CHAPTER - II

ORGANISATION AND MANAGEMENT OF RRBs
Banking, which is an intermediary of financial system, functions and facilitates the flow of funds from the surplus of income people to the needy of credit. That is why, the banking system has an essential role in the capital formation. Towards this, the banking services are essentially required for both savings and advances in order to bring the socio-economic development.

Rural development is largely depends on the effective banking system, which is pro-active to the ever-changing circumstances. In other words, the banking should have a sound organization and a prudent management fitting in the environment of rural areas. An attempt has been made to examine the organization and management of regional rural banks including their reforms in this chapter.

BACKDROP OF REGIONAL RURAL BANKS

From times immemorial, Indian farmer had depended on money lender for credit. The money lender used to exploit his ignorance, illiteracy and need. To relieve him from the clutches of money lenders, primary cooperative credit societies were started at village level in 1904. Later, higher financing agencies and land development banks were established. The primary agricultural cooperatives were to provide short term finance and land development banks long-term finance. Commercial banks kept themselves aloof from rural credit.
The Reserve Bank of India appointed the All India Rural Credit Survey Committee to evaluate the co-operative structure and make recommendations for strengthening rural credit structure. The committee felt that cooperative structure has miserably failed to provide meaningful credit to the Indian farmers at the right time and in right quantity. By the criterion of need, it fails to reach the right person. The committee recommended an integrated scheme of rural credit. As part of scheme, the Imperial Bank of India was converted into State Bank of India in June 1955.

Since the nationalization of 14 major commercial banks in 1969, they were directed to extend credit to the agricultural sector - both direct and indirect. They started penetrating into rural areas by opening branches. Several schemes started, of which, Lead Bank was one among them. Though the public sector banks were allotted 18 per cent of their total advances to the farm sector, they had not satisfy the credit needs of small farmers, agricultural labourers and weaker sections of the society.

In 1975, Smt. Indira Gandhi, the then Prime minister, announced the 20 Point Economic Program Policy with an intention to liquidate the rural indebtedness of the farmers, rural artisans and weaker sections, and make a provision of institutional credit to them. To fulfill this objective, the Government of India decided to start the
Regional Rural Banks. Initially five Regional rural banks were set up on October 2, 1975.

OBJECTIVES OF REGIONAL RURAL BANKS

The preamble of Regional rural banks Act is focused on the regional rural banks in developing the rural economy with provision of credit and other facilities for the development of agriculture, trade, commerce, industry and furthering other productive activities in the rural areas, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs. The mandate of these institutions is to:

➢ Provide cheaper institutional credit facilities to the small and marginal farmers, agricultural laborers, artisans, small entrepreneurs and persons engaged in trade or other productive activities.

➢ Mobilize rural savings in the form of deposits and canalize them for supporting the productive activities in rural areas

➢ Take banking to the doorsteps of the rural masses

➢ Generate employment opportunities in rural areas

➢ Bring down the cost of providing credit in rural areas

FUNCTIONS OF REGIONAL RURAL BANKS

To achieve the stated objectives as above, the regional rural banks undertake such functions as they lead to the socio-economic
development of the rural people. The functions by regional rural banks are:

✓ To open branches in potential rural areas
✓ To mobilize rural savings by inculcating saving habit through the customization of saving schemes suitable to the rural people
✓ To deploy adequate credit in right time to the target group such as small and marginal farmers, agricultural laborers, artisans and small entrepreneurs etc., who are economically potential
✓ To monitor the projects financed
✓ To undertake the supply, extension and customer services
✓ To recover loans lent for recycling to the economic significance programmes of the rural sector
✓ To act as agent for marketing mutual fund units

FEATURES OF REGIONAL RURAL BANKS

Regional rural banks are born with certain specific features suiting their operations in rural areas to their clientele of small and marginal, agricultural laborers and rural artisans. To render services to them needs a special framework which inter-alia covers the following features. They are:

Banking Business: The business transactions of accepting deposits, lending money and other related functions in accordance
to section 5 (a) of the Banking Regulations Act, 1949 to advance loans to the economic purposes. Regional rural banks are authorized to pay half per cent more interest on deposits than the rate payable by the scheduled commercial banks.

Refinance facilities can avail from the NABARD in addition to getting funds at a concessional rate of interest i.e., below bank rate. Further, they are treated on par with the status of the co-operatives for the purpose of Income Tax.

**Scheduled Bank:** Regional rural banks are included in Schedule II of the Reserve Bank of India Act 1934 and hence they are scheduled banks.

**Target Group:** Regional rural banks activities are confined to financing of the target group consisting of small and marginal farmers, agricultural labourers, small business, artisans and other weaker sections of the rural area.

**Jurisdiction:** Regional rural banks operate within the specified district(s) in a State and establish their branches accordingly within their geographical jurisdiction. The regional rural banks open their branches in un-banked and under banked areas where co-operative credit system is weak and commercial banks have not been able to fully meet the credit needs of the people. The branch office of a regional rural bank covers one to three blocks; and is in a position to refinance five to ten farmers' service cooperative societies. In view
of financial sector reforms to strengthen regional rural banks through the process of amalgamation, the Government of India followed amalgamation according to the sub section (1) of Section 23A of RRB Act, 1976.

**Sponsorship:** The regional rural bank is sponsored by a scheduled commercial bank preferably a public sector commercial bank. It is established at the initiate taken by the sponsoring bank in consultation with both the State Government and Central Government; and under the license from the Reserve Bank of India. The sponsoring bank subscribed the share capital of regional rural bank and extends managerial and financial assistance. The provision of managerial assistance is available for the first five years of the existence of regional rural bank under subsection (3) of Section 3 of the Regional Rural Banks Act.

The sponsor bank plays a pivotal role in the operations of regional rural bank. How decisive is the organic links between the sponsor bank and regional rural bank which could be judged from the relationship listed below.

► Only on request of the sponsor bank, the Central Government would consider establishment of a regional rural bank

► Subscribe the share capital of regional rural bank, train its personnel, and provide such managerial and financial assistance during the first five years.
Nominate two directors on the Board of regional rural bank. Appoint its senior employee as Chairman of regional rural bank and removal as well. It also deputes its employees as officers of regional rural bank.

Monitor the progress of regional rural bank and course of inspection, internal audit and security

Thus, an affiliation between the regional rural bank and its sponsor bank is nothing short of an umbilical cord through which the vital nourishment reaches the regional rural bank. It is high time the regional rural banks are deregulated. It means that the sponsor bank in the matter of designing and marketing of financial products, drawing up of their investment and credit policies, embarking upon the computerization, branch expansion, etc. Even after 35 years, if regional rural banks are felt to be incompetent to decide their own business matters, it casts a big question mark on the quality of nurturing and guidance they have been receiving. Hence, it is considered that the business development should be entirely left to the acumen and experience of regional rural banks within the sole criteria of financial viability.

CAPITAL

The authorized capital of a regional rural bank is Rs.100.00 lakhs and the issued capital is Rs.25.00 lakhs. This issued capital would be subscribed by the Government of India, the Sponsored
The Board of regional rural bank in consultation with the Reserve Bank of India, the State Government concerned and the Sponsor Bank; and with prior approval of the Central Government can increase the issued capital from time to time. Such increase in issued capital would also subscribe in the same proportion as specified earlier. The Regional Rural Banks (Amendment) Act, 1988 has enhanced the limit of authorized capital from Rs.100 lakhs to Rs.500 lakhs, provided that the issued capital shall not exceed Rs.100.00 lakhs. However, this issued capital will be decided by the Central Government. Accordingly, today, most of the regional rural banks are working with an enhanced capital of Rs.75.00 lakhs.

**ORGANIZATION**

The regional rural banks shall carry on and transact business of banking as defined in clause (b) of Section 5 of the Banking Regulations Act, 1949; and may engage in one or more forms of business specified in sub-section (1) of Section 6 of the Regional Rural Banks Act. They grant production as well as development credit. To carry the specified activities, they need sound organization structure and efficient management. A sound organisation is one which finds, develops and motivates talented people to a common goal which will be winner in the competitive
world in which operations taken place. An outlined of organization and management is discussed hereunder.

**Board:** The management of regional rural bank is vested in nine members Board of Directors headed by its Chairman. Subject to the provisions of the Regional rural banks Act, the general superintendence, direction and management of the affairs and business of a regional rural bank shall vest in a Board who may exercise all the powers and discharge all the functions which may be exercised or discharged by it. In discharging its functions, the Board shall act on business principles and shall have due regard to the public interest.

The Board of directors shall consist a Chairman appointed under sub-section (1) of section 11, and the following other members as; two directors (who are not officers of the Central Government, State Government, Reserve Bank, NABARD, sponsor bank or any other bank), to be nominated by the Central Government; (b) one director, who is an officer of the Reserve Bank, to be nominated by it; (c) one director, who is an officer of the NABARD to be nominated by it; (d) two directors, who are officers of the sponsor bank, to be nominated by it; and (e) two directors, who are officers of the concerned State Government, to be nominated by that State Government. The Central Government may increase the number of members of the Board not exceeding fifteen in the
aggregate and also prescribe the manner in which the additional number may be filled in.

**Term of office:** A director (other than the Chairman) shall hold office for such period not exceeding two years, from the date when he assumes office, as the authority nominating him may specify at the time when the nomination is made, and may, on the expiry of the said period, continue to hold office until his successor has nominated and shall also be eligible for re-nomination.

The sponsor bank shall appoint an individual to be the Chairman of a regional rural bank and specify the period, not exceeding five years, for which such individual shall, subject to the provisions of sub-section (4) hold office as the Chairman; provided that no appointment of such an individual shall be made, (a) if such individual is an officer of the sponsor bank, except after consultation with the NABARD; (b) in any other case, except with the prior approval of the Central Government. The sponsor bank shall have the right to terminate the term of office of the Chairman at any time before the expiry of the period specified in sub-section provided that no such termination shall be made (a) if the Chairman is an officer of the sponsor bank, except after consultation with the NABARD; and (b) in any other case, except with the prior approval of the Central Government provided that where the Chairman is not an officer of the Central Government, State Government, Reserve Bank,
NABARD, sponsor bank or any other bank, he shall be given notice of not less than three months in writing or three months' salary and allowances in lieu of such notice.

The Chairman shall have the right to resign his office at any time before the expiry of the period specified in sub-section by giving to the sponsor bank, notice of not less than three months in writing. The individual, appointed as a Chairman under sub-section shall, on the expiry of the period specified under that sub-section, be eligible for re-appointment. The Chairman shall devote his whole time to the affairs of the regional rural bank and shall have, subject to the superintendence, control and direction of the Board, the management of the whole of the affairs of the regional rural bank. The Chairman shall receive such salary and allowances and be governed by such terms and conditions of service as may be determined by the sponsor bank in consultation with the NABARD. If the Chairman is, by infirmity or otherwise, rendered incapable of carrying out his duties or is absent, on leave or otherwise, in circumstances not involving the vacation of office, the Central Government may appoint another individual to act as the Chairman during the absence of the first-mentioned Chairman.

**Disqualifications:** A person shall be disqualified for being appointed or nominated as the case may be, for being a director, if he (a) is, or, at any time has been, adjudged insolvent or has
suspended payment of his debt or has compounded with his creditors, or (b) is of unsound mind, stands so declared by a competent court and involve turpitude.

**OTHER ASPECTS**

**Remuneration:** Remuneration to the staff of regional rural banks is fixed by the Government of India and is payable on par with the salary of employees of the State Government and local authorities of cooperative level.

**Coordination Committee:** The Government of India in consultation with NABARD has set up a State Level Coordination Committee to undertake regular review of the progress made by the regional rural banks. The Officer-in-charge of the regional office of the NABARD in the State will convene a meeting in each quarter of the year. The Committee reviews the matters such as branch expansion, business development, credit deposit ratio, training, management of resources and qualitative aspects of lending and recovery. The Committee will ensure that each regional rural bank is selected for a detailed review at least once in six months.

**Audit:** The board of directors selects the auditor out of the approved list, which is prepared by the NABARD in consultation with Government of India and obtains the approval for the appointment from the Government of India by writing to the Ministry of Finance.
(Department of Banking), Government of India. The auditor shall complete the work by April 30 of the following year.

The audited Profit and Loss account and Balance Sheet; and also the auditor report shall be placed before the Board of regional rural bank. The regional rural bank is required to submit within 90 days of the closure of its accounting year, a set of its audited Annual Accounts, Auditor's Report together with the Chairman's Report to each of its shareholders namely Sponsor Bank, Central Government and concerned State Government. Further, 60 printed copies of these documents in English and Hindi should also be submitted to the Ministry of Finance, Government of India before June 30 of the following year.

BANK POLICY

The premier institute, Reserve Bank of India is a policy-making body and is an organization of higher control. Policy may be basic or general. A basic policy guides the executive management in its conduct. Koontz and O'Donnel have described the policy as "a general statement or understanding which guides or implied overall guide the setting up boundaries that supply the general limits and direction in which managerial actions take place." Terry defines "a policy is verbal written or implied overall guide up boundaries that supply the general limits and documents in which managerial action take place." The executive should carry
out the business in accordance with these policy guidelines. The objectives set the goal and the policy shows the way towards the goal. The policy should be:

- Made in consonance with the objectives
- Temporal dimension
- Feasible dimension
- Stock environment dimension

An organization without definite policy is like a ship without a rudder. Therefore, a policy is inscribed with sacred objectives fostering economic growth and development. Policy reflects the competence and capacity of an institution. In fact, the policy guides ‘thinking and doing’ in decision-making. Therefore, the policy prescription should take note of the fact that the banks are not only channel funds to day-to-day operations, but also act as change of the socio-economic conditions of people.

**Branch Expansion Policy**: Effective operations for collecting rural savings from the myriad of savers and proper channeling credit to the credit needy always depend upon the sound and systematic banking structure and it constitutes the first systematic planned efforts for overall economic development. A bank, though small but sounds financially, is permitted to open branches.

A greater emphasis is laid on opening of branches in the rural and semi-urban areas. A stipulation is made applicable in operation of the branch expansion policy. For every two offices opened, after
October 1971 in the rural or semi-urban centers in the case of banks which had more than six per cent of their offices in the above centers; one office each is to be opened in the urban and metropolitan centers; and in the case of other banks, one office each in the urban and metropolitan/port town for every three offices is to be opened in the rural and semi-urban centers can be opened. Branch expansion has gained a sense of urgency and a problem of all India character.

On January 1, 1977, a new branch expansion policy came into being to cover up institutionally deficient rural and semi-urban centers. This policy stipulates that a bank will have to open four offices in the unbanked rural areas to get permission to open one in urban areas.

Credit Policy: The emphasis of credit policy prior to nationalization was an ensuring an uninterrupted flow of credit to the industrial concerns. Oftenly, the political forums stirred to curb this class banking. A restructuring of credit policy during mid-sixties emerged for the agriculture sector, the reason being the cooperative preserved for agricultural credit could not cope up due to introduction of high yielding varieties. Further, the credit needs of farm sector become more and more has big farmers group shown interest to adopt the new capital-intensive farm technology.
A new credit policy, after nationalization, envisaging extension of banking facilities to priority and neglected sectors of economic significance on preferential terms and conditions has been framed. This new policy is aimed at:

- Liberal credit to priority and neglected sector of economic significance
- Liberal credit to the projects in the backward areas and to help correct regional imbalances in the economy

The envisaged credit policy has set the target and sub-targets for financing of specific purposes. Accordingly, the share of priority sector in total credit was 33.3 per cent of total bank net credit. Later, it has modified to 40.00 per cent of total bank net credit. The sub-target for agriculture has been fixed at 18.00 per cent of total bank net credit. Significant structural transaction has taken place in the sectoral distribution of credit. The shares of the agriculture, small industry and specific segments of priority sector have been stepped up. The anti-poverty programmes like, Integrated Rural Development Programme (IRDP), Jawahar Rojgar Yojana (JRY), and Development of Women and Child in Rural Areas (DWACRA) etc., which have impressive economic impact, have actually been taken by banks into altogether new areas and shown a great degree of adaptability in catering the credit needs of such programmes.
The Government of India and Reserve Bank of India have not given any undertaking so far about watering down the importance of priority sector lending in response to recommendation of the Narasimham Committee. Contrary, the Government has asked the banks to support the expanding economy and pay special focus on the priority sector lending and the credit needs of the backward States and regions. The then Prime Minister in his address at the conference of Chief Ministers on Rural Development on October 8, 1992 stressed the urgency of formulating ‘holistic’ approach, which would accelerate economy of rural sector in the country.

There is no programme which is more important or urgent than that of rural development as far as India is concerned. This discerns that the policy emphasis on priority sector is likely to continue; and perhaps, the target in this respect may not be tampered with or modified. Even, if targets are modified in near or distant future, these may be altogether dispensed.

Amalgamation: The Central Government, after consultation with the NABARD, the concerned State Government and the Sponsor Bank, if it is necessary in the public interest or in the interest of the development of the area served by any regional rural bank or in the interest of regional rural banks themselves, that two or more regional rural banks should be amalgamated, by notification in the Official Gazette with such constitution, property, powers, rights,
interests, authorities and privileges; and with such liabilities, duties and obligations, as may be specified in the notification with effect from which the amalgamation shall become effective and the continuance in service of all the employees of the transferor regional rural banks at the same remuneration and on the same terms and conditions of service. Every notification issued shall, after it has been made, be laid before each House of Parliament.

On and from the date on which the amalgamation takes effect under section 23A, the transferor regional rural banks shall cease to carry on business, including that of making of any payment to any depositors or discharge any liability or obligation to the creditors except to the extent as may be necessary for the implementation of the provisions of the said amalgamation. The transferor regional rural banks by reason of amalgamation will cease to function, shall stand dissolved and such direction shall take effect notwithstanding anything to the contrary contained in Section 26.

**Monitoring:** Notwithstanding anything contained in section 19 and without prejudice to the provisions of Section 35 of the Banking Regulation Act, 1949, the Sponsor Bank shall, from time to time, monitor the progress of the regional rural banks sponsored by it and cause inspection, internal audit and scrutiny to be made by one or more of its officers and suggest corrective measures to be taken by such regional rural bank.
ROAD MAP OF REGIONAL RURAL BANKS

Regional rural banks have emerged as only surviving rural financial institution with a professional management culture to meet small-value and large-volume rural credit needs. Therefore, the time has come to revitalize/revamp the structure of regional rural banks along with co-operatives so that they play a critical role in achieving the developmental targets in the rural sector under the Tenth Plan and emerge stronger. In this context, the following initiatives are pertinent measures. They are:

Regional rural banks need to be provided with adequate capital support to enable them to have a net capital adequacy ratio (CAR) of five per cent. The issue of capital infusion by the owners assumes critical importance and needs immediate attention to enlarge the scope of regional rural banks operations. The share of sponsoring institution in the capital structure of regional rural banks needs to be enlarged to make them a majority shareholder so that the sponsoring bank can convert it into vibrant and professional subsidiary and area-specific special business unit (SBU). In the long run, it may cover all the agricultural and rural activities under the umbrella of this SBU. Even co-operative banks can be merged with these SBUs at later stages.

NABARD has evolved over the past two decades into a strong and rural-sensitive developmental institution with complete grass-
root level understanding of the complexities of the agricultural and rural sectors. It has become a major shareholder in the proposed Agricultural Insurance Corporation of India Ltd, which includes General Insurance Corporation and four public sector insurance companies, to extend crop insurance cover to all farmers.

With district development managers in most of the districts and also on the Boards of all regional rural banks and co-operatives, NABARD is now fully equipped organizationally and expertise-wise to emerge as a strong player in the rural credit system. A case in point is the promotion of self-help group movement by it, which reflects its immense capability in capacity building and nurturing the rural credit delivery system.

REFORMS OF RRBs:

Financial and Banking sector reforms (M.Narasimham-I and M.Narasimham-II) are desirable in promoting the socio-economic justice from time to time based on the reports of banking submitted by different committees in different years. The gist of reforms in relation to regional rural banks is as: Capital adequacy norms laid down first time in 1992-93, prudential norms regarding non-performing assets laid down in 1993-94, cash reserve ratio cut from 13 per cent to 10 per cent in 1995-96, and Kisan Credit Card introduced. The concept of 'Financial Inclusion' introduced in the

Although a series of banking reforms have been initiated since 1993 to make the regional rural banks system viable, recent assessments suggest that the performance of the regional rural banks in the post-reform period has been less encouraging than expected. While aggregate profitability seems to have improved slightly, becoming less negative, the overall quality of loan portfolio management, administration and collection still remains a matter of grave concern. Accumulated regional rural banks losses through March 31, 1998, were reported at almost Rs.27,870 million; losses for the year ending that date were Rs.736.5 million by a gradual increase in the average loan size and the continued bias against women borrowers. As a result, the dependence of the rural poor on informal credit continues to be significant. This has seemingly defeated a central objective of the government's rural development strategy which is to deepen and widen the availability of finance to India's historically excluded communities.

The efforts to reform the regional rural banks have had a limited impact because reformers have paid little attention to the institutional dimensions of the problems facing the banks. Specifically, few efforts were made to redesign the perverse institutional arrangements that gave rise to incompatible
incentive structures for key stakeholders, such as politicians, policy makers, stockholders, bank staff and clients. The next leg of reforms focus is on aligning the incentives of these stakeholders by giving greater importance to the internal organizational context as well as the larger policy environment within which the Regional rural banks operate.

**Key RRB Reforms:** Based on the recommendations of the Narasimham Committee Report (1992), reforms were initiated in 1993 to turn the failing regional rural banks around. To enhance financial viability, a new set of prudential accounting norms of income recognition, asset classification, provisioning, and capital adequacy were implemented. Banks were also required to make full provisioning for bulk of their nonperforming assets. Also, they were permitted to lend to non-target group borrowers up to 60 per cent of new loans beginning in 1993-94. A number of studies indicate that while the reforms have introduced an enabling environment for efficient financial transactions, they have done little to increase the internal efficiency of the regional rural banks. Attaining financial viability is the new constraint to maximize the performance with the least risks and costs. It is not surprising note that regional rural bank managers seem to have reduced their lending to disadvantaged groups and increased their money market investments.
First, managers understand that without reduced transaction costs, incentives for repayment and innovative loan products in place, it is difficult to expect previous borrowers, who are not accustomed to the culture of loan repayment, to change their behavior and repay new loans on time. Therefore, lending to old clients is risky.

Second, although it is possible for them to make loans to the non-target group clients from outside of their service areas, most regional rural bank managers find themselves lacking in credit-appraisal skills. Again, lending without analyzing the quality of the credit is risky.

Third, making new loans requires filling out redundant forms, screening and monitoring borrowers diligently and pursuing collections intensively, if one is to be in compliance and maintain good asset quality. Although regional rural bank reforms have led to blanket salary increases, they have done little to introduce incentives for better performance. Thus, making good loans might be personally costly to the managers. Under these circumstances, it is hardly surprising that the current institutional constraint of financial viability has led many managers to conclude that “the secret [to branch profitability] is not to lend; or if [one has] to lend, . . to lend as little as possible”.8

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Unfortunately, the regional rural banks reform process has not given enough attention to designing institutional arrangements that can align the incentives of policy makers with those of banks’ field staff and clients. Neglecting this aspect of reform can be detrimental to program viability. The internal efficiency of the regional rural banks will not likely improve unless the field staff actively participates in the reform process. To say that, vesting the regional rural banks branch managers with the authority to make lending decisions and freeing the staff from redundant and time consuming reporting requirements can not only boost morale but can also serve as the foundation for making good loans and operating efficiently. In addition, not only should regional rural bank branches have group incentives for meeting and exceeding the outreach and sustainability targets for their profit centers, there also need to be upfront improvements in the operational infrastructure of the banks. Such actions which can include management information systems to facilitate data storage, retrieval and manipulation in addition to other facilities can serve as signals of credible commitment on part of the owners and may go a long way in turning the regional rural banks around.9

While rural clients will certainly notice the introduction of new banking values, investments in physical improvements may not be sufficient to change their perceptions regarding the innate
inefficiencies of the regional rural banks. It may be critical to provide them with information at village level forums, regarding the new and improved business practices of the banks. Incentives such as intensive collection strategies and interest rebates for prompt payment will encourage timely loan repayment. In sum, the key to turning the regional rural banks around and placing them on a path of increasing outreach and sustainability is to devise and implement institutional arrangements that harmonize public interest objectives with the private incentives of bank staff and clients.

The political leaders can become allies, reforms can transform failing programs into models of success, as has been the case for Indonesia’s BRI Unit Desas - money-losing branches of a State-owned bank that became profitable within two years of reforms.10 Until such time as leaders feel confident that furthering the public interest is possible without political suicide, proposals that seem to adversely impact either the agricultural sector, or socially/economically weak communities, are unlikely to find support.11 Thus, educating political leaders and winning over their support will be critical for implementing the needed reforms and ultimately making the regional rural banks viable.

CHALLENGES

Institutional constraints within the regional rural banks system might be analyzed at two stages; the program level and the field
level. The former refers to the performance of the regional rural banks. It is largely rooted in their adverse policy environment. Specifically, the constraints imposed by the bank’s objectives, governance structures and business model were key determinants of their non-viability. The regional rural banks have constraints at the bank-client level related to the lack of appropriate infrastructure, low level of motivation among regional rural banks staff and an inefficient loan delivery system.

**Governance Structure:** The challenge of regional rural bank governance needs to be understood in terms of constraints related to its ownership, control, and management. In principle, each regional rural bank is capitalized and owned 50 per cent by the Government of India, 15 per cent by the State Government, and 35 per cent by the Sponsoring bank. In practice, the owners, usually the State Governments are in default on their capital contribution, thus weakening the equity base of the banks. The lack of interest in investing on the part of the shareholders resulted from the lack of incentives in contributing to ownership. Specifically, since the regional rural banks are a money-losing proposition from the very beginning, the prospect of participating in future profits is dim for the investors.

The multiple ownership of the regional rural banks which is viewed as bureaucratic controls, led pronunciation of schemes
in the case of regional rural bank such as the Integrated Rural Development Program; and District Rural Development Agencies in which a combination of Government subsidy and term credit (in the ratio of 1:2) is provided to farmers and artisans to foster self-employment. Although the IRDP schemes were formally housed within the regional rural banks, any lending under the scheme affect their financial statements. The governing body of these agencies included locally elected representatives at the national, State, and district level Governments as well as the heads of various District Development Departments. A separate State-Level Coordination Committee is monitor the program at the State level, while the Ministry of Rural Areas and Employment is responsible for program funding, monitoring, and evaluation.

Given the top-down and static nature of policy, the owners' representatives on the board of directors as well as the sponsor bank and the regional rural bank managers, had virtually no authority to make any strategic decision regarding the regional rural banks. Devoid of freedom to make any commercial improvements to the system, most stakeholders, especially the sponsor banks, became apathetic towards regional rural bank issues. A study conducted by Government of India's Khusro Committee noted that the regional rural bank boards did a poor job of monitoring their performance, simply because they had no
interest in the affairs of the banks. In a large number of cases, boards consisted of political appointees unfamiliar with the technical aspects of banking and finance. Therefore, the informally accepted norm at the irregularly held Board meetings is to skirt any issues related to lending policies or financial performance. Instead, they spent time discussing either personal issues or those related to policy neutral areas, such as staff recruitment.\textsuperscript{12} Thus, lack of a single owner with clear ownership and control, and no prospects for profits, diffused accountability and weakened oversight of the regional rural banks, seriously impairing the governance of the banks.

**Business Model:** Rural banking policies, especially those prescribed by the RRBs Act, made it difficult for the bankers to build a viable business model. The regional rural banks are required to maintain high statutory liquidity ratios of 25 per cent,\textsuperscript{13} a constraint that reduced the availability of capital. Also, the yields on this ratio are lower than prevailing lending rates and thus implicitly taxed the regional rural banks. Further, un-standardized norms for income recognition made it difficult to assess accurately the financial performance of them, since income on loans included both interests that are paid as well as interest that is due. Not knowing how long interest payments had been in arrears, most managers found it difficult to provide for non-performing assets.
Further, defining geographic markets, opening and closing branches, making and collecting loans, containing administrative costs and setting interest rates are key barriers to enhancing financial sustainability. Disbursement of loans in the absence of collateral to economically weaker sections of the rural households with land holdings less than 6.5 acres and incomes less than Rs.10,000 located in specific and restricted geographic areas is also an added factor to the poor recovery performance. Banks are allowed to lend only predetermined amounts for specified lending terms.

Given the pressure from Government authorities to increase loan volume to meet quantitative targets, bank staff had little authority or incentive to engage in due diligence and assess the risks of lending to such individuals. Thus, lending decisions are often reduced to making superficial matches between individuals socio-economic profiles and the available schemes. Even though many poor borrowers did not have the ability to be productive entrepreneurs or the capacity to repay the loans, they participated in the programs to access what they thought is free money from the Government. In most cases, it is the wealthier sections of the community, with connections and political patronage benefited from the schemes. These well-to-do borrowers felt little pressure to repay their debts. Many bank branches are often forced to remain open even if areas had sparse populations and little potential for
entrepreneurial activities. Further, a 1993 court victory by the bank workers' labor union granted regional rural bank staff the same remuneration as their counterparts in sponsor banks and added to the banks already escalating costs.

Finally, the lack of incentives among bank staff to engage in intensive loan collection, the unwillingness of State Governments to assist in recovery procedures, and the blanket loan waivers granted by the Government further boosted loan losses. As a result, willful loan defaults became a norm over the years. In addition to the high risks associated with lending, the high cost of administration also constrained the regional rural banks financial viability. According to Mosley, the regional rural banks Subsidy Dependence Index was 153 per cent for 1992. This means that that the banks would have had to more than double their average lending rate of 16.6 per cent or more than half overdues, just to break even during that year.\textsuperscript{14}

Under the given high profile and political stature of the regional rural banks, it is noticed that the implementation of high interest rate is clearly is not possible in view of the mandated role of these institutions for financing the weaker sections at concession rates.

**Infrastructure:** Since the regional rural banks were originally envisioned to serve as low-cost rural extensions of the banking system, few investments are made in their infrastructure development. Lack of appropriate infrastructure made working at the
banks, and living in the villages, difficult propositions.\textsuperscript{15} Many staff members abstained from work to avoid the adverse work environment, choosing to live in semi-urban areas outside of the regional rural bank villages. As a result, some bank branches were open for only 18 hours a week, while others closed down several times a month to catch up on internal paper work. These practices were inconvenient for clients, who often took their business elsewhere.

**Staff Motivation:** Given the lack of basic infrastructure within bank branches, and perhaps most important, the money-losing business model of the regional rural banks, many sponsor banks assigned their junior officers who may not have business management skills to head the rural bank branches. Therefore, officers who are posted at regional rural banks often reflected in their lack of willingness to be innovative and entrepreneurial, and in their belief that the regional rural banks could ultimately do little to improve the situation of the poor.

A focus on bureaucratic compliance displaced the need to make good loans, monitor their performance and emphasize the need for timely repayment. Despite the strong focus on reporting, however, it took three to six months for the branch managers to identify borrowers in default.\textsuperscript{16} Finally, the regional rural bank pay scales which until recently were lower than those of their peers in
sponsor banks not linked to performance, bank staff had little reason to improve efficiency or to push hard and collect on nonperforming loans. In fact, the unattractive compensation scale created strong incentives for inefficiency.

**Loan Delivery System:** Inefficiencies in the loan-delivery system resulted in inflexible lending practices and high transaction costs for clients. Loan products are usually long term, required balloon repayments, and are tied to the specific types of investments that are assumed to have predetermined cash flows. Even applicants with good credit histories and collateral could be turned down if their requests did not fit the various regional rural bank schemes. Since such schemes laid out the terms and conditions of the loan, the unique financial conditions of applicants, especially in terms of the complexities of their families' cash flows and their repayment capacity, are never a consideration in lending decisions. In addition to inflexibility in lending, high transaction costs also created disincentives for borrowing.  

Loan applicants are required to produce a no dues certificate which served as proof of good credit standing, before they receive loans. Acquiring this document often took several weeks. Further, if individuals wanted to do business with a regional rural bank outside their service area, a no objection certificate had to be obtained from the bank within their service area. Finally, many prospective
borrowers, especially those who are illiterate, approached middlemen to facilitate access to funds. Borrowers faced transaction costs that are much higher compared to other financing sources. Indeed, it is not surprising that many rural farmers and small scale entrepreneurs, who generally value convenience as compared to the cost of credit, turned to informal sources for their credit needs. In enhancing the viability of the regional rural banks, reforms, no doubt address with the institutional constraints and perverse incentives in the regional rural bank system.
References:

2. Ibid
11. Klitgaard, R., "Cleaning Up and Invigorating the Civil Service."
