing protection to the borrower. For illustration, the basic product offered and being developed by the Agriculture Insurance Company of India (AICI), the main provider of crop insurance at present, is based on an area-yield formulation—the government could allow providers of risk-management services the right to allow the farmer to assign the area-yield indemnities payment to the risk provider in exchange for new tailored risk-management products better suited to the individual farmer’s risk-management needs. This innovation could prove to be pivotal in addressing the main problem with the current program, namely delayed indemnity payments.

Yet another means of reducing the default risk in rural finance may be through establishing warehouse receipt systems. The immediate priorities in this area, as highlighted by a recent task force set up by the Ministry of Finance, are as follows: (a) creation of a central warehouse registry and a central regulatory authority; (b) making warehouse receipts a negotiable instrument; (c) allowing for the full transferabil-

ity of warehouse receipts; and (d) the introduction of nationally recognized grades and qualities for commodities.

Scaling Up Microfinance

As efforts are made to improve the formal financial sector's ability to serve the poor, microfinance can play an important role in the interim. Scaling up access to finance for India's rural poor through microfinance will require attention in the following areas:

An enabling policy, legal and regulatory environment for microfinance. An enabling framework is already in place for SHG–Bank linkage, and scaling up the model would require government to ensure that the existing framework is maintained. This would require ensuring that the model continues to have a champion with a clear leadership role—a task which NABARD has assumed with exemplary diligence by introducing policies and measures to encourage banks to lend to SHGs. And it would require the authorities to maintain a hands-off regulatory policy. For MFIs, Indian policy makers now increasingly recognize that government can play an important role in establishing an enabling policy, legal, and regulatory framework for MFIs. While the success of individual MFIs is largely attributable to their visionary leaders, this is clearly not enough to mainstream the cause of MFIs. Advocates of MFIs argue that the immediate measures needed include the following: (a) reducing minimum start-up capital requirements to facilitate the transformation of MFIs into NBFCs; (b) encouraging multiple sources of equity for MFIs; (c) facilitating MFIs to raise debt, including permitting MFIs to mobilize savings, with safeguards; (d) developing a set of prudential norms that are more appropriate to institutions serving the poor, and setting up supervision mechanisms around such norms. Better policy coordination among the various government ministries/department/agencies that cover MFI issues would also help greatly.

Attention to group quality, and the importance of financial sustainability. Scaling up microfinance in India requires attention to the quality and sustainability of groups, their promoters, and lenders (banks or MFIs). A strong focus on the quality of SHGs by their NGO promoters was a key factor in the success of the SHG–Bank linkage model in its pilot phase. But in recent years growing concerns have emerged about group quality as well as the ability of partner banks to properly assess, monitor, and manage risk on their SHG portfolios. Going forward, if SHG–Bank linkage is to be scaled up, NABARD and its partners face an important challenge in ensuring that high-quality groups are created and maintained. In particular, the success and sustainability of SHG–Bank linkage depends crucially upon a clear strategy on who will promote new groups, and how they will be funded. Equally, efforts

need to focus on ensuring that banks price their loans to SHGs at rates that cover their costs in order to achieve financial sustainability. Banks also need to focus more on monitoring and managing SHG lending risk. Since most Indian MFIs also lend to groups, issues related to group quality have a bearing on the success of the MFI model as well.

Clear targeting of clients. Equally important is the need to ensure proper targeting of clients. The dual pursuit of social ends and financial profits is an ongoing tension for all in microfinance. While our analysis of SHG-Bank linkage indicates that the model has so far successfully targeted the poorer segments, mission drift is a common fear as pressures mount to serve richer clients with larger loans (and thereby to earn higher profits per loan since transaction costs per rupee tend to fall with loan size). Keeping focused on its target population is thus critical to the success of microfinance in India, as elsewhere.

The experiences of Bangladesh, Indonesia, and other countries offer some useful pointers for India. There has been much debate about how stringently to target, and how best to do it in practice. A first priority is to clearly determine who is being targeted and define eligibility rules. In Bangladesh, Grameen and BRAC employ eligibility rules to restrict attention to households holding under half an acre of land. Grameen expands the definition to also exclude households with more than the equivalent of an acre's worth of assets. BRAC excludes households without a manual laborer. Others, like *SafeSave*, rely on geographic targeting, restricting attention to specific slums in Dhaka. Microfinance in Bangladesh has earned a reputation for maintaining a focus on women from functionally landless households (although this has softened in practice). In Indonesia, BRI has also focused on serving the under-served, but, in contrast, it has focused on low-income households (and not just those below the poverty line) and most clients are men.

Appropriate products and services, and good staffing are critical to ensuring effectiveness. How products are designed, how staff are compensated, what messages are delivered from headquarters, and who is recruited onto staff all have an important bearing on the success of microfinance. Group promoters from local communities are generally better able to target poorer households. Product design is another means of targeting. Lending in groups and sending staff to villages has been credited with much of microfinance's appeal in Bangladesh, as in India. A critical but less heralded breakthrough for Grameen was to create a loan product that allowed borrowers to repay in small, weekly installments. This suited poor households well, since they could repay out of the regular bits of income coming in daily or near-daily. Charging appropriate interest rates has also helped stem leakage of resources from target

populations to those richer or politically favored. On the savings side, BRI has tried to encourage broad access by maintaining very low minimum balances (US\$0.57) and low minimum deposits for opening accounts. New depositors can start an account with 10,000 rupiah (just over US\$1), and the new savings products have given BRI its most notable success in serving the poor. On the borrowing side, BRI requires borrowers to put up collateral to secure loans, but the bank has chosen to be very flexible in what it will accept, so that collateral is not a major constraint when seeking poor clients. In order to push still further, BRI has instituted products that require no collateral at all for loans up to rupiah 2 million (\$225), offered at the discretion of the unit manager.

Inclusiveness and competition in the microfinance sector can generate high payoffs. The inclusiveness of SHG–Bank linkage, which has involved a partnership between government, NGOs, and a range of rural banks (commercial banks, RRBs, cooperative banks) has already generated a strong payoff. Further gains in terms of outreach and financial sustainability may be reaped through involving private-sector banks and MFIs in SHG banking. Recent experiments indicate good prospects for scaling up models that are variations of SHG banking, and involve MFIs as intermediaries between SHGs and private-sector banks (who want to enter the market but don't have the branch network). Equally, there is space for independent, specialized MFIs in the Indian microfinance market that could provide the necessary competition to SHG–Bank linkage in the area of savings and credit provision, and also complement the services provided by SHG–Bank linkage. Evidence from elsewhere in Asia, and particularly from Bangladesh and Indonesia, suggests that good, reliable, responsive, long-term MFIs for the poor can go a long way in improving access to finance (Morduch and Rutherford 2003).

Recent studies also indicate the key role that can be played by MFIs that provide composite services, given the wide array of financial transactions (both borrowing and lending, often simultaneously, and at all levels of income) that characterize the financial life of the poor (Ruthven, 2001; Patole and Ruthven, 2001). RFAS 2003 also supports this conclusion. The poor are constantly borrowing, lending, saving, withdrawing, using and losing money through contingencies and calamities. They need someone to help them with all these transactions. Composite service providers are preferable from the viewpoint of reducing the number of agencies with whom a poor household must deal, thus reducing transaction costs. Moreover, if a composite agency has a good internal MIS, it can use the savings history of a household as a “collateral” for loans.⁹ If the same agency

provides insurance for lives or livelihoods, it will be more willing to give a loan. From the MFIs' point of view, transaction costs come down as the same delivery system can be used, with the addition of training, software, and some staff.

Overcoming geographic concentration in microfinance. Another issue of concern is that microfinance in India continues to be skewed in its geographical distribution. The underlying causes for this include the general malaise in the economy of the central, eastern, and north-eastern states, with very little resultant demand for credit among the subsistence poor, and the absence (for historical reasons) of good quality NGOs that are willing to initiate microfinance programs in these states (there are a large number of small NGOs but all of them with limited experience and outreach—see Mahajan and Ramola 2003). Expanding the reach of microfinance to these areas is not a challenge that can be met overnight. Investments are required in areas such as watershed development, small-scale irrigation, livestock up gradation and forest regeneration. Unfortunately, none of these are amenable to the small, short, and unsecured nature of microcredit loans. These require long-term, lumpy public investments. However, once made, they unlock the potential for enhancing the livelihoods of millions of poor people, moving them up from subsistence production to surplus production and thereby increasing the demand for credit. One simple example of this is the dramatic increase in the demand for credit once irrigation becomes available to erstwhile rain-fed farmers. A proposal for increasing the number of good NGOs in the lesser-served states was made by the Tenth Five-Year Plan Working Group on Poverty Alleviation Programs (Planning Commission 2002), which recommended that well-established NGOs be asked to set up branches in selected poor districts and that they be funded for this on an assured though declining basis for the first three to five years. The experience of the Rashtriya Gramin Vikas Nidhi and the Rashtriya Mahila Kosh (RMK) in supporting hundreds of small NGOs all over the eastern region of India is useful in this regard, and lessons from such experience need to be taken into account.

Attention to the demand side. While the importance of microfinance in consumption-smoothing should not be underestimated, its success in building up poor peoples' assets over the medium term depends very much on efforts directed at providing assistance in skills development, technology, and marketing—all of which are critical to ensuring that investments made by poor households reap returns and contribute to a sustained increase in incomes and improvements in rural livelihoods.

Notes

1. RFAS 2003 data showed that among the various rural finance institutions, post office branches had the closest proximity (2 kms on average) to rural clients compared to branches of commercial banks, RRBs, and cooperatives (5 kms on average).

2. For a further discussion on this topic, see World Bank. 2003. Financing Rapid Onset Natural Disaster Losses in India: A Risk Management Approach Washington, D. C.: World Bank.

3. In this context, the recent decision to dispense with some of the more restrictive provisions of the service area approach is a welcome move. But much more needs to be done to increase competition in rural banking.

4. Including the Capoor Committee, the Patil Committee and the Vaidyanathan Committee reports on the rural cooperative banks, the Rao Committee on RRBs, and the Vyas Committee on rural credit delivery.

5. These issues are discussed in more detail in a forthcoming report on "Aligning India's Financial Sector Regulatory and Supervisory Architecture to Country Needs," World Bank, Washington, D.C.

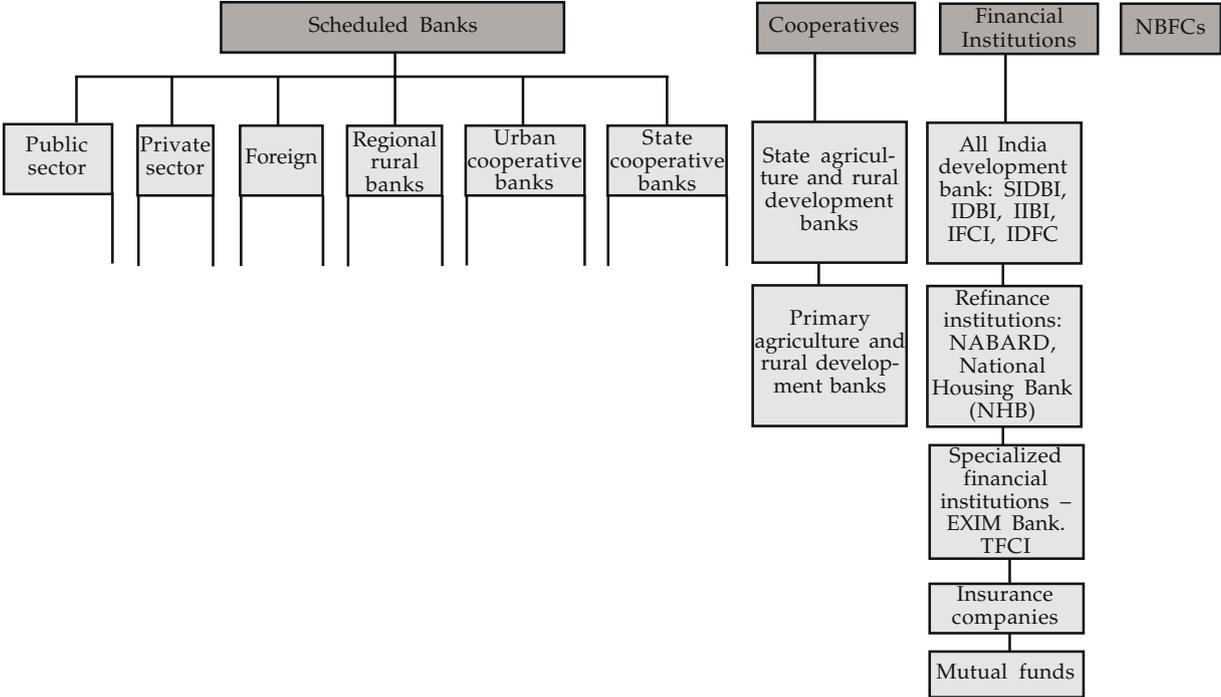
6. This is indeed in line with the recommendations made by various government-sponsored committees on the future of the RRBs and cooperatives, which suggest measures to reduce government ownership, undertake structural consolidation, improve governance and management, strengthen regulation and supervision, and so forth.

7. The flow of funds to the rural finance sector from financially weak entities not merely creates weak assets for the rural banks, it also potentially crowds out private-sector provision of financial services. While it can be argued that the private sector does not have a significant presence in rural areas at present, recent initiatives by these banks, discussed in this report, could indicate a turning point in their degree of focus on rural finance.

8. Most recently, the case of the Maharashtra State Cooperative Bank's exposures to the state's sugar cooperative sector.

9. Similarly, use of savings history of depositors, particularly those in the postal system (114 million accounts), if collated and made available, could be of considerable interest and value to financiers.

Structure of India's Financial Sector



Appendix 2

World Bank/NCAER Rural Finance Access Survey (2003)

Summary of Survey Methodology and Sampling Framework

The survey covered 6,000 households and micro-enterprises (households that rely on non-farm income for more than 50 percent of their income) in two states, AP and UP.

Why AP and UP? The choice of AP and UP as the two states in which the survey would be conducted was based on the following considerations: It was thought that AP, a leader in the area of delivering finance to the rural poor through microfinance, would present lessons that could be replicated elsewhere in India. Also, AP's formal rural finance sector has undergone reforms in recent years, notable among which is the adoption by AP of a new cooperatives law, and efforts by commercial banks, regional rural banks, and credit cooperatives to provide microfinance through establishing links with SHGs. Indeed, AP accounts for 55 percent of the total volume of credit extended under the SHG-Bank linkage program India-wide, and a little over 50 percent of the total number of groups benefiting from this program are located in AP. Moreover, a diversity of microfinance models coexist in the state. UP, it was thought, would provide a sharp contrast to AP, accounting for less than 2 percent of the total number of SHGs benefiting from the SHG-Bank linkage program and the total amount of credit extended under the program. Given that UP is the most populous and among the poorest states in India, considerable attention is now being focused on how to improve rural access to finance in that state. Therefore, while UP's experience would help us understand better the constraints and challenges to improving rural access to finance, AP's experience would help highlight what can be done to overcome constraints and improve access.

The sampling framework methodology for the survey used random sampling techniques including stratified random sampling. The sampling framework was formulated to select a representative sample of

- households (across landholding and occupation categories within each village);

- villages (geographical proximity to the nearest town and size of village); and
- districts (per capita agriculture income and per capita formal credit).

The detailed framework for each level—district, village and household is presented below.

<i>Level</i>	<i>Instrument</i>	<i>Remarks</i>
District	<ul style="list-style-type: none"> • Secondary data on per capita agriculture income and per capita formal credit for ranking villages 	
Village	<ul style="list-style-type: none"> • Census data for listing of all village names and random selection of villages • Secondary data on distance from the nearest town and number of households • Village questionnaire to obtain basic data on the village 	<ul style="list-style-type: none"> • Census information was used • Key informant in village was used
Households	<ul style="list-style-type: none"> • Listing proforma • Detailed survey questionnaire 	<ul style="list-style-type: none"> • 1 page sheet administered to all households in the 60 selected villages/ state • Detailed questionnaire administered to selected households of each selected village

<i>Level</i>	<i>Basis of sampling</i>	<i>Number selected</i>
District	<ul style="list-style-type: none"> • Two primary variables—Per Capita Agriculture Income and Per Capita Formal Credit—used to rank all districts (UP has around 70 districts and AP has 23) into six strata for each variable. • Stratified random sampling then used to select two districts from each stratum. 	12 districts per state

<i>Level</i>	<i>Basis of sampling</i>	<i>Number selected</i>
Village	<ul style="list-style-type: none"> • Used 1991 Census information on listing of villages and randomly select 10 villages per district. • Classified villages into strata according to distance from nearest town (three categories: <10 kms, 10–25 kms. >25 kms) and in terms of number of households (size). • Selected five villages from the originally randomly selected list of 10 to ensure a degree of variation on both distance and size 	<p>Five villages per district</p> <p>60 villages per state</p>
Households	<ul style="list-style-type: none"> • In each of the selected villages, a quick listing of all households was undertaken • In each selected village, the households were stratified into nine categories that include: <ul style="list-style-type: none"> ◦ Two landless categories (one who are laborers and the other who are micro-entrepreneurs) ◦ Five landholding categories according to land holding sizes ◦ The landholders' category was further subdivided into two sub-categories (one those with <50 percent dependence on non-farm income) • Five households were randomly selected from each stratum except the one with landless micro-entrepreneurs where 10 households were selected. Thus, a total of 50 (8*5+10*1) households were selected for detailed survey from each village. 	<p>Assuming on average around 200 households per village, the quick listing was for ~12,000 households per state;</p> <p>50 households per village are administered the detailed survey</p> <p>questionnaire;</p> <p>A total of 3,000 (50x60) households were administered the detailed questionnaire in each state</p>

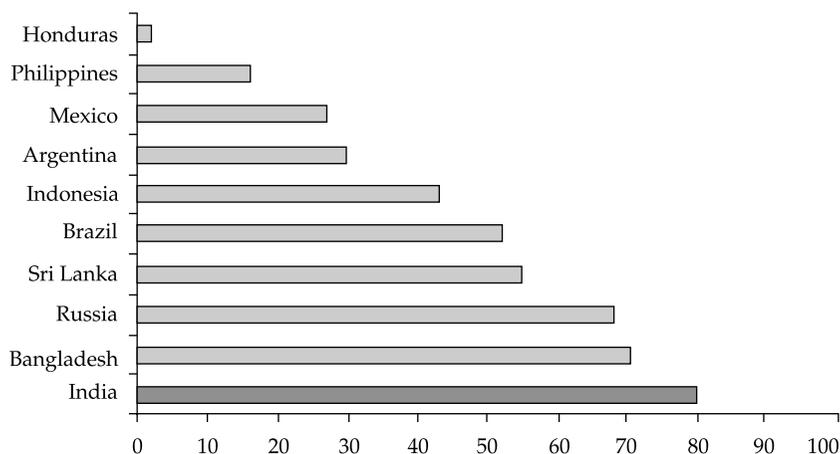
Appendix 3

Retail Rural Financial Institutions: Summary Review of Performance¹

Governance and Ownership

A distinct characteristic of India's banking system is the significant extent of state ownership. In 2001, close to 80 percent of banking assets in India were state-owned although this had come down to 73 percent by 2004 (Figure A3.1). More than 90 percent of the outstanding rural loans are accounted for by state-owned banks, including the 27 public sector banks and 196 RRBs.² Government ownership distorts bankers' incentives, affects prudent management, and leaves banks vulnerable to the pressures of moral suasion. And while the rural cooperative banks have only minority government shareholding, the state continues to exercise considerable control—the state government, through the Registrar of Cooperative Societies, controls all matters relating to registration, membership, election, financial assistance, loaning powers, business operations, loan recovery, and audit of cooperatives.

Figure A3.1 International Comparison of Government-Owned Bank Assets (percent)



Source: Barth, Caprio, and Levine 2001.

With the banking sector reforms initiated in 1991, governance issues have started receiving increasing attention in commercial banks, especially with regard to the responsibilities of boards of directors, accountability to shareholders, criteria for selection of independent members of the board, size and composition of boards, and appointments of CEOs and committees of the board—including those for audit, nomination, remuneration, and investment. Increasingly, public-sector banks are raising capital from the public, which has helped improve their corporate governance through greater shareholder participation.

However, cooperative banks and RRBs are lagging behind due to their relatively slower pace of adoption and/or implementation of reforms that are under way in the rest of the banking system. Additionally, governance issues in cooperative banks are exacerbated by duality of control by state governments on the one hand, and, RBI/NABARD on the other. State control continues to mean that RRBs and rural cooperatives have to operate within the contours of government diktat and may not be able to take decisions independently—they frequently have to reduce interest rates on loans to farmers on account of moral suasion, reschedule agricultural loans, operate as channels for the delivery of various government schemes and debt- or interest-waiver schemes,³ and have their elected boards superseded.⁴ These are just a few examples of misgovernance. These factors hinder the proper management of rural banks and reduce the attractiveness of rural lending for these banks.

Management Issues

Ongoing banking sector reforms have accelerated the processes of qualitative transformation of management and deployment of technology in commercial banks, but their rural branches as well as most RRBs and rural cooperative banks lag in this. More needs to be done for rural banks in terms of training managers and staff for improving credit appraisal, supervision and monitoring skills, and improving the quality of services provided to rural clients, as well as in creating the right incentive structures for rural lending. Weak management systems and human resource (HR) issues are most serious in cooperative banks, which lack in professionalism and are faced with imbalances in staffing and poor-quality personnel. CEOs for many StCBs are often government officials (rather than professionals) appointed by local state governments, and those for DCCBs are either government or StCB officials.

On the technology side, while the mainstream/urban commercial banking system has seen important progress in introducing electronic banking, ATMs, electronic fund transfers, and electronic clearing services, rural branches of commercial banks, RRBs, and cooperatives are way behind in this regard.

Financial Performance

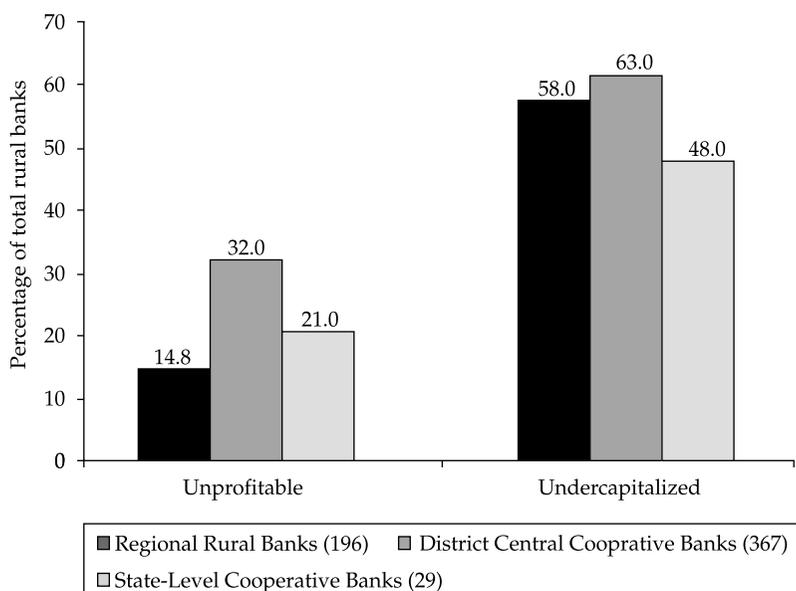
In overall terms, the financial performance of RRBs and cooperative banks is weak; only commercial banks' overall financial position can be considered satisfactory. Commercial banks' rural operations cannot be analyzed separately as these are subsumed in their overall performance. But as some select indicators on portfolio quality and asset composition below reveal, their performance on some critical indicators may not be much better than those of RRBs and rural cooperative banks.

Capital Adequacy

Commercial banks perform quite well on capital adequacy. Capital adequacy for commercial banks was comfortable at the end of March 2003—all 27 public sector banks, which account for more than 90 percent of the total rural portfolio of all commercial banks, have a very comfortable risk weighted capital-adequacy ratio in excess of 10 percent; only 2 banks (from among the smaller private banks) out of the 93 commercial banks, have a ratio below 8 percent.

However, the capital base of RRBs and cooperative banks is very weak on account of sustained losses over time (Figure A3.2).⁵ Many of these institutions continue to operate as banks despite having unacceptably

Figure A3.2 Status of Rural Banks in India



Note: Figures in parentheses in key represent total numbers of rural banks.
Source: RBI reports and NABARD statistics.

low, and even negative, levels of net worth. More than a quarter of RRBs and DCCBs and a little over a fifth of StCBs had negative net worth. An additional and significant proportion of these banks have a positive but extremely weak capital base. The average for all RRBs of the net worth to total-assets ratio (proxy for Capital to Risk Weighted Asset Ratio [CRAR] which is not computed at present) is just 2.5 percent (despite recapitalization by the government) and 4.9 percent for all DCCBs and only StCBs with a 7.2 percent ratio are, in aggregate, at a relatively comfortable position. Since these institutions constitute an important part in the flow of formal sector credit in rural areas, their extremely weak financial position, especially that of the cooperative credit institutions, particularly at the district level, is an issue of great concern.⁶

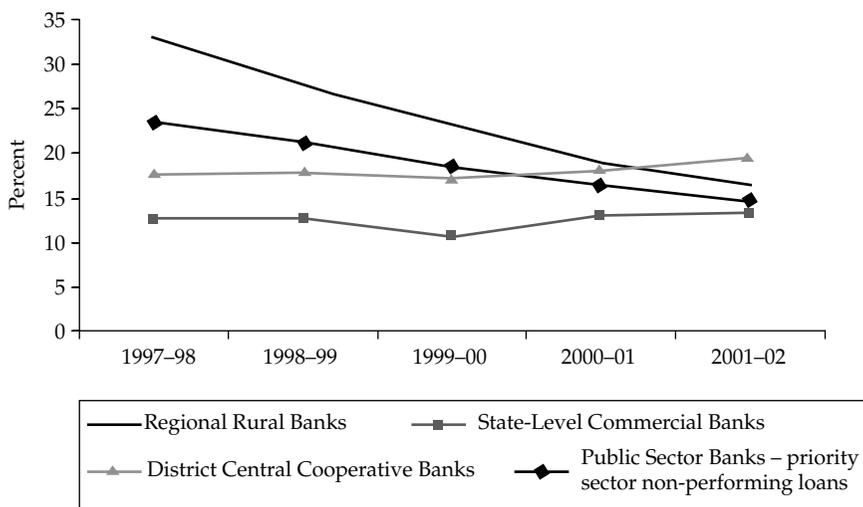
As inadequately capitalized RRBs and cooperative banks continue to operate and mobilize deposits, a significant proportion of total deposits are housed in weak rural banks. For the RRBs, a little more than 40 percent of total deposits were housed in weak banks (end March 2002), while for the rural cooperative banks the level was over 60 percent (end March 2001). While RRB and cooperative-bank deposit liabilities are only a small proportion of the total liabilities of the larger banking system, given that these institutions account for a large percentage (60 percent) of the physical branch presence of the banking system in rural areas, perceived distress could have a much larger impact on the banking system than would otherwise be expected.

While risk to depositors in the RRBs is mitigated on account of their ownership structure, deposit insurance, and the financial stake of the sponsor commercial banks that themselves have a strong capital base, for the cooperatives, such risk-mitigating factors are absent.

Asset Quality and Composition

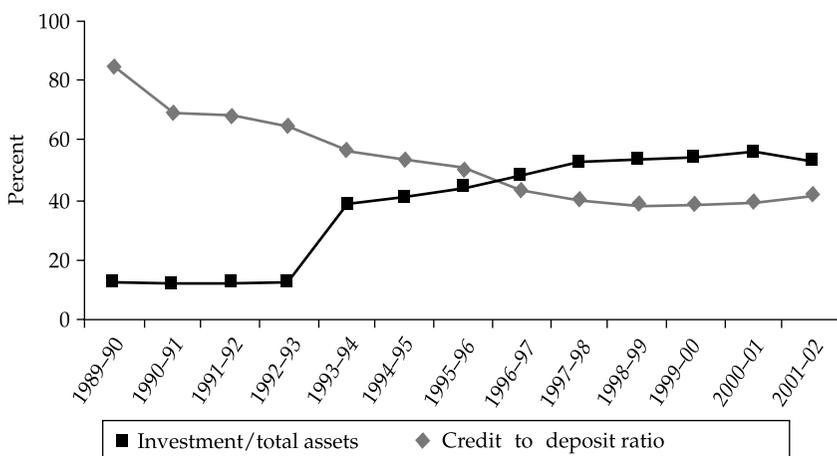
Asset quality of rural finance institutions (RFIs) across the board, including commercial banks, is weak and indicates that whatever lending does take place is generally of poor quality. Figure A3.3 shows that NPL ratios are high for all categories of RFIs. And even though RRBs have shown improvement over the last five years, present NPL levels remain uncomfortably high.⁷ Disturbingly, much of the NPLs of RFIs are in the doubtful category of classification. The reasons for poor asset quality are many, including the directed nature of lending, lack of accountability structures, poor management and human resource quality, weak credit-appraisal systems, and lack of ability to enforce collateral.

In terms of asset composition, the balance sheets of the cooperatives indicate a clear emphasis on rural lending; however, commercial banks and RRBs have been steadily moving away from rural advances and toward investments.

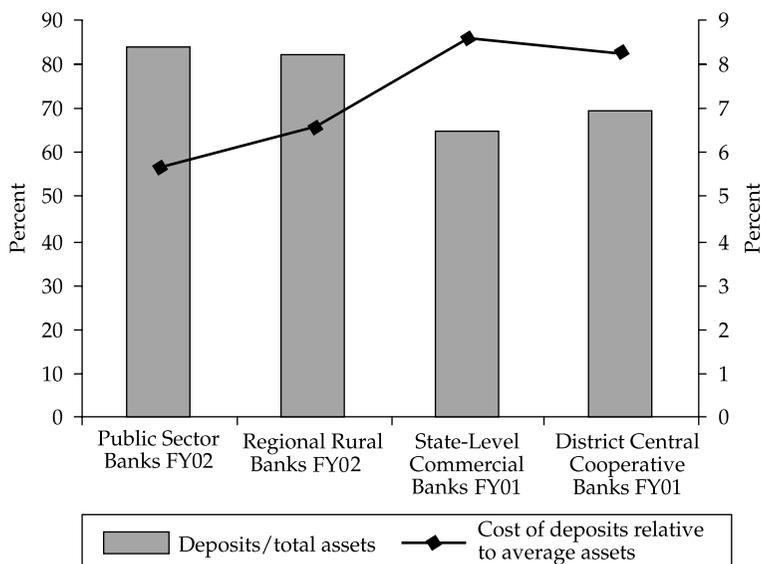
Figure A3.3 Credit Outstanding by Source

Source: RBI reports and NABARD statistics.

For RRBs, poor portfolio quality and lack of incentives to undertake lending have contributed to increased risk aversion and led to a declining credit to deposit (CD) ratio hovering at a low 40 percent and falling over time, with asset composition skewing toward an investment-driven portfolio (Figure A3.4). Commercial banks, especially in recent years, have faced a much sharper decline in rural-CD ratio

Figure A3.4 RRBs: Asset Composition Trends

Source: NABARD statistics.

Figure A3.5 Deposits of RFIs: Costs and Significance

Source: RBI reports and NABARD statistics.

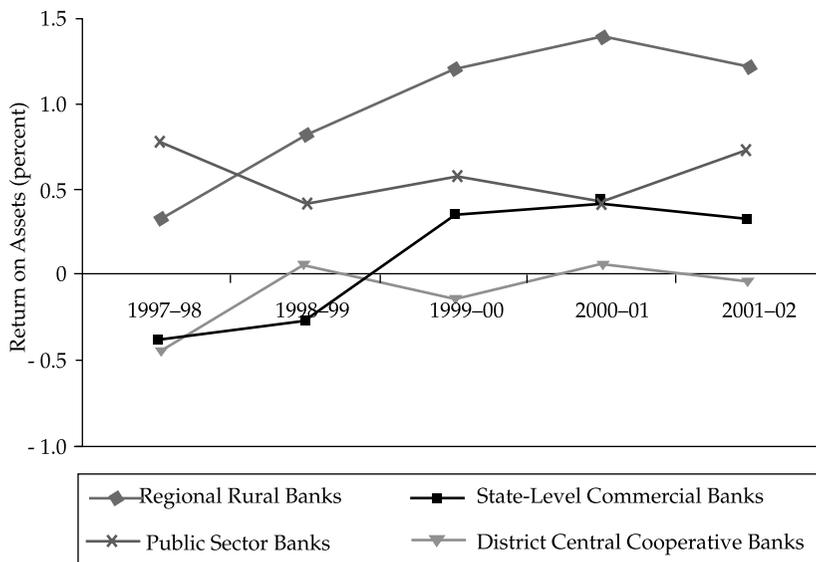
relative to overall CD ratio—this can be partly attributed to the poorer portfolio performance on rural loans. At present the rural-CD ratio stands at 42 percent, declining from around 60 percent in the mid 1980s, and compared to an overall level of 54 percent.

Liability Composition

All RFIs in India have a high dependence on deposits as a funding source—see Figure A3.5. For RRBs and public-sector commercial banks, deposits stand at more than 80 percent of total assets and 90 percent of total debt, and even for cooperative banks the deposits to total assets ratio exceeds 60 percent for state-level banks and 65 percent for district-level cooperative banks. This is indicative of a stable source of funding for banks. As the figure also indicates, the cost of deposits, relative to that of RRBs and commercial banks, is much higher for cooperative banks and, consequently, impacts of moral suasion on interest rate caps on advances are far worse on these institutions.

Earnings Quality

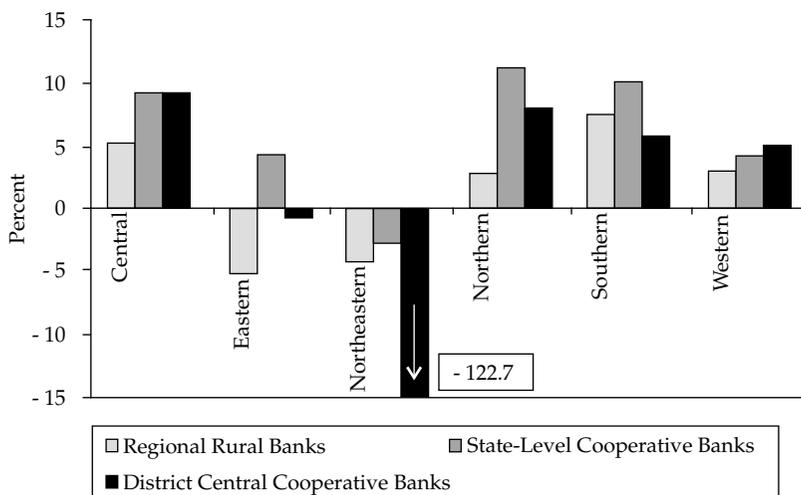
The overall recent earnings quality of RRBs and commercial banks has been satisfactory; however, cooperative banks' performance is weak—

Figure A3.6 RFI: Profitability (Return on Assets)

Source: RRB/Coop.: NABARD (RoAvg Assets); RBI:PSB data.

see Figure A3.6. Only commercial banks have had a steady performance on earnings and FY 2003 has seen further improvements, with return on assets at around 1 percent. However, this is not necessarily reflective of their rural operations and profits have been significantly driven by trading income that has been a major contributor to the operating profit (35 percent). While in recent years RRBs have showed improved profitability, much of this is not on account of lending operations and does not represent a fundamental improvement in their lending business and financial performance—as much as 64 percent of total income came from sources other than advances, of which 43 percent was investment income in FY 2002. This makes the earnings forecast for RRBs particularly susceptible to market- and interest-rate risks. In fact, the low CD ratio for RRBs (hovering around 40 percent for the last five years) indicates that lending has really stagnated. While the cooperative banks have had a lending-focused approach with high CD ratios, poor quality of assets and low financial margins have led to weak performance on earnings.

The continued weak earnings performance of cooperative banks raises special concerns, given their already weak capital base. It is evident that urgent attention to their financial health and management is needed. The particularly poor performance of DCCBs is of concern since in the three-tier short-term credit structure DCCBs play a crucial role by mobilizing deposits and channeling these funds to grassroots-level PACS and a range

Figure A3.7 RFI Capital Base Across Regions

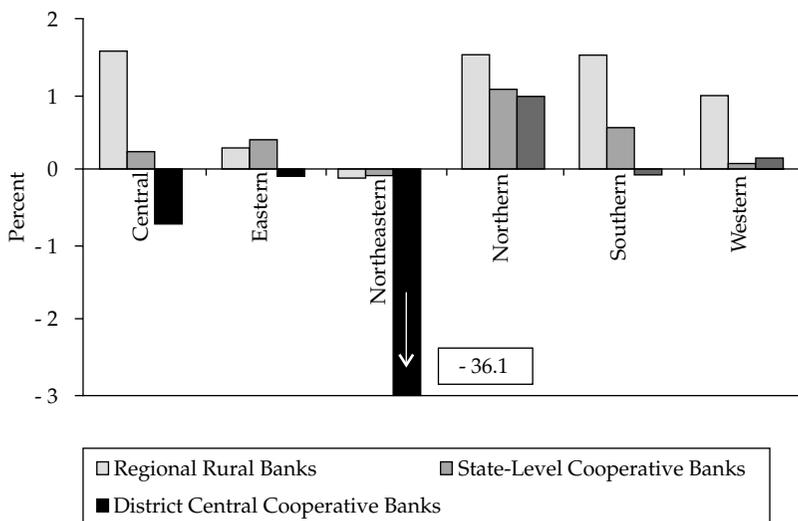
Source: NABARD statistics. FY 01 for coops, FY 02 for RRBs.

of other cooperatives. This is particularly true since the analysis above would appear far worse if it were undertaken with the application of currently used prudential norms for commercial banks, many of which presently do not apply to RRBs and cooperative banks, particularly for provisioning, income recognition, and capital adequacy.

Regional and Other Variations

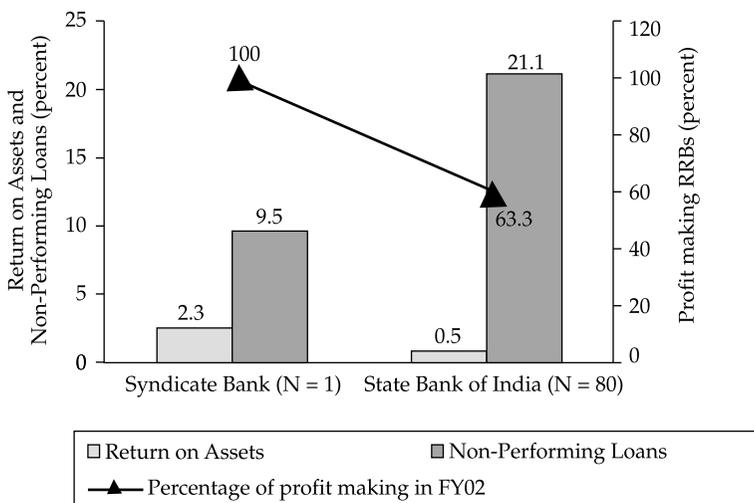
Regional and inter-bank variations are significant and indicate the additional complexities that need to be addressed in improving the performance of RFIs. While on a sectorwise aggregate average basis commercial banks, RRBs, and StCBs made profits, and DCCBs as a whole were close to break-even, a high proportion of the RRBs and cooperatives were loss-making—as many as 15 percent of RRBs (FY 2002), 21 percent of StCBs and 32 percent of DCCBs (both FY 2001). Variations exist between RFIs across a number of financial parameters across regions/states and these are highlighted for profitability and capital adequacy in Figures A3.7 and A3.8, which clearly indicate that RFIs in the north-east of the country are much worse off than those anywhere else. More generally, the north, south, and western regions are better performing than the other regions. For the RRBs, variation also exists in terms of sponsor banks. Syndicate Bank clearly appears to be the most successful among the commercial banks, having a stake in multiple RRBs, while on the whole the 30 RRBs sponsored by State Bank of India are underperformers (Figure A3.9).

Figure A3.8 RFI Profitability Across Regions



Source: NABARD statistics. FY 01 for coops, FY 02 for RRBs.

Figure A3.9 RRBs: Variations by Sponsor Banks



Source: NABARD RRB statistics 2002.

In conclusion, while commercial banks' overall financial position is, by and large, sound, the financial viability of their rural branches and also the rural operations of RRBs and rural cooperative banks is weak. Adequate attention to revamping urgently the operations and financial position of these institutions is critical. Given the large physical branch presence of RRBs and cooperative banks in rural India, their poor performance on capital adequacy, profitability, and asset quality indicate serious issues across critical financial parameters. Systematic and drastic changes in the way RFBs are operating need to be made urgently if these institutions are to play an effective role in the provision of rural finance services.

Notes

1. Those under the purview of the Banking Regulation Act, 1949—these include the commercial banks, the RRBs, and the StCBs and DCCBs. Together these account for almost all the lending to and branch presence in rural areas. The 32,000-odd rural branches of the commercial banks and the RRBs are supplemented by 14,000 cooperative bank branches and 98,000 grassroots-level PACS.

2. RRBs' ownership structure is as follows: 50 percent central government stake, 15 percent by the state government and 35 percent belongs to the sponsor commercial bank. Of the 196 RRBs, only 2 RRBs have private sector banks as their sponsor bank, but are still majority-owned by the government.

3. Most significantly the Agriculture and Rural Debt Relief Scheme of 1989–90 but several other subsequent schemes, including, most recently, the *kharif* interest waiver in 2002–3.

4. The position at end-March 2001 was that the elected boards of 75 of the 367 district cooperative banks had been superseded.

5. Data for RRBs are for the year ending March 2002; for cooperatives, for the year ending March 2001. Since risk weighted CRAR is not available for RRBs and rural cooperative banks (StCBs and DCCBs), net worth to total assets (NW/TA ratio) has been used as a proxy measure for capital adequacy. The NW/TA threshold for capital adequacy for RRBs has been taken at 5 percent and for cooperative banks at 7.2 percent—the thresholds are based on the proportions of risk weighted assets to total assets. Since the bulk of RRBs' assets are held in government securities with an expected lower risk weight, therefore, the threshold for RRBs is lower than that for cooperatives.

6. Cooperatives and RRBs account for more than 50 percent of agricultural credit flow. Also, they have great branch outreach; the RRBs have around 14,000 branches, while the cooperative banks rural branch penetration is very deep—there are 14,000 cooperative bank branches and 98,000 PACS.

7. For commercial banks, a proxy for rural-asset quality has been taken as the NPL ratio on the priority-sector advances of public-sector banks; public-sector banks account for more than 90 percent of the outstanding advances in rural areas among commercial banks.

Appendix 4

Apex Rural Finance Institutions

Three apex institutions are of main relevance to rural finance. These are the RBI, NABARD, and SIDBI. A short summary of the roles of each of these institutions is provided below.

Reserve Bank of India

Being the central bank of the country, RBI's primary responsibility has been the management of the country's monetary and payment systems. However, starting with the era of economic (central) planning in early 1950s, RBI increased its focus on promotional and/or developmental activities in the financial sector, using financial institutions as catalysts for supporting plan objectives and targets. The overall policy environment included administered resource allocation at the macro level, regulated interest rates, directed credit, and the presence of RBI and government officials on boards of financial institutions to assure policy compliance and supervision.¹

With the gradual implementation of the financial (banking) sector reforms since the mid 1990s, RBI is by and large changing toward limiting its functions to traditional central banking, allowing retail financial institutions to increasingly operate in a market-oriented and competitive environment, backed by a regime of increasingly deregulated interest rates, supplemented by RBI's enhanced prudential supervision. However, in some areas, especially rural credit, progress has been slow and RBI, in conjunction with government, continues to play a dominant role, directly and/or indirectly, in policy-making, credit planning, priority-sector lending, and regulating supply of funds to NABARD.

RBI retains the responsibility for the overall national rural credit policy and for issuing directives on rural credit. It thus remains active in the sphere of (a) formulation of rural credit policy (as part of the overall monetary and credit policy); (b) priority sector lending; and (c) interaction with government and NABARD on issues concerning rural credit. As part of its central banking functions, RBI is also responsible for prudential supervision of commercial banks, including their rural credit operations. To facilitate this role, RBI created a department called Rural Planning and Credit Department (RPCD) with a number

of staff at its central office in Mumbai and regional offices, generally one in each state. RBI staff at the regional level participate in annual district/state-level rural credit planning exercises done by local government agencies and banks, along with NABARD's district- and state-level staff.

However, over time the direct role of the RBI in rural finance has been declining in relative terms, particularly after the creation of NABARD in 1982. RBI has delegated to NABARD the responsibility of supervising rural cooperative banks and RRBs. RBI's residuary functions include, mainly (a) sanctioning of a general line of credit to NABARD (though in relative terms the importance of this for NABARD has been declining over time); and (b) making annual allocations from profits to the two statutory funds now maintained by NABARD. RBI has three of its directors (members of the RBI board) on NABARD's board, which perhaps provides an effective link between the RBI (as the central bank) and NABARD (the second-tier apex bank) for policy deliberations.

Clearly, as the regulator of the rural finance sector, the central bank continues to play a critical role. Strengthening prudential regulations and ensuring improved supervision—particularly of the weak rural cooperative banks and RRBs—facilitating the creation of an enabling environment for rural finance (including improving the contract enforcement mechanism and facilitating credit information on rural finance), improving policies related to interest rates and directed credit, and ensuring regulations for MFIs, are all areas where the RBI needs to play a leading role.

NABARD

NABARD was established in 1982 by an act of Parliament as a public sector institution. Its share capital is contributed by RBI and the government, currently at 73 percent and 27 percent of the total (Rs2,000 crores or US\$435 million equivalent), respectively. NABARD has a nominated board of directors comprising a chairman, a managing director (both appointed by government in consultation with RBI) and representatives from the RBI, the central government, state governments, and other directors nominated by the central government. NABARD has three main functions: (a) institutional development; (b) credit provision; and (c) supervision.

The institutional development functions include development and implementation of rural credit policy with a focus on integrated rural development and related training, research and consultancy/ advocacy. The credit function primarily covers refinancing of co-operatives, RRBs, and commercial banks—the credit includes short, medium and

long-term loans for agriculture; refinancing for SHG–Bank linkage, production, and marketing credit. NABARD can also make direct loans but currently this window is limited to loans provided to state governments for rural development and rural infrastructure-creation, which is financed through commercial bank deposits with NABARD to the extent of their shortfall in meeting the mandated priority sector lending target of 18 percent of net bank credit for agriculture (see Table A4.1 for amounts reflected against the Rural Infrastructure Development Fund, RIDF). Additionally, NABARD provides technical assistance and advice on rural credit policy and institutional issues to the central government, state governments, local governments, microfinance institutions and SHGs.

Table A4.1 NABARD's Balance Sheet

(Rs billion)

<i>Sources of Funds (as on 31 March)</i>	2003	2002	<i>Uses of Funds (as on 31 March)</i>	2003	2002
Capital (incl. Advar towards capital)	20.00	20.00	Investments in Government Securities	13.55	12.98
Reserves and Surplus	43.19	36.26	Refinance Outstanding (Medium and Long-term)	254.18	228.71
NRC (LTO) Fund	129.45	127.23	Production and Marketing Credit	60.53	67.72
NRC (Stabilization Fund)	14.74	12.52	Mediumterm Loans from NRC (LTO) Fund	0.09	0.15
Borrowing from GOI (incl. IDA/IBRD Assistance)	5.89	8.32	Loans to State Governments for contribution to share capital of co-operative Credit Societies	4.41	4.72
Borrowing from RBI (General Line of Credit)	57.92	65.00	Other Loans	0.10	0.09
RIDF Deposits	121.59	97.25	Loans out of RIDF	130.62	104.35
Open Market Borrowings	87.02	60.78	Conversion Loans from NRC (Stab. Fund)	3.70	4.88
Foreign Currency Loans (KfW Germany)	3.02	2.50	Others	41.69	27.38
Others	26.03	21.12			
Total Liabilities	508.85	450.98	Total Assets	508.85	450.98

As for supervision, by powers delegated by RBI, NABARD does on-site and off-site surveillance of short-term cooperative credit banks and RRBs. Besides this, NABARD undertakes supervision of long-term cooperative banks on a voluntary basis in its capacity as a major subscriber to their debenture portfolio. In 1999 NABARD established an independent Board of Supervision (BoS) for cooperative banks and RRBs to provide guidance and direction on matters relating to supervision. This is consistent with a similar initiative taken by RBI in setting up a Board of Financial Supervision (BFS) in 1994, following the recommendation of the Narasimham Committee I. In practice, under its delegated authority, NABARD sends all supervision reports to the RBI as this continues to be the regulatory authority, and regulatory follow-up actions based on these reports are taken with RBI's concurrence.

Clearly, given NABARD's mandate, its role in rural finance is critical and a lot of the credit for the development of this sector, the increase in the scale of the SHG-Bank linkage program, and other such can be attributed to NABARD. Nonetheless, going forward, in addition to the challenges to sustain the performance of well-performing initiatives (KCCs, SHG-Bank linkage), there are certain issues that need consideration. NABARD's role as supervisor of the rural cooperatives and RRBs (delegated by the RBI), as well as a development and refinancing agency to these institutions, creates a potential conflict of interest. To the extent that its refinancing role may face a natural decline in demand in a general falling interest rate, this issue may well be addressed on its own in course of time, even though it would mean that NABARD will need to explore other sources of revenue generation. However, Narasimham Committee II suggested that, over the longer term, all regulatory and supervisory functions over rural credit institutions should vest with RBI's BFS. Therefore, the issue of integration of the Board of Supervision set up by NABARD with the BFS set up by RBI needs to be explored further.

In the interim, NABARD needs to strengthen its supervisory functions further, even while making its refinancing eligibility conditions stronger and linked clearly to the bank's ability to service the debt (including specific consideration to the bank's CRAR).² In the interests of not causing a sudden large dip in ground-level credit flow, the conditions for refinancing could perhaps be made more stringent in a phased manner. Using an appropriately designed and balanced carrot and stick approach is critical since it provides signals to rural banks on the need for a strong balance sheet to qualify for refinancing from NABARD, particularly in a context wherein the biggest challenge confronting NABARD is the weak financial position of rural cooperatives and RRBs that it supervises and finances.

The institution also needs to review its role in financing projects against government guarantees or lending to state governments with

a charge on their fiscal resources (under Rural Infrastructure Development Fund, RIDF)—such financing needs could be undertaken, but only for those cases where the underlying financing is a financially viable proposition. Already, there are instances where, despite such arrangements, state governments express inability to service their debt to NABARD.

Also, in terms of its own capital structure, NABARD's strong balance sheet (Table A4.1 above) can perhaps be used to leverage greater market-based fundraising. Further, NABARD can play an important role in creating an enabling environment for rural finance. Initiatives could be strengthened in supporting rural banks in contract enforcement, facilitating improved credit information on rural clients, facilitating technical inputs, capacity-building among rural banks (utilizing its existing grant resources for such purposes), working with state and central governments to ensure provision of a conducive policy framework for rural finance (avoidance of interest waivers, not allowing cooperatives to be forced to be used as channels for government schemes/PDS without adequate margins), working with regulators to widen the scope of business, and facilitate new lines of businesses for rural banks (bank assurance, SHG–Bank linkage, franchisees of public and private sector banks). All this would improve utilization of the vast banking infrastructure that already exists in the country.

SIDBI

Another financial institution of relevance to the rural sector is the Small Industries Development Bank (SIDBI), which was established by an act of Parliament in 1989 to function as the principal financial institution for the promotion, financing and development of industry in the small-scale sector, and to coordinate the functions of institutions engaged in similar activities. SIDBI's role in rural finance is most prominent in terms of the microfinance sector, where the agency has been taking a leading role in supporting the scaling up of MFIs through lending and capacity-building efforts.

SIDBI's role in rural finance is thus particularly important from the point of view of its support to MFIs. In this field SIDBI can perhaps play a significant role by acting as a catalyst to facilitate an enabling regulatory environment which provides foundations for the sustained growth of MFIs. The areas where MFIs have expressed the need for regulatory changes are listed in Appendix 5. In this regard, as a leading apex financier for MFIs, SIDBI needs to further its role, perhaps in conjunction with MFI networks, to pre-empt any kneejerk regulatory reaction, particularly if there is any instance of rural poor clients losing their deposits by the odd, unscrupulous MFI. Moreover, SIDBI's role in

fostering innovation, new technology, and crowding in private-sector financing to MFIs has been important. It needs to pursue these areas even more in the future to help increase the sustained growth of MFIs in the country. This growth of MFIs is important, if for nothing else than for serving as a demonstration model for formal-sector rural banks on how new and innovative approaches can be used to address some of the key problems that banks face in rural credit—information asymmetry, transaction costs, contract enforcement, and recovery. SIDBI's role can also be strengthened to address the needs of NGOs transforming into MFI-NBFCs via of introducing new financial instruments, including equity capital and subordinate debt for MFIs. One other area where SIDBI could play a role is contributing to the creation of credit information on microfinance clients, using its base of NGO/MFI partners to develop the database.

Notes

1. Established in 1935 as a shareholders' bank, RBI was nationalized in 1948. The Reserve Bank of India Act, 1934, which was amended a number of times, provides for provisions that either enable the Indian Government to give directions to RBI or require RBI to consult with government on specific matters. The government plays an important role, on its own and through RBI, in matters concerning rural credit policies and institutions.

2. Presently applicable eligibility conditions are weak: For cooperative banks, if recovery is more than 50 percent of demand in the previous year and the bank has a non-overdue portfolio equivalent to the size of the refinancing from NABARD (the latter condition does not mean much since loans are often rescheduled), refinancing can be extended.

Appendix 5a

Regulation of Rural Banking— Select International References

<i>Country</i>	<i>General financial system regular</i>	<i>Specific regulation</i>	<i>Fragmented regulation</i>	<i>Comments</i>
Australia	X			Since 1999, credit unions have held the same license as banks and are subject to the same single set of flexible prudential standards for all deposit takers.
Canada			X	Regulation of credit unions involves primarily provincial governments, although the federal government charters and regulates the Credit Union Central of Canada. The legislative and regulatory framework for these intermediaries generally parallels that of federal financial institutions, such as banks.
Chile	X			Each type of microbanking intermediary is regulated by its own specific law, the General Banking Law and the General Cooperatives Law.

<i>Country</i>	<i>General financial system regular</i>	<i>Specific regulation</i>	<i>Fragmented regulation</i>	<i>Comments</i>
China		X		All financial institutions are regulated by the central bank, but specific features apply depending upon the intermediary.
Indonesia			X	Commercial and rural banks are regulated under the Banking Act of 1992. However, Rural Fund and Credit Institutions (LKDPs) fall under sub-national jurisdiction, while Savings and Loan Cooperatives are regulated by the Ministry of Cooperatives and Small Enterprises.
Korea		X		Each type of microbanking intermediary is regulated by its own specific law, with commercial banks falling under the General Banking Act.
Mexico		X		Following the enactment of the Popular Savings and Credit Law in 2001, practically all deposit taking institutions fall under the same regulatory framework.

Source: Adapted from APEC 2002.

Appendix 5b

Supervision of Rural Banking— Select International References

Country	<i>Direct supervision</i>		<i>Delegated or auxillary supervision</i>	<i>Comments</i>
	<i>by the same Institution that supervises the entire banking system</i>	<i>by a decentralized government agency specifically for their insitutional form</i>		
Australia	Australian Prudential Regulatory Authority			Credit unions hold the same license and are supervised on the same basis as banks.
Canada				All credit unions are provincially incorporated. Consequently, the industry is almost exclusively regulated and supervised at the provincial level. The federal government does, however, play a regulatory role in the credit union movement through some of the centrals. The national central is chartered and regulated by the federal government.

Country	Direct supervision		Delegated or auxiliary supervision	Comments
	by the same Institution that supervises the entire banking system	by a decentralized government agency specifically for their insitutional form		
Chile	Superintendency of Banking and Financial Institutions	Department of Cooperatives of Ministry of Commerce	Federation of Saving and Loan Cooperatives (FECRECOOP)	The Department of Cooperatives of the Ministry of Economy, which supervises small saving and loan cooperatives, has delegated some of its functions to the FECRECOOP.
People's Republic of China	People's Bank of China			Supervision is done through separate departments.
Indonesia	Bank of Indonesia (BI)	State Ministry for Cooperatives and Small Enterprises (Savings and Loans Cooperatives)	Bank Rakyat Indonesia	Bank of Indonesia (central bank) supervises commercial banks and most of the rural banks. However, some smaller-scale rural banks are supervised by BRI on behalf of the Central Bank.
Korea	Financial supervisory Commission			
Mexico	National Banking and Securities Commission (NBSC)		Federations	Federations may group two types of intermediaries: cooperative savings and loans societies and popular financial societies.

Source: Adapted from APEC 2002.

Appendix 6

Rural Banking Crises and Policy Reform—Recent International Experiences

<i>Country</i>	<i>Type of intermediary</i>	<i>Policy response</i>
Korea	Mutual savings and Finance Companies, City Banks	Authorities fostered exit and mergers as part of an overall policy for the domestic financial sector following the 1997 crisis.
Mexico	Savings and Loan Cooperatives	In 1999–2000 bad management practices in some non-regulated cooperatives forced the government to intervene to avoid a massive run against these institutions.
Peru	Cajas Rurales and EDPYMES	Over the past few years, problems associated with poor risk management and lack of technical capacity led authorities to intervene, forcing (in some cases) mergers among intermediaries.
Chinese Taipei	Credit Cooperatives and Credit Departments of Farmers and Fishermen’s Associations (FAs)	Cronyism and poor risk evaluation affected the sector, leading to a high non-performing loan ratio and poor portfolio quality. As a result, authorities have implemented broader reforms aimed at transforming credit cooperatives into commercial banks and FAs into commercial/ agricultural banks.

<i>Country</i>	<i>Type of intermediary</i>	<i>Policy response</i>
Thailand	Bank for Agriculture and Agricultural Cooperatives (BAAC) and Cooperatives	In the aftermath of the 1997 crisis, BAAC faced a critically low capital adequacy rate, forcing the government to inject more capital. Thai cooperatives were also affected by this crisis, although less than 1 percent faced bankruptcy.

Source: Adapted from APEC 2002.

Appendix 7

Enabling Framework for MFIs—Demands from the Sector

- *Reducing minimum start-up capital requirements to facilitate the transformation of MFIs into NBFCs.* At present, the minimum start-up capital requirement for registering as an NBFC in India is high (Rs20 million, or US\$465,000), beyond the reach of most MFIs. MFI representatives argue that these requirements should be relaxed for MFI-NBFCs. In Indonesia, for instance, the comparable minimum capital requirement ranges from US\$58,000 to US\$232,000. In the Philippines, the low start-up minimum capital requirement for rural banks is between US\$68,000 and US\$170,000; this has prompted the conversion of many erstwhile microfinance NGOs into rural banks.
- *Encouraging multiple sources of equity for MFIs.* MFIs argue that they have problems raising equity because (a) NGOs are not allowed to invest in MFI equity because of the charitable status of NGOs under the Sections 11 and 12 of the Indian Income Tax Act; and (b) regulation on foreign direct investment in MFIs dictates that foreign equity must be a minimum of \$500,000 for FDI up to 51 percent, US\$5 million for FDI between 51–75 percent, and US\$50 million for FDI between 75–100 percent. MFI advocates argue that these problems could be addressed through, inter alia (a) allowing NGOs to invest in MFIs (under Section 11(4)(xii) of the Income Tax Act); (b) revising the minimum FDI requirements.
- *Facilitating MFIs to raise debt.* While Indian banks have been lending more easily to MFIs than earlier, the supply is still limited. Moreover, until 2002, a number of foreign donors and development finance institutions were lending money to MFIs under the RBI's external commercial borrowing (ECB) scheme, which had been considerably simplified by the RBI over the years. However, in 2002 the RBI stopped allowing MFIs to raise funds through the ECB route, as also from donor agencies. MFI representatives argue that RBI should consider allowing NGO-MFIs access to ECB, provided they meet certain pre-agreed criteria.
- *Permitting MFIs to mobilize savings, with safeguards.* Arguments for allowing MFIs to mobilize deposits, at least from their members,

center on the importance attached to savings by poor households, and also on the need for MFIs to mobilize deposits in order to achieve financial sustainability. It is argued that borrowing cannot be the sole source of funds for lending. While recognizing RBI's concerns about allowing deposit-taking by loosely-regulated entities, advocates of MFIs argue that deposit taking by MFIs can be allowed if appropriate safeguards are put in place. For example, deposit-taking by MFIs can be confined to their borrowers, and an appropriate level of SLR imposed.

- MFI representatives have also made the case that the regulator, jointly with the MFIs, could consider developing a set of prudential norms that are more appropriate to institutions serving the poor, and set up supervision mechanisms around those. The case has also been made that, given the need for, and benefits of, composite microfinance institutions that provide credit, savings, insurance, and other services, regulators should examine the potential benefits of a Microfinance Services Act which would recognize the composite and special needs of the poor and of institutions serving them. Experience from around the world suggests that since microfinanciers are not monolithic, imposing regulatory standards and procedures where none are called for could constrain growth, and that regulation of the sector should be flexible and well tailored (World Bank 2003).

Appendix 8

Summary of Recommendations of Recent Government Committees on Formal RFI Reforms

Capoor Committee: Task Force to Study the Cooperative Credit System and Suggest Measures for Its Strengthening, 2000

Summary of Key Recommendations/Observations

- Cooperatives should be allowed to function as member-driven enterprises with minimum government control and interference
- Implementation of Model Act by all state governments
- Human resource development in cooperatives, including objective and transparent policies for recruitment of staff, no appointment of government officers as CEOs
- Professionalism in cooperative banks; need for professionals in the board and to consider doing away with caderization within cooperatives wherever this is not effective; allowing DCCBs with a good deposit base to have their own staff; audit all levels by professional chartered accountants
- Need to remove overlapping of controls, eliminate duality of control, and make the central bank control and regulate all banking functions
- Allow cooperative banks to diversify their businesses, including exploring avenues for housing loans, consumer loans, financing of services sector, distribution of insurance products
- Enable financing to cooperatives such that their lending operations have sufficient margins and ensure that no unremunerative business is thrust upon cooperatives
- Develop and facilitate funds-management skills among cooperative banks and reduce the role and need to seek the permission of the registrar of cooperatives for making investments
- Delaying cooperative banks: While the three-tier system may be required in future, reorganizing and restructuring wherever necessary should be undertaken to make the entire system viable; consider merging the short- and long-term cooperative structures into one

- Phased compliance with capital-adequacy norms for cooperative banks
- Recovery management: Avoid loan waivers announced by governments; allow provisions of DRT to apply to cooperative banks; allow foreclosure of mortgages by primary cooperative banks for willful defaulters
- Rehabilitation package for cooperative banks, not across the board, but for those with potential to function as viable units—revitalization to cover financial, operational, organizational, and systemic aspects; establishment of a cooperative development fund at NABARD by an initial contribution of Rs500 crores by the central government
- Funding mechanism to revive cooperative banks should be firmed up only subject to states taking steps to ensure elimination of duality of control; share of central and state governments may be in the form of bonds issued in favor of DCCBs bearing a reasonable rate of interest

**Patil Committee: Joint Committee on
Revitalization Support to Cooperative
Credit Structure, 2001**

Summary of Key Recommendations/Observations

- Agreed with the Capoor Committee on the need for revitalization assistance
- Pattern of sharing funding assistance to be between the central and state governments in the ratio of 60:40 (except for the north-east and J&K, where the ratio could be 90:10)
- Form of funding suggested was bonds, as in the Capoor Committee
- Selectivity of states and institutions suggested, rather than an across-the-board revitalization package; conditions for the state governments included, commitment to abolish cadre system, autonomy to cooperative institutions, adoption of the Model Cooperative Act, removal of duality of control, audit by professional chartered accountants, and transparent HRD policies; conditions for the institutions included viable functioning, commitment to enhance value of the shares and undertake timely audits, deregulation of interest rates and fair share of margins between different tiers, grassroots-level business planning, improving systems and rationalization of procedures
- Establishment of a national-level committee for monitoring performance of cooperatives
- De-layering of cooperatives but making this forced

- Support for setting up a cooperative development fund at NABARD for institutional strengthening measures

Vyas Committee: Expert Committee on Rural Credit, 2001

Summary of Key Recommendations/Observations

- Adopt Model Cooperative Act in all states and make the Banking Regulation Act applicable to cooperatives
- Central government to support revitalization of cooperatives and RRBs
- Restore health of the PACS, partly by doing away with the cadre system
- Selective de-layering of the short term cooperative structure and integration of long- and short-term structures
- Training of cooperative bank staff, study on human resource requirements for cooperatives
- RRBs without accumulated losses should be recognized as LABs
- With regard to government schemes, emphasis should be on using groups as channels, but efforts at ensuring group quality are critical
- Efforts at rural non-farm sector financing should be encouraged

Rao Committee: Working Group to Suggest Amendments in RRB Act, 2002

Summary of Key Recommendations/Observations

- Widen scope of financial services to be provided by RRBs
- Capital-adequacy norms, with due adaptation, to be introduced in RRBs in a phased manner · Based on financial health of RRBs, differentiated ownership structures to be allowed
- Prescribed minimum level of shareholding should be at 51 percent for sponsor institutions
- The area of operation of RRBs to be extended to cover all districts of uncovered states/union territories
- Keeping in view the regional character and distinct socio-economic identity of issues, RRBs falling in one socio-economic zone to be amalgamated so as to create one or a few RRBs in each state
- RRBs may have a minimum of five and a maximum of eleven board members, including the chairman. The number of directors not to be fixed uniformly for all RRBs, as at present
- As part of consolidation process, some sponsor banks to be eased out and some FIs and other strategic managing partners to take over as sponsor institutions

- The regulatory framework for RRBs to be on the lines of those for commercial banks, with provision for such bank-specific relaxations as may be necessary for specific time periods; RRBs to be subjected to the statutory norms of licensing and each RRB should be required to obtain a license from RBI under the provisions of the Banking Regulation Act, 1949, within a specific time period; half-yearly financial audit to be introduced in the RRBs
- RRBs may avail of all the services of their sponsor banks/institutions or other established and authorized public-sector portfolio-management service providers, based on their own judgement of costs and benefits for professionalization of the investment function in order to achieve optimal returns on the bank's resources

Source: Adapted from RBI, *Report on Trend and Progress of Banking in India, 2002–03*.

Vaidyanathan Task Force on the Revival of Rural Cooperative Credit Institutions (2005) and the Government of India's Reform Package for Rural Credit Cooperatives

The GoI set up a Task Force on the Revival of Rural Cooperative Credit Institutions in August 2004 under the chairmanship of A. Vaidyanathan to formulate a practical reform action plan to strengthen rural credit cooperatives. The task force submitted its final report in February 2005. Based on extensive consultations with the states, a final reform package was recently approved by the GoI.

Summary of Broad Elements of the Package

- The package covers the period 2005–06 to 2008–09 and includes the following: (a) financial assistance to wipe out accumulated losses (this, however, does not mean writing off loans that are yet to be repaid by borrowers; the cooperatives will have to continue to make efforts to recover these loans) in all three tiers of the rural credit cooperative structure and bring all the institutions to a minimum capital to risk weighted assets ratio of 7 percent in the first year, and further, within three years, to 9 percent for the PACS and an RBI-stipulated ratio for the DCCBs and StCBs; and (b) introduction of legal, regulatory, and institutional reforms that are deemed necessary for the democratic, self-reliant, and efficient functioning of the rural credit cooperative structure.
- Participation by the states is on a voluntary basis. State governments wishing to participate will be entitled to financial assistance under the package provided they sign a formal "consent letter" or memorandum of understanding with the GoI, which will include a commitment to implement (in a phased manner, and within a

- period of three years) the legal, regulatory, institutional, and managerial/operational reforms envisaged. States not ready to make the choice yet will be given two years to make a decision.
- The total cost of the reform package has been estimated at Rs13,596 crores (US\$3 billion). The funding will be shared by the central government (68 percent of the total estimated package, that is, Rs9,245 crores or a little over US\$2 billion), state governments (28 percent), and the credit cooperative structure (4 percent). The central government will provide its share as grants to the states, while the states are expected to meet their share from their budget or through open-market borrowing.
 - The financial restructuring process under the package will start with the PACS (the lowest tier), aiming to restore the financial health of the PACS through cleansing their balance sheets and strengthening their capital base. The premise is that this will enable the PACS to clear their dues to the upper tiers and thereby help reduce the accumulated losses of the DCCBs, which will thereafter be provided assistance to clear their balance sheets and accumulated losses, if any, and to reach the minimum capital adequacy standard. Once the financial health of the DCCBs has been restored, and their dues to StCBs cleared, the StCBs will receive assistance, if required.
 - The proposed financial restructuring process will also be used as a vehicle to dilute the share of state governments in the equity of PACS, DCCBs, and StCBs so that it does not exceed 25 percent of the total subscribed share capital of any institution, and state governments will be encouraged to progressively reduce their equity participation to zero over a three-year period, from the date on which they sign up to the reform program. Where the state government's equity in any institution is more than 25 percent, the excess amount will be converted into a grant by the state government to the concerned entity.
 - All PACS with a loan recovery rate of 50 percent or above (as of June 30, 2004) will be eligible for a one-off recapitalization. PACS with recovery rates of between 30 and 50 percent will qualify for phased assistance in three annual installments at the end of each year, subject to (a) their achieving an incremental increase in their loan recovery rate by at least 10 percentage points on June 30, 2006 against the benchmark recovery achieved on June 30, 2004, and an annual increase of 10 percentage points thereafter; and (b) actions for legal, regulatory, and institutional reforms (it is not clear whether they would be required to simply commit to such actions, or implement them).

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Finance is an extraordinarily effective tool in spreading economic opportunity and fighting poverty. India has a relatively deep financial system and wide network of rural banks. But India's financial markets and institutions have not served the poor well. Despite improvements in the delivery of financial services over the past 30 years, the vast majority of poor households, which are concentrated in rural areas, do not have access to formal finance.

Improving Access to Finance for India's Rural Poor examines the current level and pattern of access, evaluates various approaches to delivering financial services (including formal, informal, and microfinance), analyzes the present lack of adequate financial access, and identifies solutions to the problem of financial exclusion. Using the analysis of a large-scale rural household survey in combination with an evaluation of the role of financial markets and institutions, the report makes recommendations for meeting the diverse financial needs (such as savings, credit, and insurance) of India's rural poor in a commercially sustainable manner.

The conclusions drawn will be of interest to anyone involved in economic policy, finance or microfinance, poverty analysis, or poverty reduction.



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