Chapter - 1
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1. Introduction:
Institutional credit system has been playing a vital role in the economic development of rural India specially to meet the need of the weaker sections viz, small and marginal farmers, agricultural labourers, rural artisans, small entrepreneurs. The history of rural credit in India dates back to 1904, when co-operative credit societies were established. These institutions, however could not keep pace with the growing demand for rural credit. The establishment of the State Bank in 1955 and nationalization of major commercial banks in 1969 and 1980 made a significant impact on institutional rural finance. However, the high salary structure and urban orientation were supposed to be major hurdles in their efforts to accomplish the social objectives of rural financing. It was observed by the Banking Commission, (1972)¹ that the co-operatives and commercial banks both were lacking in many ways and would not be able to fill the regional and functional gap in the rural credit system and that a more determined effort was needed in this direction. In such conditions, Banking Commission 1972 recommended the establishment of a chain of ‘Rural Banks’ in addition to rural branches of commercial banks.

Consequently on July (1975)², the Government of India appointed a Working Group on ‘Rural Banks’ under the Chairmanship of Mr. M. Narasimham to

¹Report of the Banking Enquiry Commission, New Delhi, 1972, NABARD, Annual Report
²Govt. of India (1975) ”Report of the Committee on Rural Banks”, New Delhi
examine in depth the setting up of new rural banks as subsidiaries to public sector banks to cater the needs of the rural people. Considering the size and regional diversity, the Working Group viewed that no single pattern - be it commercial banks or co-operative credit institutions can be expected to meet all the emerging requirements in all areas. A degree of adaptation and improvisation is called for and the range of institutional alternative widened. It is in this context that the group recommended a new type of institution combined with the local feel and familiarity with the local problems which co-operatives poses, and the degree of business organization, ability to mobilize deposits, access to central markets and a modernize outlook which commercial banks have. The Govt. of India accepted the recommendations of the working Group. Accordingly, RRB ordinance 1975 was promulgated which was later replaced by the Regional Rural Banks Act. On 2nd October 1975 three RRBs were established whose number has increased to as high as 196 and presently reduced to 82 numbers.

The main objectives of the establishment of RRBs were to boost up rural development, to provide credit facilities to small and marginal farmers, landless labourers and rural artisans, to inculcate banking habit in the rural masses; to help small entrepreneurs in the establishment of industries; to eradicate unemployment of rural areas. The authorized capital of RRBs was Rs. 1 crore and paid up capital was Rs. 25 crores which contributed by central and state govt. and sponsor banks in the ratio of 50:15:35.

3 Originally established by an ordinance in September 1975, these banks are governed by the RRB Act which was passed in 1976, and amended in 1987
On June 23, (1977)\(^4\), RBI appointed a committee under the chairmanship of Prof M.L. Dantwala. The committee recommended that over a period of time the rural branches of commercial banks be totally replaced by the RRBs. Another working Group known as Kelkar Committee (1984)\(^5\) examined the basic problems of the RRBs and made recommendations to improve the viability, efficiency and managerial effectiveness of RRBs. For a general review of the agriculture credit delivery system with the objective of improving the quality of lending, the RBI in consultation with the govt. and the World Bank constituted a senior expert group, under the chairmanship of Prof A. M. Khusro in August (1986)\(^6\). The group analyzed the causes of the weaknesses of the RRBs and recommended the mergers of the RRBs with the sponsor’s banks. However, the recommendations of the group were not accepted by the govt. Afterwards the Narasimham committee (1991)\(^7\) on financial sector reforms set up by the govt. of India, gave recommendations on setting up of rural banking subsidiaries and mergers.

In 1994, Hon’ble Finance Minister in his budget speech remarked that out of 196 RRBs, 150 incurred losses during the last five years. The Committee on Restructuring of RRBs, 1994 (Bhandari Committee)\(^8\) identified 49 RRBs for comprehensive restructuring. It recommended greater devolution of decision-making powers to the Boards of RRBs in the matter of business development and staffs. The option of liquidation again was mooted by the Committee on Revamping of RRBs, 1996 (Basu Committee)\(^9\). The Expert Group on RRBs in 1997

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\(^4\) RBI (1978): Report of the Committee on Rural Banks (Dantawala Committee, 1978)
\(^5\) RBI (1984); Report of the Working Group on Regional Rural Banks (Kelkar Committee, 1984)
\(^6\) RBI (1986); “Report of the Expert Group” (Khusro Committee)
\(^7\) Govt. of India (1991), "Report of the Committee on Financial System 1991 (Narasimham Committee)", Ministry of Finance, p-54
\(^8\) RBI Report of the Committee on Restructuring of RRBs (Bhandari Committee, 1994)
\(^9\) RBI (1996) Report of Committee on Revamping of RRBs (Basu Committee)
(Thingalaya Committee)\textsuperscript{10} held that very weak RRBs should be viewed separately and possibility of their liquidation be recognized. They might be merged with neighbouring RRBs. The Expert Committee on Rural Credit, 2001 (Vyas Committee)\textsuperscript{11} was of the view that the sponsor bank should ensure necessary autonomy for RRBs in their credit and other portfolio management system. Subsequently, another committee under the Chairmanship of Chalapathy Rao in 2002 (Chalapathy Rao Committee)\textsuperscript{12} recommended that the entire system of RRBs may be consolidated while retaining the advantages of regional character of these institutions. As part of the process, some sponsor banks may be eased out. The sponsoring institutions may include other approved financial institutions as well, in addition to commercial banks. The Purwar Committee (2004)\textsuperscript{13} recommended the amalgamation of RRBs on regional basis into six commercial banks one each for the Northern, Southern, Eastern, Western, Central and North-Eastern Region (NER). Thus one finds that a host of options have been suggested starting with vertical merger (with sponsor banks), horizontal merger (amongst RRBs operating in a particular region) to liquidation by different committees that have gone into the issue of financial viability and restructuring strategies for the RRBs.

Among the various official committees that were set up to review the situation and make policy recommendations on the future course of development of the

\textsuperscript{10}RBI, (1997); “Report of the Expert Group on Regional Rural Banks” (Thingalaya Committee).
\textsuperscript{11}RBI (2004); "Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities From the Banking System". (Vyas Committee II) URL: (www.rbi.org.in, date 20/6/2009).
\textsuperscript{12}Government of India, (June 2002);”Report of the Working Group to Suggest -Amendments in the Regional Rural Banks Act, 1976” (Chalapathy Rao Committee)
\textsuperscript{13}RBI (2004); “ Group of CMDs of Select Public Sector Banks”, 2004 (Purwar Committee)
RRBs, the Parliamentary Estimates Committee (2002-03)\textsuperscript{14} suggested to undertake the shrinking credit delivery to the priority sector and the rural areas. From the year 2003-04, the RBI revised upwards the lending target for priority sector to 60 percent of the total advances for the RRBs. The farm credit target for the RRBs at Rs 11,900 crores for the fiscal year 2005-06 is 40 percent higher than Rs 8,500 crores target set during the fiscal year 2004-05. In reviewing the action taken by the RBI on the proposals of the Estimates Committee (2002-03), the Committee in (2004-05)\textsuperscript{15} found that no specific action has been taken on most of the major recommendations. RRBs have completely bypassed the subject while making policy recommendations. Instead attention is held by issues of ownership and capital requirements for the RRBs as necessary steps towards restructuring. As there was no capital to risk weighted asset ratio (CRAR) prescription for RRBs, the Internal Working Group on RRBs (RBI, 2005) has recommended that the RRBs be asked to maintain a CRAR of 5 percent to begin with, and over time they may align themselves to the Basel I standards. The committee under the Chairmanship of A.V. Sardesai dealt with the issue of restructuring the RRBs (Sardesai Committee, 2005)\textsuperscript{16}. The Sardesai committee held that to improve the operational viability of RRBs and take advantage of the economies of scale, the route of merger/amalgamation of RRBs may be considered taking into account the views of the various stakeholders. Merger of RRBs with the sponsor bank is not provided in the RRB Act 1976. Mergers, even if allowed, would not be a desirable

\textsuperscript{14}The Estimates Committee, (2002-03); "Regional Rural Banks” Sixteenth Report on the Ministry of Finance and Company Affairs, Department of Economic Affairs, Banking Division. (Chairman: Prof. UmmaReddy Venkateswarlu)


\textsuperscript{16}RBI (2005); "Report of the Internal Working Group on RRBs", Chairman: A.V. Sardesai, Mumbai. URL: (www.rbi.org.in), visited 24/5/2010
way of restructuring. The Committee was of the view that merging a RRB with its sponsor bank would go against the very spirit of setting up of RRBs as local entities and for providing credit primarily to weaker sections. Having discussed various options for restructuring, the Committee was of the view that a change in sponsor banks may, in some cases help in improving the performance of RRBs. A change in sponsorship may, inter alia; improve the competitiveness, work culture, management and efficiency of the concerned RRBs.

As per the financial statements of RRBs for the year 2006-07, 29 RRBs were having negative networth amounting to Rs 1,857.05 crores. One of the budget proposals for 2007-08 was that RRBs having negative net worth would be recapitalized in a phased manner. With a view to providing more business avenues and opportunities to RRBs for lending, RBI (2007)\(^\text{17}\) has permitted them to participate in consortium lending, within the existing exposure limits, with their sponsor banks as also with other PSBs and development financial institutions (DFIs). However, this is subject to the condition that the project to be financed is in the area of operation of the RRB concerned and guidance and appraisal of the project is provided by their sponsor bank. In order to review of the financial status of RRBs, a committee was constituted in September 2009 (Chakroborty Committee)\(^\text{18}\), under the chairmanship of Dr. K.C. Chakrabarty, Deputy Governor, RBI to analyze the financials of the RRBs and to suggest measures including re-capitalization to bring the CRAR of RRBs to at least 9 per cent in a

\(^{17}\) RBI (2007); “Task Force on Empowering RRB Boards for Operational Efficiency”

sustainable manner by 2012. The committee has inter-alia recommended the following.

- RRBs to have CRAR of atleast 7 per cent as on 31st March 2011 and at least 9 per cent from 31st March, 2012 onwards.
- The recapitalization requirement of Rs.2200 crores for 40 RRBs out of the 82. This amount is to be released in two installments in 2010-11 and 2011-12. The remaining 42 RRBs will not require any capital and will be able to maintain CRAR at least 9 per cent as on 31st March, 2012.

Against this backdrop, a number of issues need empirical probing in the wake of aforesaid measures. Such as whether RRBs have been working efficiently? What changes have been undertaken in the focus and operation of banks? What factors drive the performance of RRBs? This situation calls for an investigation in the working of RRBs particularly at micro level. The present study is an attempt in this direction.

2. RRBs and Financial Sector Reforms:
In the year 1989 for the first time, the conceptualization of the entire structure of Regional Rural Banks was challenged by the Agricultural Credit Review Committee (Khusro Committee)\textsuperscript{19}, which argued that banks have no justifiable cause for continuance and recommended their mergers with sponsor’s banks. The Reserve Bank and Govt of India quite prudently pushed the Khusro committee report under the sprinter without the public debate. With the onset of economic reform and liberalization of financial system, RRBs came under the scanner once

again. The Committee on Financial System, (1991)\textsuperscript{20} stressed the poor financial health of the RRBs to the exclusion of every other performance indicator. 172 of the 196 RRBs were recorded unprofitable with an aggregate loan recovery performance of 40.8 percent (June 1993). The low equity base of these banks (paid up capital of Rs. 25 lakhs) didn't cover for the loan losses of most RRBs. In the case of a few RRBs, there had also been an erosion of public deposits, besides capital. In order to impart viability to the operations of RRBs, the Narasimham Committee suggested that the RRBs should be permitted to engage in all types of banking business and should not be forced to restrict their operations to the target groups, a proposal which was readily accepted. This recommendation marked a major turning point in the functioning of RRBs. For the time being though, the suggestion of mergers of the RRBs with their sponsor bank, which the Committee on Financial Systems had put forth in a slightly modified form sponsor banks might decide whether to retain the identities of sponsored RRBs or to merge them with rural subsidiaries of commercial banks to be set up on the recommendation of the committee was put on hold.

In the ensuing years, reforms of the RRBs largely followed the same format as that of the commercial banks, irrespective of the fact that their very role in the society required a special status and a different set of policies. Since the early 1990s, there was a complete freeze on recruitment of new staff in the RRBs. As a part of comprehensive restructuring programme, recapitalization of the RRBs was initiated in the year 1994-95, a process which continued till 1999-2000 and covered 187 RRBs with aggregate financial support of Rs. 2188.44 crores from the

\textsuperscript{20} Report of the Committee on Financial System (Narasimham Committee, 1991)\textsuperscript{7}, Ministry of Finance
stakeholders. Simultaneously, prudential norms on income-recognition, asset classification and provisioning for loan-losses following customary banking benchmarks were introduced. From 1996-97 there has been a tendency to allow greater role and larger operational responsibilities to sponsor banks in the management of RRBs.

3. Review of Literature:
A wide body of literature already exist dealing with the various aspects of working of RRBs both in India and abroad. A brief review of these studies is highlighted in the following paragraph to identify the significance of the present study.

RRBs though operate with a rural focus are primarily scheduled commercial banks with a commercial orientation. The literature probing into factors influencing performance of banks recognizes two broad sets of factors, i.e., internal factors and factors external to the bank. The internal determinants originate from the balance sheets and/or profit and loss accounts of the bank concerned and are often termed as micro or bank specific determinants of profitability. The external determinants are systemic forces that reflect the economic environment which conditions the operation and performance of financial institutions. A number of explanatory variables have been suggested in the literature for both the internal and external determinants. Given the nature of banking business, the need for risk management is of crucial importance for a bank’s financial health. Risk management is a reflection of the quality of the assets with a bank and availability of liquidity with it. During periods of uncertainty and economic slow down, banks may prefer a more diversified portfolio to avoid adverse selection and may also raise their liquid holdings in
order to reduce risk. In this context, both credit and liquidity risk assumes great importance.

The literature provides mixed evidence on the impact of liquidity on profitability. Bourke (1989)\textsuperscript{21} in contrast, reports an opposite result. One possible reason for the conflicting findings may be the different elasticity of demand for loans in the samples used in the studies. Credit risk is found to have a negative impact on profitability (Miller and Noulas, 1997)\textsuperscript{22}. This result may be explained by taking into account the fact that more the financial institutions are exposed to high risk loans; the higher is the accumulation of unpaid loans implying that these loan losses have produced lower returns to many commercial banks (Athanasoglou, Brissimis and Delis, 2005)\textsuperscript{23}. Some of the other internal determinants found in the literature are funds source management and funds use management (Haslem, 1968)\textsuperscript{24}, capital and liquidity ratios, the credit-deposit ratio and loan loss expenses (Bell and Mushy, 1969)\textsuperscript{25}, (Kwast and Rose, 1982)\textsuperscript{26}. Expense management, a correlate of efficient management is another very important determinant of bank’s profitability. There has been an extensive literature based on the idea that an expenses-related variable should be included in the cost part of a standard

\textsuperscript{22}Miller,S.M., Noulas, A.G. (1997); 'Portfolio Mix and Large-bank Profitability in the USA", \textit{Applied Economics}, 29 (4), pp.505-512.
\textsuperscript{26}Kwast, Myron L. and John T. Rose (1982); "Pricing, Operating Efficiency and Profitability Among Large Commercial Banks", \textit{Journal of Banking and Finance}, Vol.6.
microeconomic profit function. In this context, Molyneux and Thomton (1992)27 found that better quality management and profitability go hand in hand. As far as the external determinants of bank profitability are concerned the literature distinguishes between control variables that describe the macroeconomic environment, such as inflation, interest rates and cyclical output, and variables that represent market characteristics.

The most frequently used macroeconomic control variables are the inflation rate, the long-term interest rate and/or the growth rate of money supply. Revell (1979)28 introduced the issue of the relationship between bank profitability and inflation. He notes that the effect of inflation on bank profitability depends on whether banks’ wages and other operating expenses increase at a faster pace than inflation. Perry (1992)29 in a similar vein contends that the extent to which inflation affects bank profitability depends on whether inflation expectations are fully anticipated. The influence arising from ownership status of a bank on its profitability is another much debated and frequently visited issue in the literature. The proposition that privately owned institutions are more profitable, however, has mixed empirical evidence in favour of it. For instance, while Short (1979)30 provides cross-country evidence of a strong negative relationship between government ownership and bank profitability, Barth et al. (2004)31

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claimed that government ownership of banks is indeed negatively correlated with bank efficiency.

The literature on RRBs recognizes a host of reasons responsible for their poor financial health. According to the Narasimham Committee, RRBs have low earning capacity. They have not been able to earn much profit in view of their policy of restricting their operations to target groups. The recovery position of RRBs is not satisfactory. There are a large number of defaulters. Their cost of operation has been high on account of the increase in the salary scales of the employees in line with the salary structure of the employees of commercial banks. In most cases, these banks followed the same methods of operation and procedures as followed by commercial banks. Therefore, these procedures have not found favour with the rural masses. In many cases, banks have not been located at the right place. For instance, the sponsoring banks are also running their branches in the same areas where RRBs are operating. The issue whether location matters for the performance has been addressed in some detail by Malhotra (2002)\(^3\). Considering 22 different parameters that impact on the functioning of RRBs for the year 2000, Malhotra asserted that geographical location of RRBs is not the limiting factor for their performance. He further finds that ‘it is the specific nourishment which each RRB receives from its sponsor bank, is cardinal to its performance’. In other words, the umbilical cord had its effect on the performance of RRBs. The limitation of the study is that the financial health of the sponsor bank was not considered directly to infer about the umbilical cord hypothesis. Banking commission (1972)\(^3\) reviewed bank operating methods and procedures and made recommendations for improving and

\(^3\)Malhotra, Rakesh (2002); "Performance of India’s Regional Rural Banks (RRBs): Effect of the Umbilical Cord”. URL: http://www.alternativefinance.org.uk/rtf/rrbsmalhotra.rtf.(visited on 23/5/11)

\(^3\)Report of the Banking Enquiry Commission, New Delhi, 1972, NABARD, Annual Report
modernizing operating methods and procedures, particularly relating to customers service, credit procedures and internal control system. The commission further observed that present methods of working out branch profitability are not appropriate. Considering the need of an integrated cost and financial reporting system it suggested the use of certain ratios for the measurement of operational efficiency of branches.

Singh (1979)\(^{34}\) examined the relationship between cost of bank credit and prices and concluded that high rates of interest produces in general a significant tender to the prices to raise more and the percentage spread of the difference between interest received and interest paid has been decreasing for the banks. Prasad (1985)\(^{35}\) studied the role of SBI in rural development. He has covered various aspects of its functioning and recommended further simplification of security norms, improvement in reporting system and computerization of operation etc. The decline in profitability has originated both from factors of income and of expenditure of banking industry. In this context, the Committee on Financial System (1991)\(^{36}\) recommended that to impart viability of banks, they should be permitted to engage in all types of banking business and should not be forced to restrict their operations to the target groups. This recommendation marked a major turning point in the functioning of RRBs. Basu (1991)\(^{37}\) studied on performance of the RRBs. He focused on financial viability, staff resources, asset

\(^{34}\)Singh, S.P (1979); "Cost of Bank Credit and Prices" The Journal of Indian Institute of Bankers, October-November

\(^{35}\)Prasad, N (1985); "The SBI and Rural Development" Amar Prakasan, Delhi

\(^{36}\)Govt. of India.(1991); "Report of the Committee on Financial System 1991 (Narasimham Committee), Ministry of Finance, P-54

management etc. He suggested for proper efficiency, management of resources and improvement of customer quality.

The Narasimham Committee (1998)\textsuperscript{38} emphasized that ‘while discharging their functions as purveyors of rural credit and mobilizes of rural savings, RRBs should not ignore the importance of financial viability and operational efficiency. The productivity, profitability and solvency of the RRBs must be maintained and sustained to enable them to function as an effective and efficient institution of rural credit.

Naidu ((2001)\textsuperscript{39} viewed that until and unless the RRBs functionaries serve the rural poor with urge and devotion, mere cosmetic changes would pay little in revamping the present scenario. Sikidar (1992)\textsuperscript{40} in his study on the rise of banking for rural development has critically evaluated one side of bank finance in the development of hill area in the north east. He has suggested for a practical approach towards recovery of bank outstanding from the tribal population in hill areas. Tarapore (1994)\textsuperscript{41} observed that there is a reasonable spread between cost of raising fund and the return of development of funds. He suggested that rural financial agencies like RRBs should not hesitate to finance large projects in rural areas strictly on commercial basis. Rangarajan (1996)\textsuperscript{42} in a study on role of rural credit highlighted that the drive of Indian public policy towards rural credit to ensure that sufficient and timely credit at reasonable rates of interest. The study suggested that credit should be made available to a large segment of rural

\textsuperscript{38}Govt. of India (1998); "Report on Banking Sector Reforms” (Narasimham Committee - II) Ministry of Finance
\textsuperscript{39}Naidu, M.C (2001); " Regional Rural Banks: A Review”, Yojana, Vol-45, March, pp-40-50
\textsuperscript{40}Sikidar, S (1992); " Rural Banking: An Infrastructural Input for Hill Area Development” Anmol Publication, New Delhi
\textsuperscript{41}Tarapore, S.S (1994); "Rural Banking at Cross Roads”, RBI Bulletin, September
\textsuperscript{42}Rangarajan, C, (1996); “The Role of Rural Credit”, RBI Bulletin, 1(5), May
population to the possible extent. Kausik (1999)\textsuperscript{43} in his study on credit productivity of RRB has found that an inverse relationship between credit assets and credit productivity has been establish due to low income generation, lack of appropriate skills and infrastructural facilities. He suggested that RRBs should supply adequate credit along with skill and training facilities to the beneficiaries. Sinha et al (2003)\textsuperscript{44} in a field study of 5 RRBs has found that non-priority sector advances increased sharply in the second-half of the 1990s for all the sample banks. The study recommended for priority sector advances by RRBs for the benefit of low income group clients. Uddin (2003)\textsuperscript{45} in his study identified the problems like defective control, poor staffing, lack of trained staff, rigid policies, inefficient management etc. In the context of institutional dimension, Nitin and Thorat (2004)\textsuperscript{46} observed that efforts taken during the reform era have limited impact because the reform process change in institutional dimension has not been given adequate importance. Few efforts were made to redesign the perverse institutional arrangements that gave rise to incompatible incentive structures for key stakeholders, such as political leaders, policy makers, stockholders, bank staff, and clients and suggested to bring change further to increase productivity of the bank.

Das and Ghosh (2004-05)\textsuperscript{47} in their examining study on excess capacity in RRBs focuses on regional rural banks because, if excess capacity exists in banking, it is

\begin{itemize}
  \item Kaushik, A.C (1999); "Productivity of RRBs Credit in Haryana", \textit{Productivity}, 40(3): October-December
  \item Uddin, N (2003); "Regional Rural Banks and Development", \textit{Mittal Publications}, New Delhi
  \item Nitin Bhatt and Thorat Y. S. P. (2004); "India’s Regional Rural Banks: The Institutional Dimension of Reforms", \textit{National Bank News Review}, NABARD, April-September
\end{itemize}
in this setting where it is likely to be most prominently manifested. If the demand for traditional banking activities declines, commercial banks are likely to have greater flexibility to rationalize their operations and diversify their activities than RRBs with limited option to rationalize branches. The study develops indicators of potential excess capacity in the RRB segment and illustrates its application to individual banking firms. Bose (2005) concluded that the inception and expansion phase (1976-1990) saw rapid growth of the RRBs activities; the reform phase (1991-2002/3) raised the profitability of these banks at the cost of massive rural disintermediation, particularly of the targeted borrower categories; and the most recent phase of stock taking and perhaps some repositioning to strike a balance in the conundrum of ‘viability versus outreach’. Batra and Dangwal (2005) observed a better performance of RRBs after the introduction of prudential norms in 1996-97 and recommended for further improving the efficiency in the present competitive era. Rammohan and Roy (2004) compared the performance of banks using revenue maximization efficiency approach and found that Indian banks did not have much freedom in trimming costs especially the cost of labour. Chatterjee and Sinha (2006) estimated efficiency of banks taking net interest income, non-interest income and loan as output indicators and branches and borrowed capital as inputs. Their study observed an improvement of bank’s performance in Indian context. Pati (2005) studied the economic

48Bose, Sukanya (2005); “Regional Rural Banks: The Past and the Present Debate”, Macro Scan, URL: http://www.macroscan.com/jet/jul05/jet200705RRB_Debate.htm.(visited on 4-5-10)
52Pati, A.P. (2005); “Regional Rural Banks in Liberalized Environment”, A Mittal Publication, New Delhi
viability of RRBs in general and Subansiri Gaonlia Bank (SGB) of Assam in particular. He found that the banks are facing the problem of loan recovery and fresh accretion in NPAs, lower profitability and the management problem. His study suggested that proper management of spread and burden will improve the performance of the bank. Reddy (2006)\textsuperscript{53} examined total factor productivity technical and scale efficiency changes in regional rural banks by using data from 192 banks for the period 1996 to 2002. It observed that total factor productivity growth of rural banks was higher than the service provision during liberalization. Banks located in economically developed as well as low banking density regions exhibited significantly higher productivity growth. It also observed that parent PSBs have no influence on the efficiency and productivity growth of rural banks.

Tasi (2006)\textsuperscript{54} studied the role of RRBs in general and Arunachal Pradesh Rural Bank in particular. The study dealt with the performance evaluation of Arunachal Pradesh Rural Bank (APRB) for the economic development of the state. The study has ignored the technical parameters of banks rather it has assessed role of RRBs in economic development in general. The financial viability and possible restructuring of RRBs was studied by Misra (2006)\textsuperscript{55}. He has categorized RRBs into profit making and loss making. He recommended sponsor bank for the loss making RRBs could be given time to improve the performance. The paper has also enquired the factors that influence the performance of RRBs. Hadi and


\textsuperscript{54}Tasi, K (2006); "Role of Regional Rural Banks in Economic Development", Eastern Hook Corporation, New Delhi

\textsuperscript{55}Misra, B.S (2006); "The Performance of Regional Rural Banks (RRBs) in India: Has Past anything to Suggest for Future?" RBI Occasional Paper, 27(1& 2): 89-119
Bagchi (2006) assessed the performance of RRBs in India in general and in West Bengal in particular. The study reviewed the progress of the RRBs in West Bengal in terms of expansion of branches, credit expansion and deposit mobilization since inception till the end of June 2001. The analysis revealed that RRBs have been more or less successful in expanding outreach of institutional credit in rural areas. However, it has identified certain coherent causes of unsatisfactory state of recovery performance and loan repayment in the case of selected branches and beneficiaries of Murshidabad Gramin Bank. Shivappa (2007) in a study examined the growth in advances, deposits and financial performance of the RRBs. The study covered the RRBs as a whole; discussed mostly theoretical issues rather than any analytical depth. Sadakkadulla (2007) observed that with the passage of three decades, the RRBs are now looked upon with hope for rejuvenating the rural India. They have been empowered to make their operations viable. One of the recent policy interventions in this regard is the constitution of Empowered Committees (EC) of RRBs to provide an institutionalized mechanism to resolve all operational and regulatory problems of RRBs then and there. The study looks at role of the Empowered Committees, particularly in making RRBs as a tool to fill the gap in rural development.

In a study, Banos (2007) by using panel data for the period 1993 to 2005 from 16 regions of the Philippines investigated whether the resource allocation efficiency of Philippine rural banks resulting from the quantity and quality of banking

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56Hadi, A and Bagchi, K.K (2006); "Performance of Regional Rural Banks in West Bengal: An Evaluation", Serial Publications, New Delhi
57Shivappa, H (2007); "Working of Regional Rural Banks in India," Indian Journal of Agricultural Economics, July 1, 2007
58Sadakkadulla, J (2007); “Regional Rural Banks and the Role of Empowered Committees”, Cab-Calling, (October-December)
intermediation activities affects regional economic growth. To explore this relationship, four measures of resource allocation efficiency were alternatively tested employing pooled generalized least squares (EGLS) estimation. The findings suggest that Philippine rural banks need to make allocative adjustments in the areas of branch presence, operational efficiency and credit participation. These results lend support to government efforts to strengthen the rural banking sector and to increase the volume of investments in the regions. The important policy implications of these findings include the need to enhance confidence in the Philippine rural banking system, to encourage savings in regional rural banks, and to ensure efficient transfer of resources from savers to investors. Khankhoje and Sathye (2008) investigated the implication of restructuring strategies on the efficiency of RRBs with the help of DEA. The study considered the variables like interest income and non-interest income as outputs and interest expenses and non-interest expenses as inputs. The analysis found that efficiency of rural banks has significantly improved after restructuring and hence it recommended its continuance. Kumar (2008) in a case study on the amalgamation of RRBs highlighted that amalgamation became a death blow to the credit starved rural poor, most of whom are small and marginal farmers, agricultural and landless labourers, and artisans. The paper recommended for an immediate de-amalgamation of RRBs in the interest of the vast majority of the rural poor. Dhaliwal, Kaur and Arora (2009) in their study pointed out that Regional Rural Banks (RRBs) were established in India in 1975 essentially for taking banking to

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60Khankhoje, D and Sathye, M (2008); "Efficiency of Rural Banks; The Case of India" *International Business Research, 1*(2):140-149, (April)

61Kumar, V. A (2008); "Case for De-amalgamation of Regional Rural Banks" *Economic and Political Weekly, 43*(42):60-68, (October)

the doorstep of rural masses, particularly in areas without banking facilities. RRBs were expected to operate as State sponsored, region based and rural-oriented commercial banks. RRBs were expected to mobilize resources from rural areas and play a significant role in developing agriculture and rural economy by deploying mobilized resources in rural sectors for the needy not conversed by other formal credit institutions. Singh and Singh (2009)\textsuperscript{63} in their paper examined the recovery performance of Manipur Rural Bank. The study observed that the repayment of loans mainly depends on proper utilization of the loan amount, supply of quality assets, generation of sufficient income from schemes, availability of infrastructural and marketing, facilities, willingness to repay, continuous supervision and follow-up visits etc. Ibrahim (2010)\textsuperscript{64} made a study on the performance evaluation of Regional Rural Banks in India investigated whether the merger/amalgamation of Regional Rural Banks in India, undertaken in 2005-06 has helped to improve their performance. Several committees have also emphasized the need to improve the performance of these banks which play an important role in the rural credit market in India. The study finds and concludes that performance of rural banks in India has significantly improved after amalgamation process which has been initiated by the Government of India.

Bhaskar (2011)\textsuperscript{65} in his study concludes that distribution of RRBs is not same in India. RRBs have to be repositioned and carry out their entrusted responsibility of meeting the credit requirement in rural sector, their various constraining factor such as low credit off take, small ticket business, low recovery rate and high

\textsuperscript{63}Singh, N.T and Singh T.J (2009); "Recovery Performance of RRBs: A Case Study of Manipur Rural Bank" Jurnal of Accounting and Finance, 23((1):66-74 (October 08- March 09)

\textsuperscript{64}Ibrahim, M.S.(2010); “Performance Evaluation of Regional Rural Banks in India, International Business Research Vol-3,No.4; (Nov)

employee cost. In order to reposition RRBs loss making RRBs should take step for enhancing productive by improving the skill and performance of their employees by better and specialized training in the areas of banking and finance, IT, management etc. Reddy and Prasad (2011)\textsuperscript{66} in his evaluative study observed that these banks penetrate every corner of the country and have been extending a helping hand in the growth of the economy. Despite the RRBs journeyed over three decades, they have achieved performance to the expected level quantitatively but not turning towards sound financial management and productivity. He made an attempt to discuss the financial performance of selected regional rural banks during post reorganization period by using the technique of CAMEL Model. Again Kumar and Sharma (2011)\textsuperscript{67} on the comparative study of Himachal Gramin Bank and Parvatiya Gramin Bank found that the Parvatiya Gramin Bank is more conservative as compared to the Himachal Gramin Bank with regard to NPAs' management. It is because NPAs to total assets ratio for the Parvatiya Gramin Bank has decreased during the last few years of the study. This may be due to better management of NPAs by the bank and the use of better methods of loan recovery.

Whatever studies have emerged on the topic, they have primarily relied on exploratory analysis done for a particular year or on a group of RRBs to draw inferences. This kind of an approach has a serious limitation that the findings are guided by the choice of the year of analysis. To overcome this problem, one need


to consider, as attempted in this proposal, reasonably long period for analysis where extreme observations would be evened out so that one may get results that are more dependable.

4. Research problem:
RRBs have been in existence for around three and half decades in the Indian financial scene. The inception of RRBs can be seen as a unique experiment as well as experience in improving the efficacy of rural credit delivery mechanism in India. With joint share holding by Central Government, the concerned State Government and the sponsoring bank, an effort was made to integrate commercial banking within the broad policy thrust towards social banking keeping in view the local peculiarities. The genesis of the RRBs can be traced to the need for a stronger institutional arrangement for providing rural credit. The Narasimham Committee conceptualized the creation of RRBs in 1975 as a new set of regionally oriented rural banks, which would combine the local feel and familiarity of rural problems characteristic of cooperatives with the professionalism and large resource base of commercial banks. Subsequently, the RRBs were set up through the promulgation of RRB Act of 1976.

RRBs were supposed to evolve as specialized rural financial institutions for developing the rural economy by providing credit to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs. Over the years, the RRBs, which are often viewed as the small man’s bank, have taken deep roots and have become a sort of inseparable part of the rural credit structure. They have played a key role in rural institutional financing in terms of geographical coverage, clientele outreach and business volume as also contribution to development of the rural economy. A remarkable feature of their performance
over the past three decades has been the massive expansion of their retail network in rural areas. From a modest beginning of 6 RRBs with 17 branches covering 12 districts in December 1975, the numbers have grown into 196 RRBs with 14,446 branches working in 518 districts across the country in March 2004. Govt. of India initiated the process of structural consolidation of RRBs by amalgamating RRBs sponsored by the same bank within a State as per the recommendations of the Vyas Committee (2004). The amalgamated RRBs were expected to provide better customer service due to better infrastructure, computerization of branches, pooling of experienced work force, common publicity marketing efforts, etc. and also derive the benefits of at large area of operation, enhanced credit exposure limits and more diverse banking activities. As a result of the amalgamation, the number of RRBs was reduced from 196 to 133 as on March, 2006 and further to 82 RRBs with 15,658 branches operating in 621 districts as on March 2011. Thus, under the amalgamation process, a number of RRBs have been amalgamated but the branches have increased. The credit deposit ratio of RRBs has increased from 46.3 per cent in March 2004 to 59.6 per cent in March 2011 (RBI, 2010-11).

RRBs have a large branch network in the rural area forming around 43 per cent of the total rural branches of commercial banks. The rural orientation of RRBs is formidable with rural and semi-urban branches constituting over 97 per cent of their branch network. The growth in the branch network has enabled the RRBs to expand banking activities in the un-banked areas and mobilize rural savings. The mandate of promoting banking with a rural focus, however, would be an

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68 RBI; Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities (Dr. Vyas Committee, 2004)
69 RBI (2010-11) Trend and Progress of Banking in India, Reserve Bank of India, Mumbai
enduring phenomenon only when the financial health of the RRBs is sound. With built in restrictions on their operations, it is common to expect that the financial health of the RRBs itself would be a matter of concern. As regards to their financial status, during the year 2003-04, 163 RRBs earned profits amounting to Rs.953 crores while 33 RRBs incurred losses to the tune of Rs.184 crores. The aggregate income of RRBs during 2007-08 grew by 20 percent on account of higher interest as well as non-interest income. The growth in expenditure during the year was relatively subdued. As a result, profitability of RRBs improved significantly. RRBs earned a net profit of Rs. 1374 crores in March 2008 as compared to Rs.625 crores in previous year. (Out of 90 RRBs, 82 RRBs earned a combined profit of Rs. 1429 crores whereas 8 RRBs incurred a combined loss of Rs. 55 crores during 2007-08). The branch productivity of RRBs has been increased from Rs. 7.71 crores in March 2006 to Rs. 10.7 crores in March 2008. Further more, non-performing assets (NPAs) of the RRBs in absolute terms stood at Rs.3, 299 crores as on March 2004. The percentage of net NPAs was 8.51 per cent during the year ending March 2004 reduced to 1.80 per cent in March 2010 (2010)\textsuperscript{70}.

Given the multi agency share holding and various restructuring strategies of RRBs introduced from time to time, the bank under severe pressure to improve their foundation with a view to attain competitiveness. Given the attention at the policy level to restructure the RRBs, it is necessary that the functioning of RRBs be analyzed separately than the RRBs as a whole so that it helps in policy formulation. The present study is an attempt to enquire into such factors that influence the working of the RRBs in general and MRB in particular.

\textsuperscript{70} RRB Monitoring, Key Statistics of RRBs, 2009-10
5. Meghalaya Rural Bank: A Profile

Meghalaya Rural Bank (MRB) is the only RRB (sponsored by State Bank of India) operating in 6 districts out of 7 districts of Meghalaya as on March 2010. The bank was established on 29th December 1981 under the RRBs Act 1976 as a joint undertaking of Govt. of India, the Govt. of Meghalaya and State Bank of India with the share capital at the ratio of 50: 15: 35. Prior to 1st May 2007 the name of this RRB was ‘Ka Bank Nonkyndong Ri Khasi Jaintia’. As per power conferred by sub-section (1) section (3) of the RRB Act 1976 (21 of 1976) Department of Economic Affairs (Banking Division), Ministry of Finance, Govt. of India, in its notification dated 1st May 2007 substituted the name "Ka Bank Nonkyndong Ri Khasi Jaintia" as "Meghalaya Rural Bank". The MRB is operating in 6 districts with 58 branches as on March 2011. It is the 2nd largest bank in Meghalaya in terms of branches. The network of MRB is presented in table-1.1 and table-1.2.

Table-1.1
Network of Meghalaya Rural Bank as on March 2011

<table>
<thead>
<tr>
<th>SL. No</th>
<th>Districts</th>
<th>No. of Branches</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>East Khasi Hills District</td>
<td>25</td>
</tr>
<tr>
<td>2</td>
<td>West Khasi Hills District</td>
<td>14</td>
</tr>
<tr>
<td>3</td>
<td>Jaintia Hills District</td>
<td>13</td>
</tr>
<tr>
<td>4</td>
<td>RiBhoi District</td>
<td>4</td>
</tr>
<tr>
<td>5</td>
<td>East Garo Hills District</td>
<td>1</td>
</tr>
<tr>
<td>6</td>
<td>West Garo Hills District</td>
<td>1</td>
</tr>
<tr>
<td>7</td>
<td>South Garo Hills District</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td><strong>Total</strong></td>
<td><strong>58</strong></td>
</tr>
</tbody>
</table>

Table-1.1 depicts that as on 2010-11, the East Khasi Hill constituted 25 number of branches, West Khasi Hills 14 branches, Jaintia Hills 13, Ri Bhoi district 4, West
Garo Hill and East Garo Hill districts are having 1 branches in each district. The branch expansion of MRB in Garo Hills district of Meghalaya is very negligible because the MRB has started functioning in West Garo Hill from 31.03.2008 and East Garo Hill district from 09.01.2009 with only one branch in each district.

<table>
<thead>
<tr>
<th>Year</th>
<th>Rural</th>
<th>Semi urban</th>
<th>Urban</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000-01</td>
<td>43</td>
<td>3</td>
<td>5</td>
<td>51</td>
</tr>
<tr>
<td>2001-02</td>
<td>42</td>
<td>7</td>
<td>2</td>
<td>51</td>
</tr>
<tr>
<td>2002-03</td>
<td>42</td>
<td>7</td>
<td>2</td>
<td>51</td>
</tr>
<tr>
<td>2003-04</td>
<td>42</td>
<td>7</td>
<td>2</td>
<td>51</td>
</tr>
<tr>
<td>2004-05</td>
<td>42</td>
<td>7</td>
<td>2</td>
<td>51</td>
</tr>
<tr>
<td>2005-06</td>
<td>42</td>
<td>7</td>
<td>2</td>
<td>51</td>
</tr>
<tr>
<td>2006-07</td>
<td>42</td>
<td>7</td>
<td>2</td>
<td>51</td>
</tr>
<tr>
<td>2007-08</td>
<td>42</td>
<td>8</td>
<td>2</td>
<td>52</td>
</tr>
<tr>
<td>2008-09</td>
<td>42</td>
<td>9</td>
<td>3</td>
<td>54</td>
</tr>
<tr>
<td>2009-10</td>
<td>42</td>
<td>10</td>
<td>3</td>
<td>55</td>
</tr>
<tr>
<td>2010-11</td>
<td>43</td>
<td>12</td>
<td>3</td>
<td>58</td>
</tr>
</tbody>
</table>

**Source:** Annual Report of Meghalaya Rural Bank, Various Issues

It is also observed that more number of branches is expanded in rural areas than the semi urban or urban areas except in East and West Garo Hill districts as revealed from table 1.2.

As on March 2008, the total deposit mobilized Rs. 304 crores and advances channeled of Rs. 95 crores by MRB. Though credit deposit ratio of MRB has been increased ie, from 24.7 per cent in March 2004 to 29.4 per cent in March 2007. The same is far lower than the ratio of RRBs as a whole. The bank has shown profit consistently for the last 15 years, the net figure posted Rs. 3.4 crores in March 2007. The productivity per branch has increased from 5.3 crores in March 2005 to
Rs. 7.1 crores in March 2008. The percentage of net NPA to advances increased from 6.8 in March 2006 to 7.7 in March 2008. The aforesaid brief profile shows some disagreement in the performance of MRB with the RRBs of the country as a whole. Hence there is the necessity of further enquiry on the working of the bank.

6. Need of the study:
In the wake of introduction of financial sector reforms in 1991-92, the feasibility of RRBs emerged as the most crucial factor in deciding about the desired role due to their limited business flexibility with hardly any scope of diversification, smaller size of loans with higher exposure to risk-prone advances and professional inefficiency in financial deployment. To strengthen RRBs and to improve their performance many initiative have been taken by the Govt. and Reserve Bank of India. As a part of comprehensive restructuring programme, recapitalization of RRBs was initiated in the year 1994-95. The process continued till 1999-00 and covered 187 RRBs with an aggregate financial support of Rs. 2,188.44 crores from the shareholders viz, Govt. of India, State Governments and sponsors banks. Further the branch licensing policy of RRBs has been liberalized. Under the new norms, empowered committees at the regional offices of RBI are clear about the RRB’s application to open new branches. The branches of RRBs may undertake govt. business including conducting foreign exchange business with prior approval of the govt. authority and RBI. These banks have also been allowed to open extension counters and permitted to open off-site ATMs. As against the policy of opening a large number of branches in far flung rural areas, RRBs have been permitted to close down their unviable branches. As per Mid-Term Review of Annual Policy statement for 2004-05, RRBs have to adhere to good governance practices and comply with prudential regulations. In view of their importance as
providers of rural credit, the union budget 2004-05, emphasized that the sponsor banks would be accountable for the performance of their RRBs. As per the financial statements of RRBs for the year 2006-07, 29 RRBs are having negative networth amounting to Rs 1,857.05 crore. One of the budget proposals for 2007-08 was that RRBs having negative networth would be recapitalized in a phased manner. The process of recapitalization has already commenced and its completion would make all RRBs comply with the necessary prescribed minimum capital requirements. As a first step to bring RRBs to international capital adequacy standards, all RRBs have been advised to disclose their Capital to Risk Weighted Assets Ratio (CRAR) as on March 31, 2008 in their balance sheets.

It is, therefore clear that RRBs have moved far away from the conditions and compulsions that were prevailing at the time of RRBs in 1975. Hence, an evaluation in respect of performance of RRBs is extremely relevant in the present scenario.

7. Objectives of the Study:
The main objective of the proposed study is to evaluate the performance of RRBs in general and Meghalaya Rural Bank in particular over the period under consideration. The specific objectives of the study are-

1. To study the growth performance of MRB in terms of branch expansion, deposit mobilization, credit channelization, C/D ratio in the context of RRB as a whole.
2. To examine the efficiency in respect of profitability and productivity of MRB on the basis of selected parameters.
3. To study the asset quality and the level of NPAs of MRB over the years.
4. To analyze the progress of MRB on the basis of balance sheet variables.

8. Hypotheses of the study:
The following hypotheses have been framed to meet the objectives of the proposed study.

1. MRB has made special dent in the banking operation in Meghalaya over the years.
2. Despite the onslaught of openness measures adopted in banking sector, MRB is performing efficiently.

9. Research Methodology:
(a) Research Population and Data Collections:
The RRBs operating in the state of Meghalaya has been considered as research population of the proposed study. As on March 2011, there is only one RRB ie, Meghalaya Rural Bank with 58 numbers of branches is operating in six districts of Meghalaya (details are shown in table-1.1 and table-1.2). For the purpose of the proposed study, we have considered all the branches particularly for the analysis of working and efficiency of the bank. The sources of data collection are financial statements compiled by the head office of Meghalaya Rural Banks, RBI bulletin, RBI Annual Reports, RBI Trend and Progress of Banking in India, Annual Reports of Meghalaya Rural Bank, Annual Reports of NABARD, Directorate of Economics and Statistics, various reports, surveys, published and unpublished research papers and dissertations.
(b) Variables Selected:
To assess the growth performance of the bank, we have taken the variables like total deposits, total advances, and credit deposit ratio. The variables like net profit, paid up capital plus retained earnings, advances outstanding, loan recovered etc have been considered for measuring the efficiency of bank. The variables includes interest earned, interest paid, manpower expenses, non-interest income, spread, burden, cost responsiveness, return on working fund, volume of business (deposit plus advances), labour productivity and branch productivity for assessing the profitability and productivity of banks. To assess the nature of unbridled virus of NPAs of bank, the variables considered are net and gross NPA, total standard asset, doubtful and loss asset. The variables for identifying the determinants of NPAs includes priority sector lending, capital adequacy ratio, net NPA to net advances, branch expansion and credit deposit ratio. To assess the asset liability management, we have considered the liabilities items like capitals, deposits, borrowings and asset side items like cash and bank balances, investment, advances, fixed assets and other assets.

(c) Research tools and techniques:
A wide range of financial ratio and statistical techniques have been used to test the proposed hypotheses of the study. The statistical techniques viz, correlation co-efficient, regression analysis, skewness, measure of central tendency and dispersion have been used. The parametric test ie, ‘t’ test, has been considered to test significance level in appropriate cases. The most popularly used financial ratios has been used which include return on assets, return on equity, net profit per employee, liquid asset ratio, advances to total assets, interest income, non-
interest income, spread, burden, slippage ratio (the ratio of fresh NPA added during the year to standard loan assets at the beginning of the year), NPA accretion ratio (the total NPA added during the year to total NPA reduce during the year) and so on.

The growth performance of banks has been tested with compound annual growth rate analysis. The correlation coefficient between incremental deposits and incremental advances has been used to find out the nature of growth of deposit as well as credit. Besides this, whether banks are deploying credit at the same rate what they have mobilized, researcher visited the branch managers of the bank for collecting necessary information and has discussed with them the present position, weaknesses, the problem being faced by them and future role of branch for the development of the operational area. The correlation matrix analysis has been employed to assess the relationship between advances and NPAs along-with its components viz, sub-standard assets, doubtful assets and loss assets. The regression models have also been fitted in appropriate places.

10. Period Coverage:

The period coverage for the proposed study is 11 years from 2000-01 to 2010-11, to analyze the position of RRBs in the context of global financial sector recession in 2000-01. The impact of restructuring strategies adopted on RRBs performance has been studied for the aforesaid time period. The data prior to the period has also been considered in a few cases in order to make some sort of comparison and in the circumstances where historical information is required.
11. Chapter Plan:

The entire study has been displayed as per the following chapter break up.

9. Bibliography

12. Limitations of the study:

The data relating to the performance and working of banks is mostly based on secondary sources. The unavoidable limitation inherent with the data like year wise un-uniform data are bound to be exists. For the purpose of analysis of the data, some sort of uniformity and adjustment has been made.

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