Working Paper 229

The Outreach/Viability Conundrum: Can India's Regional Rural Banks Really Serve Low-Income Clients?

Sanjay Sinha, Tanmay Chetan, Orlanda Ruthven and Nilotpal Pathak

October 2003

Overseas Development Institute
111 Westminster Bridge Road
London
SE1 7JD
UK

Acknowledgements

This paper was prepared as part of the ODI Livelihood Options study with funding from the Department for International Development but the views expressed here are those of the authors alone. It was undertaken by EDA (UK) Ltd through its associated organisation Micro-Credit Ratings International Limited (M-CRIL). The authors are grateful to Daniel Start of the Overseas Development Institute for initiating the study and for his contributions to the proposal – in determining the content and methodology of the study. Thanks also to John Farrington for his guidance and support in the publication of the report as an ODI Working Paper.

In the initial stages of the study consultations were held with NABARD (Mr Y.C. Nanda, Chairman and Mr K.K. Gupta, General Manager of the Institutional Development Department), the Reserve Bank of India (Mr Yashwant Thorat, then Resident Director in Mumbai, Mr Sardesai, then Chief General Manager and Dr Deepali Pant-Joshi, General Manager of Rural Planning and Credit Department) and the College of Agricultural Banking, Pune. Ajit Kanitkar of the Swiss Agency for Development and Cooperation, New Delhi was also consulted. At various times in the course of the study Professor Malcolm Harper provided useful comments on the methodology of the study and the approach of the team in the field.

Specific assistance in identifying the appropriate sponsor banks and enlisting their support was provided by Krishan Jindal of the Bankers Institute for Rural Development, Lucknow and Vijay Mahajan of BASIX, Hyderabad. The authors are extremely grateful to them for this. Special thanks are also due to Mr M.A. Krishnan, Chief General Manager, State Bank of India and Mr B. Pramod, General Manager, Syndicate Bank for their support in enabling access to the sample Regional Rural Banks (RRBs) covered by the study.

Finally, and most of all, the authors acknowledge gratefully the assistance of the Chairmen, General Managers, various Branch Managers and staff of the Head Offices and sample branches of the RRBs covered by the study. In order to respect the request of the RRB managements for preserving confidentiality, the specific banks are not named in the report.

The authors sincerely hope that the six months of research and analysis invested in this study will not only result in increasing the focus of the RRBs on viable lending to low-income clients but will also increase the interest of commercial banks in supporting and working with the RRBs for this purpose.

Sanjay Sinha, EDA (UK) and M-CRIL
Tanmay Chetan, M-CRIL
Orlanda Ruthven, Consultant
Nilotpal Pathak, M-CRIL
Email: edarural@nda.vsnl.net.in

Micro-Credit Ratings International Ltd
104 Qutab Plaza, DLF City-1
Gurgaon 122002
INDIA

ISBN 0 85003 691 7

Contents

List of Figures

List of Boxes

Acronyms and Abbreviations

ATL	Agriculture Term Loan
BIRD	Bankers' Institute for Rural Development
CAB	College of Agricultural Banking
CB	Cooperative Bank
DCCB	District Central Cooperative Bank
DDM	District Development Manager
DRDA	District Rural Development Agency
GDP	Gross Domestic Product
ISB	Industry, Service and Business
KCC	Kisan Credit Card
LAB	Local Area Bank
MFI	Microfinance Institution
NABARD	National Bank for Agriculture and Rural Development
NGO	Non-governmental Organisation
NIBM	National Institute for Bank Management
NPA	Non-performing Assets
NPS	Non-priority Sector
PACS	Primary Agricultural Cooperative Societies
PCARDB	Primary Cooperative Agricultural Rural Development Bank
PSB	Public Sector Bank
RBI	Reserve Bank of India
RRB	Regional Rural Bank
RoA	Return on Assets
SBI	State Bank of India
SCARDB	State Cooperative Agriculture and Rural Development Bank
SCB	State Cooperative Bank
SGSY	Swarnajayanti Gram Swarozgar Yojana (Golden Jubilee Rural Self-Employment Programme)
SHG	Self-help Group
UCB	Urban Cooperative Bank

Summary

The provision of formal financial services in rural India has traditionally been the domain of government-owned financial institutions. Even in the mid-1990s, public sector institutions owned over 90% of the assets of the banking sector. Some 65% of the small loans sector (i.e. under US$ 4,200 [=Rs200,000]) is accounted for by public sector Regional Rural Banks, and the small (but growing) number of private and foreign banks have shown virtually no interest in the rural sector.

A series of reforms in the late 1990s particularly affected the RRBs, infusing them with new capital, encouraging them to achieve better repayment levels, and allowing them to close down non-viable branches. Thus, whilst the majority of RRBs were incurring losses in 1996–7, by 2001 over 85% were earning current profits. But these improvements were in large measure attributable to a shift towards a wealthier clientele.

A study by Economic Development Associates and Micro-Credit Ratings International Ltd for the Livelihood Options study sampled a total of 5 RRBs, three in a healthy financial condition, and two less so, one of which was located in a remote area. It sought to assess how far the apparent tension between coverage (especially of poorer clients) and financial viability was a real one.

The study suggests that there is no binding tension between the two. There has been some growth in average size of account but RRB business remains geared to small clients. The combination of product design and efficiency of operations explains why some RRBs can override this tension, whilst for others it remains real. Products such as the Kisan Credit Card and Non-Priority Sector advances (mainly tied to gold and jewellery) are safe, profitable and easy to administer. The more efficient RSBs score well on Industry, Service and Business loans, whereas the less efficient do not. However, loans to self-help groups are so costly to administer in staff time that even the more efficient RRBs would virtually have to double interest charges on them (from the current 12.5–13%) in order to break even.

Overall, the crucial ingredient is the quality of branch management: managers have considerable latitude to adjust products to the local market, to take decisions independently of head office, to engage staff in decision-making and so on. Profitability is very strongly correlated with proactive and well-judged management, and it is in only two of the five RRBs surveyed that these qualities were observed. Programmes of capacity building and motivation among managers are likely to generate high returns.

1 Rationale for this Study

1.1 The Indian rural financial sector: institutions and bank coverage

The provision of formal financial services in rural India has traditionally been the domain of government-owned financial institutions. Before the initiation of the first phase of economic reforms in 1991–2, almost the entire banking sector consisted of state-owned institutions. Even in the mid-1990s, public sector institutions owned over 90% of the assets of the banking sector (Deolalkar, 1999).

India's principal commercial banks were taken over by the government through successive phases of nationalisation, mainly in 1969 and 1980. These banks, referred to as the Public Sector Banks (PSBs), still constitute the mainframe of the Indian financial sector. The rural coverage of these banks was augmented through the introduction of two other types of institutions – the Regional Rural Banks (RRBs) and the Cooperative Banks (CBs)[1]– the former through an Act of the Central Government in 1975 and the latter through Central and State Acts in the 1980s. Together, these three categories of institutions carry out almost the entire formal sector financial activity in rural India, though in the country as a whole private and foreign banks, State Financial Corporations, private intermediaries (such as non-banking finance companies, societies and trusts – collectively referred to as microfinance institutions, MFIs) also gained importance during the 1990s.

Table 1 Coverage of rural markets by banks

	PSBs	RRBs	CBs	Private, foreign and others
Number	27	196	397	76
Total branches	46,118	14,473	n.a.	5,595
% rural branches	42%	83%	n.a.	20%
Total deposit balances (Rs billion)	9,688	432	944	2,340
Total credit outstanding (Rs billion)	5,094	184	823	1,716
Credit in rural areas, % of total credit	10%	72%	~100%	2%
Credit in 'small' rural accounts, % of total outstanding credit	6%	65%	>90%*	1%

Sources: RBI (2002a; 2001)
* Authors' estimate
Notes
1 All figures are for March 2002, except for information related to Cooperative Banks and the share of rural bank business (last two rows) where March 2001 data is presented, since updated information was not available at the time of writing.
2 PSBs include 19 public sector banks, the State Bank of India and seven associate banks.
3 The column on Cooperative Banks includes State Cooperative Banks (SCBs) and District Central Cooperative Banks (DCCBs) only; data available for 31 March 2001.
4 Cooperative Banks number 397, comprising 30 SCBs and 367 DCCBs.
5 The column on private, foreign and other banks includes 31 private, 41 foreign and 4 Local Area Banks (LABs).
6 Data on deposit and credit outstanding for RRBs is only for 188 of 196 RRBs for which information is available.
7 The cooperative banks function mainly through village-level cooperative societies (Primary Agricultural Cooperative Societies, PACS, and Primary Cooperative Agricultural Rural Development Banks, PCARDBs). There are approximately 100,000 PACS and 732 PCARDBs in the country.
8 Small borrower accounts are defined by the Reserve Bank of India (RBI) as loans less than Rs200,000 (US $4,200).
9 The rural sector is defined by the RBI as centres with a population less than 10,000.

[1] Cooperative banks have a multi-tier structure and the rural cooperative banks are broadly classified into: Tier 1 – State Cooperative Agriculture and Rural Development Banks (SCARDBs); Tier 2 – State Cooperative Banks (StCBs) and District Central Cooperative Banks (DCCBs); Tier 3 – Primary Agriculture Cooperative Societies (PACS) and Primary Cooperative Agriculture and Rural Development Banks (PCARDBs). In addition, Urban Cooperative Banks (UCBs) also function as individual banking units that are independent of this structure.

The coverage of formal sector financial institutions, especially in rural areas, is summarised in Table 1. It is apparent from the table that private and foreign banks have not taken an interest in rural financial markets and, in terms of credit supplied in rural areas compared to their other banking activities, even the Public Sector Banks have a limited stake. On the other hand, RRBs and Cooperative Banks were incorporated for the specific objective of rural banking and, therefore, operate with a distinct rural focus. Further, a significant proportion (65%) of RRB portfolios are in accounts of less than Rs200,000 (US $4,200) – classified by the Reserve Bank of India as 'small' – indicating the depth of outreach of RRBs. The state and district Cooperative Banks, on the other hand, work through village-level credit societies (PACS) and lend mainly to the agricultural sector resulting in almost their entire credit supply being in rural areas.

1.2 Rationale for this study: the policy and operational context and concerns

It is apparent from the above information that RRBs play a major role in the rural financial sector. Since their inception in the 1970s, they have been seen as a vital means of dispensing credit to low-income families in rural areas and have traditionally been assigned the primary responsibility for the outreach of government-sponsored lending schemes intended for poor rural families. Having been saddled with the twin burdens of directed credit and a restrictive interest rate regime, however, RRBs have historically incurred substantial losses. These losses were accentuated by politically motivated decision-making, emphasis on subsidised lending and an overall welfare-orientation expected of such institutions.

With the initiation of reforms in the early 1990s, the Indian banking sector saw a shift in approach. Private and foreign banks were allowed to establish and expand operations while profitability also became the major guiding principle for government-owned banks. The impact of this was seen in the subsequent policy decisions of the government and the Reserve Bank of India (RBI), many of which had a significant impact on RRBs. The important policy landmarks during this period included asset quality classification and provisioning norms for RRBs (1995–6), rationalisation of the remuneration structure for RRB staff (that were brought at par with other commercial bank officers), guidelines on staffing (as part of the efficiency norms for RRBs), and relaxation on limits set for lending to the 'priority sector'.

These policies were formulated with the objective of improving the viability of the operating structure of RRBs for delivering financial services in rural areas. Through these changes, RRBs were geared to treat their advances with more caution than in the past and repayment performance became a crucial operating parameter.

However, other policy measures that were dictated by this concern for viability were also seen as diluting the traditional outreach objective of RRBs during the 1970s and 1980s. RRBs were, thus, allowed to relocate, merge or close down loss-making branches. Relocations or mergers were undertaken mostly from relatively inaccessible rural areas to more vibrant semi-urban locations. Licensing norms for opening new branches were relaxed, to the extent that some RRBs were even able to open branches outside their designated districts of operation.

The impact of these measures was augmented through fresh infusions of public capital into the RRBs during the late 1990s, to make up for the accumulated losses of the past. This, coupled with the viability orientation brought about through the supervisory authorities and the sponsor banks, has resulted in the revival of the financial health of most of the RRBs during the late 1990s. While in 1996–7, when provisioning norms were first introduced, the overwhelming majority of RRBs incurred losses, by 2001, as many as 172 of 196 such banks in the country were earning current profits. As Table 2 shows, the recent overall financial performance of this category of banks compares favourably with that of the commercial banking sector.

Table 2 Financial performance indicators by sector (March 2001)

Indicator	All RRBs	All scheduled commercial banks[2]
Credit-Deposit ratio	39.0%	49.0%
Deposits/total liabilities	77.0%	81.0%
Priority sector advances/total advances	73.0%	30.0%
Cost of funds	7.4%	7.3%
Return on advances	12.3%	11.5%
Return on investments	19.0%	11.0%
Return on total assets	1.3%	0.57%

Source: RBI Database, www.rbi.org.in

When seen in relation to the coverage of rural and small clients (in Table 1) the overall competitiveness of RRBs and their relative suitability for serving the needs of the rural poor become apparent. However, in relation to the importance of viability to the managements of RRBs, while their share of business in the rural sector remains high, in recent years a tendency to shift from low-income rural clients towards more urban, higher value clients has become apparent.

1.3 Study objectives, methodology and sample selection

It is in the context of concerns about maintaining and improving the outreach of formal financial services to low-income rural clients while ensuring the viability of the service providers that this study has been undertaken.

The broad questions addressed by the study are:

1. Has the viability objective drawn the RRBs away from their original focus on serving low-income rural clients?
2. Is it possible for RRBs to continue to serve low-income clients with small accounts in a viable manner? What products succeed and which ones fail on this account?
3. What modifications to loss-making products would make them a viable proposition for the banks?

Thus, the specific objectives of this study were to:

1. Assess the RRBs' current level of commitment to low-end market products (including smaller farm loans, non-farm loans (both secured and unsecured), term deposits, insurance products/linkages, small savings and credit services, and other fee-based services).
2. Assess the cost and income structure (profitability) of providing these products and ascertain their likely sustainability in the current economic situation.
3. Project the potential for the future viability of these products versus other investment and lending options available to the RRBs.
4. Map the constraints that exist already or may arise in the future in achieving a sustainable focus on poorer markets. These could relate to staff incentives, skills, ability to adapt to new ways of

[2] Scheduled commercial banks include RRBs in addition to all private, foreign and nationalised banks, and the State Bank of India and its associates.

working, political pressure, management control, leadership. Identify the constraints faced by the managements of the RRBs in taking advantage of the new freedoms apparently provided by deregulation.

This study relies primarily on detailed case studies of five sample RRBs to achieve its objectives. These sample RRBs were selected on the basis of:

- Financial performance: a range of indicators was considered for selecting RRBs that were performing well, in terms of a focus on lending (Credit-Deposit ratio), portfolio quality (levels of non-performing assets (NPA)) and profitability (Return on Assets (RoA) out of current profits). Apart from three financially healthy RRBs, the sample selected included one RRB performing poorly on lending (low C-D Ratio) and profitability to understand the issues that lead to such market withdrawal, and an RRB located in a remote and very poor region of the country – with average performance overall. Therefore, the indicator mix aimed to neutralise issues of profitability based on investment income, which has been the strategy adopted by a number RRBs during the last five years in their quest for viability.
- Regional spread: most RRBs that show good performance on the indicators above are situated in southern India. The study includes RRBs from central, northern and eastern India in the sample in order to capture any regional issues that may arise although some of the sample RRBs were not the best performers. Further, the salient features of the working areas of the sample RRBs were also factored in to provide adequate area context and analyse performance of RRBs across varying levels of difficulty in terms of the local operating environment. The work area of the sample RRBs is discussed in Section 3 in relation to the analysis of outreach and financial performance.
- Sponsor banks: the role of the sponsor bank as a guiding factor for RRBs – particularly in the reform period – has been paramount. The study included RRBs sponsored by two large progressive commercial banks that have sponsored a number of RRBs. This was done in order to assess the impact of the institutional environment on RRB operations.

The selection of the sample was carried out after discussions on the scope of the study with personnel from the RBI (Rural Planning and Credit Department), National Bank for Agriculture and Rural Development (NABARD), Bankers' Institute for Rural Development (BIRD), the College of Agricultural Banking (CAB) and the National Institute for Bank Management (NIBM) amongst others.

The final sample of RRBs consisted of four RRBs strong on C-D ratio (>50%), three on current profitability (positive annual net profits) and two on portfolio quality (NPAs<10%), as listed in Table 3. In addition to bank level indicators, sample branches within the selected banks were identified for a detailed analysis of cost and revenue parameters, along with other outreach and branch-level operational issues. The selection of branches took into account geography and demography as well as placing relative emphasis on branches that were doing well in reaching low-income clients through specific loan products (such as the Kisan Credit Card (KCC), self-help group (SHG) and off-farm industry, service and business (ISB) loans). Between two and eight branches were studied at the five RRBs, depending on area variations as well on the strategy employed by the particular bank for reaching the low-income client segment that is the focus of this study.

Table 3 Key indicators of the sample RRBs

Sample RRB[3]	Sponsor bank	Financial performance (%)			Region
		C-D ratio	RoA	NPA	
RRB1	Syndicate Bank	66	1.9	7.4	Southern
RRB2	Syndicate Bank	57	3.2	9.6	Northern
RRB3	State Bank of India	57	(3.9)	16.0	Eastern
RRB4	State Bank of India	27	(0.7)	20.9	Central
RRB5	SBI subsidiary	65	2.4	13.0	Southern

Source: Data obtained from each of the sample banks

The sampling at this level relied on the guidance of RRB senior staff at head offices, since branch-level data compilation and analysis for sampling purposes was often not possible. The criteria used for this selection were:

- rural location (except that the experience of RRB branches in semi-urban/urban centres was also discussed in order to understand the challenges faced);
- typical in size, scale of operations and portfolio quality to overall bank operations;
- possession of a predominantly low-income clientele, as indicated by regional characteristics;
- demonstration lending to low-income groups through adequate exposure in product categories that are more likely to serve their needs (such SHG, deposit-linked or ISB loans) and a similar or higher C-D ratio in comparison with the bank as a whole.

A few adjustments to this selection were necessitated by practical considerations. The adjustments made related to scale and quality of operations resulting in the study sometimes focusing on branches with above average size and performance. The selection of branches, however, ensured that the client profiles were typical of the RRB.

Data from all sample branches was analysed and, for the purpose of this report, one branch for each bank was selected for its proximity to the overall bank performance in terms of scale and client profiles. The aim of this selection was to illustrate issues in product design and delivery that are specifically relevant for banks that plan to reach low-income clients in greater numbers rather than to make generalisations about overall RRB performance or to highlight individual banks. A summary profile of the branches covered in detail in this report is provided in Table 4.

As shown in Table 4, all branches in the sample have in their operational (service) areas high levels of families either without any agricultural holdings or who are small/marginal farmers. This is taken as indicative of the concentration of low-income families in the area. RRBs have fixed working areas – specific villages allocated to each bank branch – and usually do not venture out of their areas for lending operations. Though they do accept deposits from clients outside their service areas, this is rare in the sample branches as their location is generally not favourable for such customers.

At each sample RRB the study incorporated discussions with senior managers, data collection at the bank level and that of the sample branches, a group discussion with a set of branch managers to understand their perspective in relation to issues of outreach, viability and product delivery. Detailed discussions with managers and other staff at the sample branches were undertaken in relation to time allocated to specific tasks and visits were also made to a random, if limited, sample of clients.

[3] The names of the sample RRBs have been withheld at the request of one of the sponsor banks.

Table 4 Profiles of branches selected for detailed operations study

Particulars	**RRB 1**	**RRB 2**	**RRB 3**	**RRB 4**	**RRB 5**[4]	
Region	Southern	Northern	Eastern	Central	Southern	Southern
Number of villages (service area)	8	12	45	22	10	33
Total population	20,000	40,000	15,000	13,000	25,000	60,000
Small and marginal farmers (%)	15%	75%	80%	70%	50%	50%
Landless (%)	50%	20%	15%	18%	30%	40%
Total irrigated cultivable area	50%	0%	30%	25%	70%	30%
Small and marginal farmers (% of cultivated area)	10%	60%	60%	65%	40%	35%
Distance (km) of nearest competing bank branch	16	5	(next door)	8	12	16
Number of crops per year	4–5[5]	2	2	1	2	1
Main crops	Chillies, sweet orange	Mentha, paddy, wheat, potato	Paddy, turmeric, vegeta-bles, hill gram, niger seed	Paddy, wheat, gram, vegeta-bles	Paddy, sugar-cane, turmeric	Tobacco, cotton, sugar-cane

Source: Branch-level data collected from the sample banks.

[4] Since RRB 5 shows distinctly different lending strategies in different areas, two branches of the bank were included in the final sample – this is explained in Section 4.
[5] Chillies, the main crop in the sample area, are harvested 4–5 times a year, from the same standing crop.

2 Operational Framework, Policy and Business Strategy

2.1 Ownership and governance: the roles of sponsor banks and regulators

The ownership structure of RRBs has remained unchanged since their inception. Three categories of owners of the RRBs –central and state governments and the sponsor banks – hold the equity of RRBs in the ratio 50:15:35 respectively. This allows them representation on the board of directors of the RRBs in the same proportion. Typically there are four nominees from central government (including one RBI and one NABARD officer), three from the sponsor bank (including the Chairman, who is also the Managing Director) and two from the state government.

NABARD, the supervisory authority, and the Reserve Bank of India, the regulator, are closely associated with operations through their nominee Directors. The District Development Manager (DDM) of NABARD from one of the operational districts is on the Board and advises the RRB on operational strategies on a regular basis. The other Directors also play a role in decision-making but the operational leadership of the RRB lies mainly with the Chairman, who is a deputed officer of the sponsor bank.

The sponsor banks – invariably the large public sector banks – were entrusted with the role of guiding the RRBs in banking operations, a role that continues even 25 years after the establishment of the first RRBs. For this reason, the sponsor banks still also depute a General Manager to each of the RRBs to manage day-to-day operations and supplement the banking skills of their nominated Chairmen.

At times, the non-official directors of the RRBs – who are political appointees in most cases – are reported to display low interest levels and are guilty of espousing populist measures or even getting involved in staff-union issues of the bank. Overall, the governance structure in RRBs is complicated because of the varied interest groups involved.

The performance of the major public sector banks as sponsors of RRBs is summarised in Table 5. Whereas the State Bank of India (SBI) and its subsidiaries account for the largest share of business volumes and network the other sponsor bank of the sample RRBs for this study, Syndicate Bank performs exceptionally well in financial performance and coverage in relation to its market share. It handles more business than its RRB share, and does so with a good focus on lending, portfolio quality and with excellent performance on overall profitability. Further information on the performance of the sponsors of the sample RRBs is provided in Box 1.

Table 5 Performance of RRBs under main sponsors, March 2001

Particulars	State Bank of India	SBI subsidiaries	Syndicate Bank	Central Bank of India	Punjab National Bank	Bank of Baroda	Total all RRBs
Number of RRBs (%)	15%	9%	5%	12%	10%	10%	100%
Advances accounts (%)	18%	5%	11%	8%	7%	7%	100%
Deposits accounts (%)	15%	3%	11%	9%	8%	9%	100%
Advances share (amount, %)	14%	5%	16%	7%	8%	8%	100%
Deposits share (amount, %)	13%	4%	9%	11%	10%	9%	100%
NPAs (weighted, %)	20%	19%*	9%	21%	21%	25%	18%
C-D ratio (weighted, %)	42%	67%*	73%	28%	31%	37%	41%
Profitability contribution (weighted, %)	13%	5%	20%	5%	13%	6%	100%
Number of RRBs in current profits (% of sponsored RRBs)	83%	100%	100%	87%	89%	84%	88%

Source: NABARD (2001)
* For only one SBI subsidiary that was included in the sample RRBs. The range for all SBI subsidiaries is 3–19% for NPAs and 39–67% for C-D ratio.

Box 1 Syndicate Bank and the State Bank of India as sponsors of RRBs

The State Bank of India sponsors the largest number of RRBs in the country. It has been very actively involved in the development of RRBs and has provided them with significant governance and management support. RRBs sponsored by the SBI account for 16% of branches, 15% of staff, 15% of deposit accounts, 18% of advances accounts and 16% of borrowings of all the RRB branches in the country. Of the 30 SBI-sponsored RRBs, 25 are currently earning a net profit – with nine having been able to wipe out their accumulated losses – whereas five are still incurring losses. The combined C-D ratio of all these RRBs is 42%, almost equal to the all-India weighted average of 41% for March 2002. The combined NPA of the SBI-sponsored RRBs at 20% is somewhat higher than the national average.

The efficacy of Syndicate Bank's support to its RRBs is reflected in the performance of the sponsored banks. All ten Syndicate Bank-sponsored RRBs are currently profitable and only one has residual cumulative losses. The Credit-Deposit ratio of these RRBs averages 73% and NPAs 9%.[6] This is in contrast to the all-India average for RRBs: a C-D ratio of 41% and NPAs of 18%. While Syndicate Bank's RRBs make up 8% of branches nationally, they manage 16% of loans outstanding and are responsible for 20% of net profits generated by all the RRBs in the country.

Source: NABARD (2002)

2.2 Operational policies: human resources, expansion and other benchmarks

The last decade has seen important policy initiatives in the banking sector in India, and has encouraged RRBs to move from 'social' banking to more commercial operations. The biggest initiative has been the deregulation of interest rates that has, at least in theory, allowed banks to move towards pricing both in line with market trends and with their own delivery and financing costs.

[6]March 2001 figures

Other operational policy decisions that concern the operations of RRBs are discussed in this sub-section in the context of important policy measures that were taken – mostly for RRBs as a whole – during the reform period of the 1990s.

2.2.1 Impact of important policy measures

Organisational structure and human resources

A ban on new recruitments has been in place since 1991 while business has grown more than ten-fold for most RRBs and total assets have grown almost three-fold between 1996–2002 for all RRBs.[7] Thus, substantial growth in both advances and deposit levels has been associated with constant staff levels. Since the first batch of RRB staff (recruited around 1976–7) is due for retirement in a few years, the pressures on staff efficiency – with increased business – is likely to increase over the next two to three years.

The organisational structure of RRBs is similar across regions and sponsor banks. The concept of area offices as control as well as promotional units – and intermediaries in information flow – has augmented the efforts of the branches without being a significant cost burden. The only conceptual difference in this is that some RRBs have a centralised structure, with all area managers located at the head office. This has limited the control functions of area managers since frequent travel to branches and verification checks are more expensive and time consuming because of the greater distances involved.

The organisational structure at the head office is also standardised to a large extent, with clearly segregated areas for the management of investments, advances, deposits, planning, legal, accounts and personnel functions. The responsibility centres at the head office are clearly defined with very little, if any, duplication.

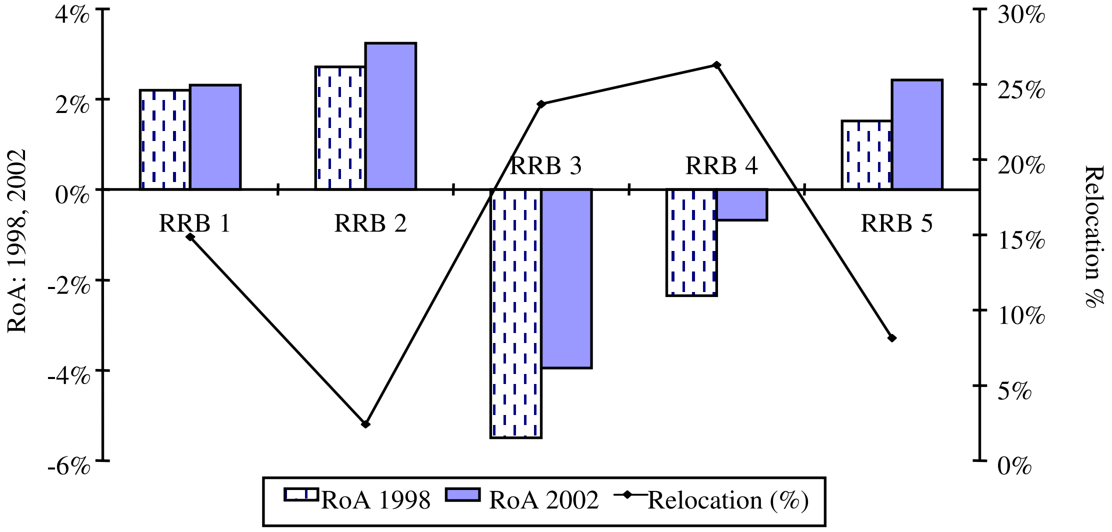
Branch relocations

Permission to relocate branches that have been consistently making losses for more than three years was accorded to the RRBs in 1993. This policy presented a window of opportunity for RRBs to shift branch premises to more commercially promising areas from localities where they had incurred sustained losses. This resulted in a tendency for RRBs to shift branches towards more urban centres. As many as 90 branches in the five sample RRBs have been relocated or merged since 1993–4. This represents about 14% of the 650 present branches of the five RRBs studied, with relocations ranging between 4–27% for the five banks. This strategy of relocation alone did not result in any dramatic improvement in the profitability profile of the RRBs – as is apparent from Figure 1 below.

---

[7] Total assets during this period have grown from Rs190.5 billion to Rs568 billion (RBI, 2002a; RBI website www.rbi.org.in)

Figure 1 Branch relocation and RRB profitability



Source: Data from sample banks

In the figure, the banks with the highest relocation percentage still continue to show the poorest profitability, and the effect of relocation – most of which happened before 1997–8 – do not seem to have had any discernible impact on overall profitability by financial year 2001–2. However, the RRB with the highest relocation percentage (RRB 4, 27%) does show higher profitability improvement than the other four in the sample.

While relocations and mergers have not had a dramatic impact on profitability, it is apparent from field observation that the often remote rural areas from where they have moved to more commercial centres are now under-served and this has resulted in a clear shift in clientele.

Lending to the non-priority sector (NPS)

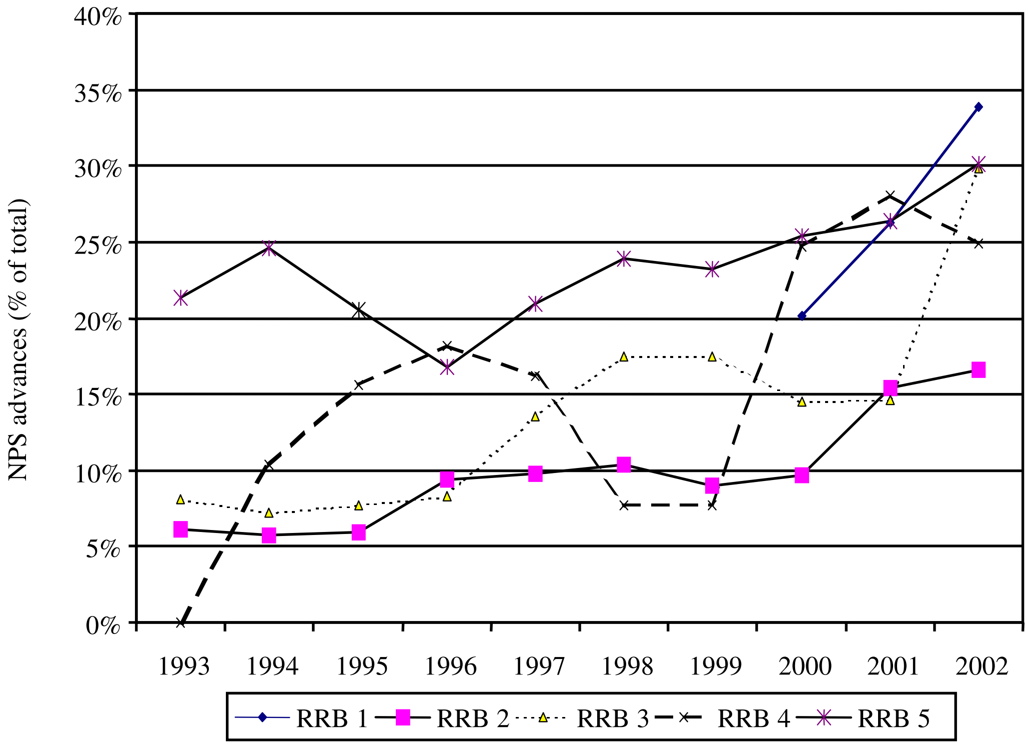
Lending from RRBs was initially restricted to the priority sector and it was only in 1991 that this restriction was lifted. Since then, RRBs have diversified into a range of non-priority sector (NPS) advances, including jewel- and deposit-linked loans, consumer loans and even home loans.[8] This move has allowed banks to reduce exposure to agriculture and also to earn more from the higher interest rates on these products.

The movement of the overall loan portfolio of sample RRBs from a predominantly priority sector portfolio towards a more balanced sectoral distribution can be seen in Figure 2.

This indicates the strong trend towards NPS advances in the second half of the decade, in all RRBs except RRB 5, which already had a high NPS share by 1993. All RRB managers agree that this was a deliberate strategy adopted to improve viability – since NPS advances carry higher interest charges in comparison with other advances – as also for covering hitherto untapped markets; specifically market-based (rather than directed credit) to low-income clients through deposit and jewellery-linked loans. Except for one bank in the sample (RRB 2, which relies more on the agricultural potential in its area), all others have a significant 25% of their portfolios invested in non-priority sector loans.[9]

[8] From 2002 onwards, home loans are classified under the priority sector.
[9] This data could not be compiled for the entire period for RRB 1, though the distribution suggests high proportions throughout.

Figure 2 Trends in the share of NPS advances in total loan portfolio



Source: Data from sample banks.

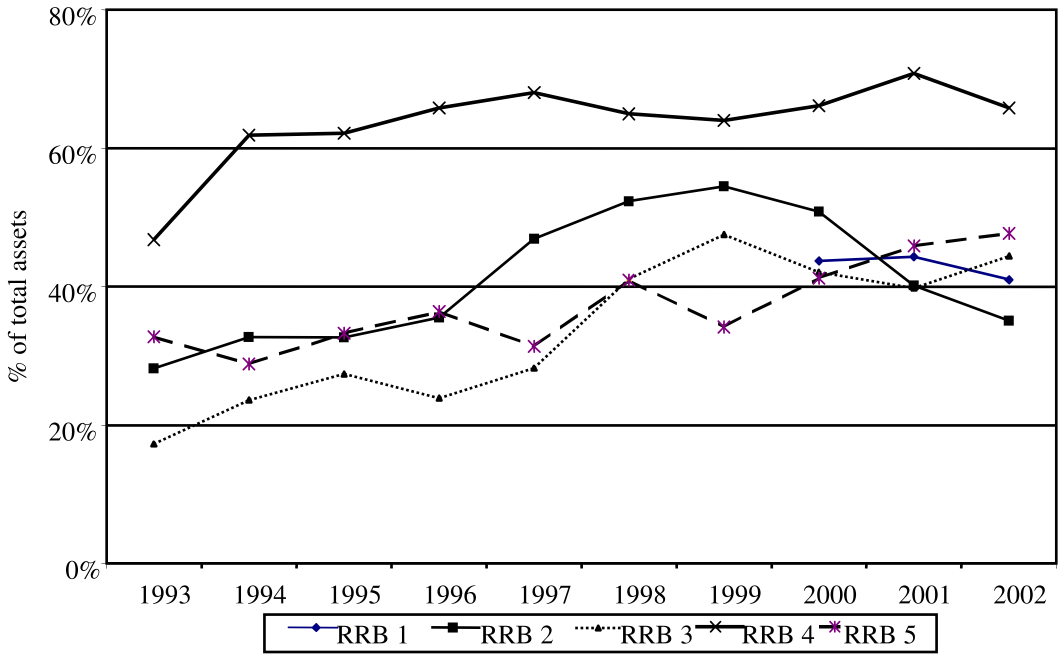
Prudential norms for accounting and asset classification
Until 1995–6, the RRBs did not undertake any provisioning for potential loan losses. In 1995–6, the RBI formulated asset classification norms for RRBs that followed customary banking benchmarks. As a result, the RRBs were hard hit during the financial year 1996–7, when these norms were first introduced. Apart from providing a more realistic picture of their loan portfolio, the application of asset classification norms forced RRBs to place greater emphasis on appraisal systems for lending and many slowed down their disbursements to allow for better systems to be introduced and for these systems to stabilise.

2.3 Business strategy: portfolio investments and reduced dependence on agriculture

The sample RRBs have adopted multiple strategies for the achievement of the profitability/viability objective. In addition to the measures made possible or necessitated by the policy changes – branch relocation, non-priority sector lending and greater emphasis on appraisal systems – RRBs have, particularly since the latter half of the 1990s, placed a high proportion of their assets in investments. Essentially, these banks were able to take advantage of the high real interest rate regime prevailing at the time to obtain relatively high yields from financial instruments such as government bonds, inter-bank lending and the call money market with only a fraction of the real level of risk associated with their loan portfolios.

Figure 3 shows the increase in the share of investments in total assets that took place for the sample RRBs in the 1990s. It is only over the past couple of years that a decline in the yields on investments has resulted in some renewal of interest in lending.

Figure 3 Share of investments in total assets



Source: Data from sample banks

Overall, the investments of all 196 RRBs as at end-March 2002 constitute 44.5% of total assets.[10] Thus, it is apparent from the figure that the sample is representative of the industry as a whole. RRB 4, which has a very low C-D ratio, expectedly has the highest exposure to investments. However, it is also the least profitable of the sample RRBs and it would appear that neither its lending nor its investment strategies have been particularly successful.

In addition to shifting away from priority sector lending, RRBs have adjusted their portfolios within the priority sector. There is now a much lower dependence on agriculture and allied activities than in the past. While to begin with RRBs lent almost exclusively for agriculture and allied activities the current industry average is around 46% of the loan portfolio (sample average, 50%; range 39–75%).

2.4 Conclusion: the importance of leadership

Finally, the policy framework, its impact and the evolution of business strategies need to be seen in the context of the leadership of RRBs. Decisions on strategic issues rest with the Chairman, who is the Chief Executive Officer of the bank and also the representative of the Sponsor Bank. Variations in the response to the policy framework occur even when the RRB operates under the aegis of the same Sponsor Bank. This phenomenon will become apparent from the analysis of operations in the following sections.

For now, the radical differences in operational policy as implemented by the senior management of the RRBs are illustrated in Box 2. These examples demonstrate the dependence of operational policy on the approach and outlook of the RRB Chairman. It is the Chairman who has to persuade the Sponsor Bank to take appropriate policy decisions. In the sample RRBs, where the Chairmen have lost interest and do not make efforts beyond the routine functions, the bank show few signs of financial recovery or outreach achievements. On the other hand, dynamic Chairmen have brought

[10] RBI (2002a). This proportion includes investments in government and other approved securities and assets with the banking system, most of which is parked with the Sponsor Bank and the RBI to meet Statutory Liquidity Ratio and Cash Reserve Ratio requirements.

about significant operational changes and improved staff morale along with financial performance. Specifically:

- RRB 1: Progressively decentralised decision-making functions enabling the senior RRB management to participate in the making of all important decisions. This improved morale and made the bank more professionally driven.
- RRB 5: One of the first RRBs to initiate salary revisions for the staff in line with the Supreme Court's orders, thereby showing an inclination to recognise and address staff issues, had a tremendous morale-boosting effect at all levels of the bank.

Box 2 clearly demonstrates the importance of leadership to the management and the strategic orientation of the RRBs. RRB managers and officers repeatedly blame their Chairmen for all the ills affecting their banks, but are also quick to shower praise for innovation and positive strategies in RRBs where the Chairmen have done well. It is, perhaps, unfortunate that even after 25 years of banking experience, so many RRB staff feel so completely dependent on their Chairmen/Sponsor Banks and isolated from the decision making process.

As a detailed discussion of financial performance and outreach achievements is undertaken in the following sections, this central concern about the importance of leadership will provide the backdrop for the analysis and conclusions.

Box 2 Leadership differences within the same Sponsor Bank

RRBs 4 and 5 have the same sponsor – the State Bank of India. In RRB 4, the Investment Committee that takes final decisions on investments and the trading of securities must always confer with the Chairman before making investments. In RRB 5 the Investment Committee is free to take decisions up to Rs50 million ($1.05 million) without the involvement of the Chairman if he is not available. The result is that whereas RRB 5 has earned Rs12 million over the past few months through the trading of government securities (in a falling interest rate environment during 2002), RRB 4 cannot claim to have taken similar advantage of the changing environment in spite of the greater importance of investments in its asset profile. Moreover, the senior RRB staff at RRB 5 has developed a good understanding of the securities market, whereas RRB 4 managers still feel the need for capacity-building on treasury management.

RRBs 1 and 2, both sponsored by the Syndicate Bank, have different approaches to agriculture and SHG lending. RRB 1 is actively trying to diversify its portfolio through aggressive marketing of consumer and gold loans, whereas RRB 2 relies more on the strong agricultural demand in its area. SHG linkages in RRB 1 are through government agencies, whereas RRB 2 managers form their own groups (farmer SHGs), train them and link them to the bank. RRB 1 has lower profitability since its portfolio in non-agricultural loans needs a greater marketing effort, however, its risk is lower due to its lower share of portfolio in agriculture. RRB 2 has not made much of an effort to diversify its portfolio and spread the risk on its (>70% of portfolio in) loans for agriculture. This also has outreach implications since RRB 1's strategy is more suitable to the needs of low-income clients than RRB 2's focus on agricultural loans.

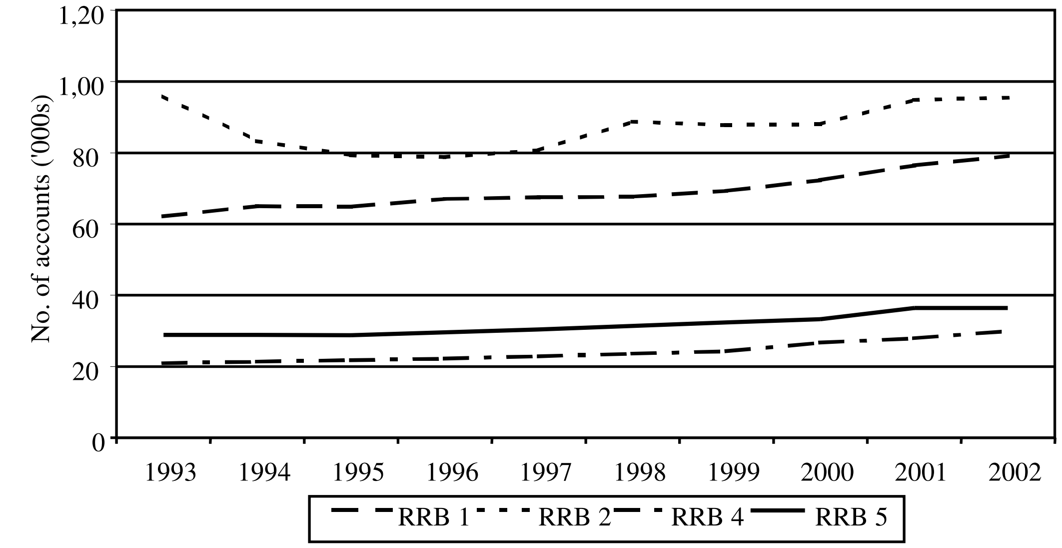
The leadership in these banks is reported to be directly responsible for the strategies selected. Whereas RRB 1's strategy is the result of the conscious devolution of decision-making, RRB 2's continuing focus on agriculture is reflective of a lack of initiative in exploring new markets on the part of its senior management.

3 Growth, Outreach and Financial Performance

3.1 Business growth: stagnant outreach but increasing account size

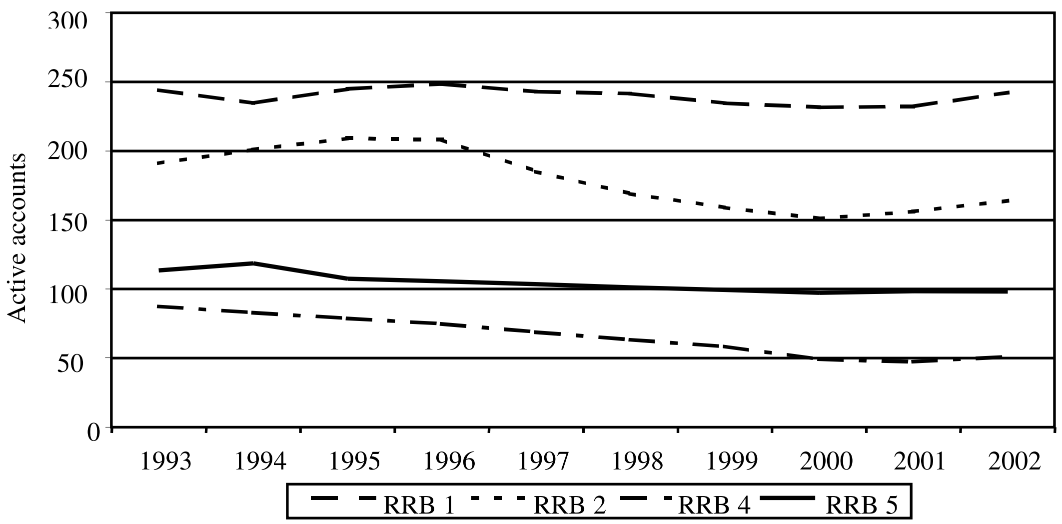
The trends for the last decade show very little, if any, growth in the number of loan accounts for the sample RRBs. The number of deposit accounts has increased slightly, though the market share of RRBs is still low. Growth in business has taken place via an increase in the sizes of both deposit and advance accounts. Figures 4 and 5 show the trends in the number of deposit and advance accounts for the sample RRBs.[11]

Figure 4 Trends in deposit accounts



Source: Data from sample banks

Figure 5 Trends in loan/advance accounts



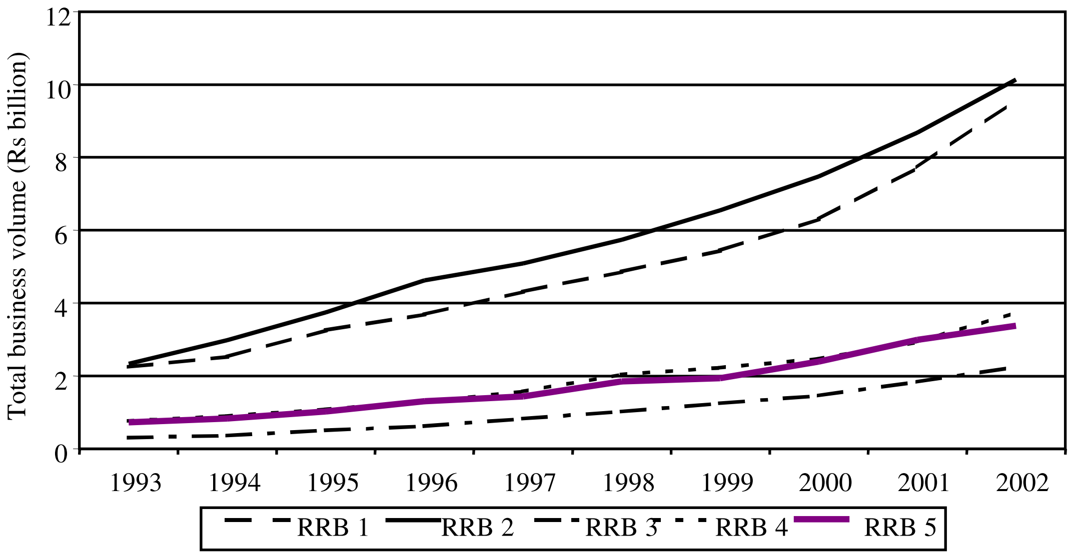
Source: Data from sample banks

[11] These figures were not available for RRB 3, which did not compile this information as part of its information systems. For RRBs 4 and 5, figures for some years were not available, so estimates based on discussion with staff have been used to arrive at overall trends.

These two figures indicate a small growth in the number of deposit accounts and a decline in the number of loan accounts. The weighted average annual growth for deposit accounts of four of the sample RRBs over the nine-year period is 1.7% – this ranges between zero (RRB 2) to 4.0% (RRB 4) for the sample banks. However, the number of advance accounts actually registers a weighted average annual decline of 1.5%, with a range of -0.1% (RRB 1) to -5.8% (RRB 4) for the sample RRBs.

In terms of overall outreach, therefore, the sample shows negligible change from the levels nine years ago. On the other hand, the overall business levels of the sample branches have grown significantly, as illustrated by Figure 6.

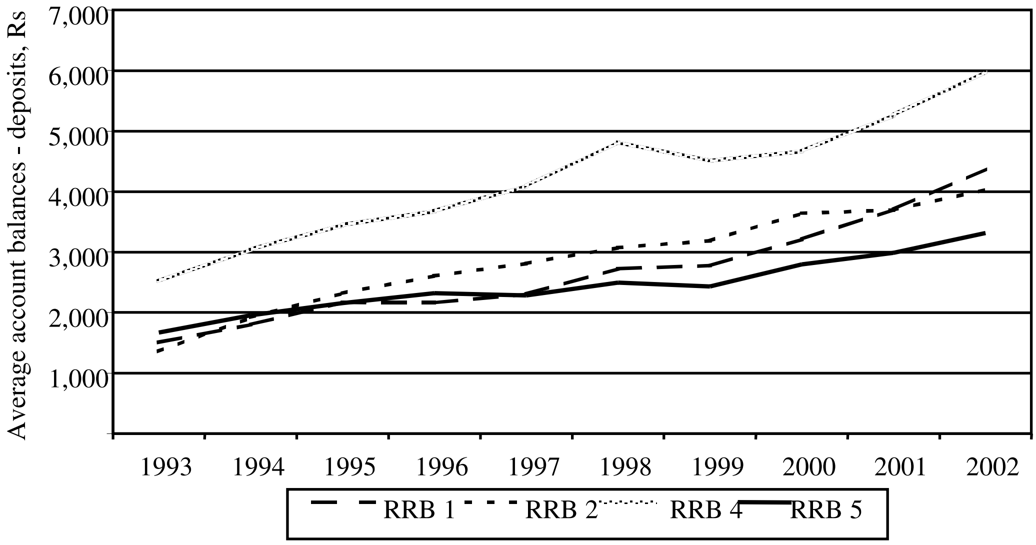
Figure 6 Trends in growth of overall business levels



Source: Data from sample banks

The weighted average for the sample registers a compound growth rate of 18.8% annually. The compound annual growth rates for the five RRBs range between 17.5% for RRB 1 to 25.0% for RRB 3. This indicates the rapid increase in account sizes, since the number of accounts has not increased during the decade. An analysis of average deposit and advance balances emphasises this increase, which is significant even after inflation adjustments. The trends in average account sizes after adjusting for inflation are presented for the sample RRBs in Figures 7 and 8.

Figure 7 Trends in growth of average deposit balances (inflation adjusted)

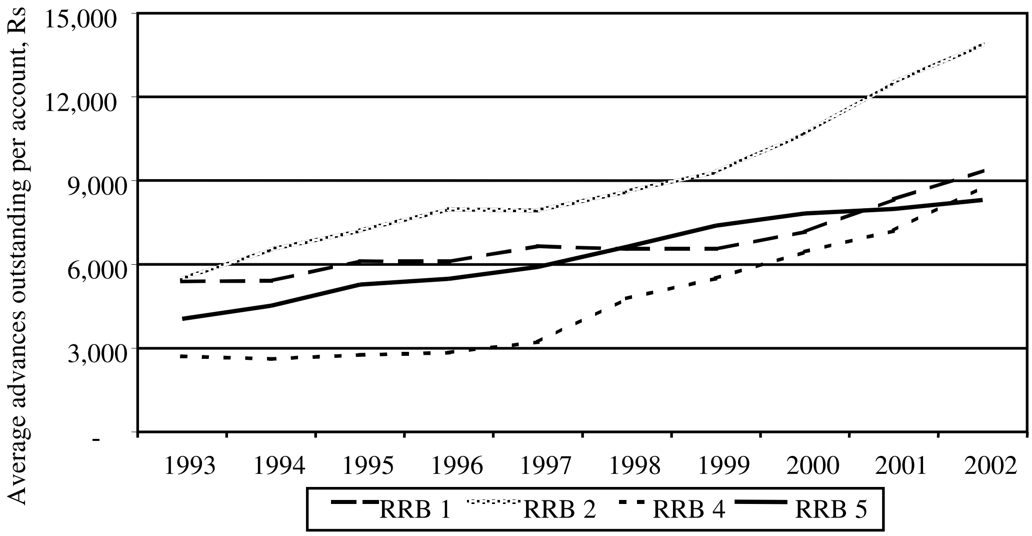


Source: Data from sample banks

Average growth in the size of deposit accounts after adjusting for inflation ranges between 7.9% (RRB 5) and 12.9% (RRB 2) annually. The overall weighted average growth rate of deposit account sizes for four of the sample RRBs is 11.8% per annum. The growth rate of deposits is marginally higher during the first half of the decade than in the second. The sample shows similar trends in the growth of deposit sizes of the RRBs and, barring RRB 4, even the average account sizes are comparable. This is indicative partly of macro-economic factors like the increase – during this period – in overall disposable income with the public.

Advances show similar growth trends (Figure 8), the sample RRBs record good growth rates on outstanding balances, and average balances are comparable for three of the four RRBs. RRB 2 has an almost 50% higher size of outstanding balances at end-March 2002, though this gap has not been so significant at any time in the past. The vibrant sugarcane-based agricultural economy of RRB 2's operating environment is apparently responsible for this substantial difference (see Section 3).

Figure 8 Trends in growth of average advances balances (inflation adjusted)



Source: Data from sample banks

The overall weighted average annual growth of advances for the sample is 9.0% for the nine-year period, and ranges from 6.3% for RRB 1 to 13.9% for RRB 4. This means that the real value of account balances has more than doubled during the period (the inflation adjusted weighted average of account balances has increased from Rs8,054 to Rs17,511 at 2002 prices) over a period when the real per capita GDP grew, on average, at 4.3% per annum. Since per capita GDP was of the order of Rs12,000 in 1992–3 and rose in real terms to Rs18,400 in 2001–2,[12] the average loan outstanding to GDP ratio has increased from 0.67 to 0.95 during this period.

It is clear from this discussion that there has been a shift in RRB clientele away from the poorer segments of the population and – as discussed earlier – from areas with low potential to those with better off client groups.

Amongst the sample banks, RRB 2 has recorded the strongest growth rate in deposit sizes and is the second highest in growth of advances outstanding. On the other hand, it is the weakest in the sample in terms of client growth, with lowest (0% annual) growth in depositors and second lowest (-1.7% annual) growth in loan clients. The extent to which its retreat from serving low-income clients has contributed to RRB 2 becoming the most profitable in the sample (and one of the most profitable in the country) is discussed in the following section.

3.2 Coverage indicators: market shares and main client categories

RRBs were established as banks for the large (65%) rural population of India, with the prime objective of improving outreach to hitherto non-banked areas of the country.

Market share: small in terms of business volumes
Their network of rural branches, however, does not necessarily translate into business transactions with the rural clients, who might prefer the commercial bank branch of the area for efficiency reasons, or the primary agricultural cooperative society for reasons like ease of access to subsidised fertiliser and seed and also because of the location of the cooperatives at village level. An analysis of the branch network and business volumes of the sample RRBs in their operational areas is presented in Table 6. Despite good geographical coverage and a high share of accounts, the share of RRBs in overall bank business is quite low.

Table 6 Branch network and market share within their respective areas (percentage of all commercial banks)[13]

Particulars – RRBs' share in	RRB 1	RRB 2	RRB 3	RRB 4	RRB 5
Number of branches	31%	38%	47%	25%	25%
Number of accounts – advances	36%	54%	52%	8%	n.a.
– deposits	27%	41%	44%	10%	n.a.
Advances portfolio	18%	19%	28%	4%	9%
Deposit portfolio	10%	28%	28%	7%	7%

Source: Data from sample banks

Visits to branches of the sample banks indicate that RRBs still have a long way to go before they can emerge as market leaders in the semi-urban and urban centres in their service areas. A host of factors, including service time and delivery features (related to the computerisation of branches, policies allowing cheque/draft clearance facilities, maintenance of currency chest) as well as product

[12] Information from Table 1.1, IES (2002).
[13] Cooperative banks and postal services are not included here.

characteristics (loan interest rates in RRBs are typically higher than those of commercial banks) make it difficult for RRBs to compete in urban centres.

3.2.1 Outreach: significant to low-income clients

Given the low business volumes of RRBs in relation to their share in the accounts of banks operating in their districts, it is not surprising that while the average rural advances of the scheduled commercial banks were of the order of Rs25, 900 and deposits around Rs11,200 in March 2002, the sample RRBs average advances were just Rs17,500 and deposits just Rs7,200. This substantiates the presumption that, in comparison with the scheduled commercial banks, RRBs continue to service the lower end of the market.

This is further substantiated by Table 7 which provides the distribution of small loan accounts (below Rs25,000, $520) across loan categories. As the table shows, more than three-quarters of all advance accounts in the sample RRB branches – except RRB 4 – are classified as small with RRBs 1, 4 and 5 reporting average sizes of advance accounts that are lower than the national GDP per capita (Rs18,400, approximately $400).

Table 7 Distribution of small advances by sector in sample RRB branches, March 2002

Advances category	Loan quantum <Rs25,000 (% of outstanding accounts)				
	RRB 1	RRB 2	RRB 3	RRB 4	RRB 5
Average size of outstanding loans for the RRB, Rs	15,677	23,263	n.a.	14,696	13,903
% of loans classified as small (<Rs25,000) – bank average	85%	92%[14]	n.a.	58%[15]	n.a.
% of total, sample branch	94%	89%	77%	55%	83%

Source: Data from sample banks

Thus, despite a 15% shift in branches away from the poorest and remotest rural areas and a high overall increase in loan amounts during the late 1990s, it is apparent that the RRBs continue overwhelmingly to serve low-income clients. Their role of providing financial services to low-income clients in a situation where commercial banks are reluctant to serve small depositors and borrowers remains as important as ever.

3.3 Work area profiles and sectors of operation

An important issue for this study was to understand the degree to which success – or the lack of it – of RRBs may be attributed to factors affecting the banks' operating environment. This analysis aims to determine whether area characteristics are a major factor or whether there are inherent strengths in the system that can be leveraged to maintain financial performance of RRBs even in the most difficult working areas.

Table 8 plots the working areas of the five sample RRBs on socio-economic area characteristics

[14] A sample of 12 branches has been taken since this information for the entire bank was not available.
[15] A sample of 11 branches was taken as in RRB 2.

Table 8 Socio-economic characteristics of RRBs' areas of operation

RRB	Irrigation	Agriculture	Infrastructure	Literacy	Population density
RRB 1 – South	✗	✗	✗	✓	✗
RRB 2 – North	✓	✓	✗	✗	✓
RRB 3 – East	✗	✗	✗	✗	✗
RRB 4 – Centre	✓	✓	✗	✓	⇔
RRB 5 – South	✗	✗	✓	✗	✓

Note: Irrigation: area under irrigation as a percentage of total cultivable area, including private irrigation facilities. Agriculture: value of crops grown, net sown area. Infrastructure: infrastructure index of the Centre for Monitoring the Indian Economy, or where not available, indicators such as road length/100 km^2. Literacy: overall literacy rate, number of schools/100,000 persons.

✓ Better than country average;

✗ Lower than country average.

⇔ Similar to the country average.

Source: Assessment of the study team using information from various sources.

This classification, and the discussion in Box 3, suggests that RRB 3 has the most difficult operating area in the sample. The working environments of RRBs 1 and 5 are also quite difficult. RRBs 2 and 4 operate in areas known for their agricultural potential and, therefore, have a relatively more promising environment for rural banking.

Box 3 Working environment challenges, opportunities and responses

RRBs 1 and 5 operate in areas that are frequently under the spell of drought while irrigation facilities are erratic and scarce. Though a range of cash crops is grown in these areas – tobacco, cotton, chillies and even oranges in some areas – these are totally dependent on private bore-wells.

Both banks have realised the futility of over-dependence on agriculture for their banking operations and have actively diversified their products. Their portfolios have shown rapid growth in SHG lending, ISB loans and non-priority sector advances like gold and deposit loans. Since these products typically carry higher rates of interest and are fully secured by way of liquid assets they have had a very positive impact on the financial performance of the two banks.

RRB 2 lies in an area known for its agricultural prosperity. The bank has leveraged this strength well until now. It has linked up with a number of agricultural processing units (sugar mills) and handles a large volume of their deposits.

On its loan portfolio, the bank has shown great initiative in forming farmer's SHGs and Vikas Volunteer Vahini Clubs (VVV clubs), which act as an extension of the bank's branches, mobilise demand and also help with recovery. Since the work area of the bank has immense potential under agriculture, it has neither needed nor tried to look beyond this market segment. A variety of crops – sugarcane, mentha, wheat – and the clientele of an affluent farmer community have been harnessed by the bank. However, its profitability is still only marginally better than that of RRB 1 which operates in a significantly more difficult environment.

RRB 4 presents a rather sad picture. Though the bank operates in an area referred to as the rice bowl of central India, it has not managed to harness the banking potential of the area. The bank has not taken any interest in lending, and as articulated by one senior manager, 'it has functioned primarily as a deposit collector for its Sponsor Bank'. This situation has been worsened by local interests that have burdened the RRB with huge responsibilities under government-sponsored schemes, most of which have fared poorly in banking terms. Compounding matters, a difficult human resource environment in the past has marred its operations.

RRB 3 admittedly functions in one of the most impoverished areas of the country. To the bank's credit, it has attempted to take banking to the poor, engaged with local NGOs in its efforts and has succeeded in achieving reasonable outreach under the SHG-linkage programme. At the same time, it has also improved coverage under non-priority sector advances – gold and deposit loans. However, its performance has been affected by a high exposure to government schemes, where the portfolio quality and the profitability of the bank have suffered.

In practice, whereas RRB 2 has a predominantly agriculture-oriented loan portfolio (>75%), RRBs 1 and 5 have less than 60% invested in agriculture, and have diversified into financing small businesses, providing consumer loans and financing women's SHGs for diverse activities. RRB 4 has continued to rely on agriculture and has not experimented with new products and market segments. RRB 3 has tried non-priority (deposit- and gold-linked) and SHG lending to some extent, and has succeeded in reducing its exposure to (dependence on) agriculture. The discussion of financial performance of the sample RRBs in the following sub-section takes account of these differences in operating environment and operational strategies.

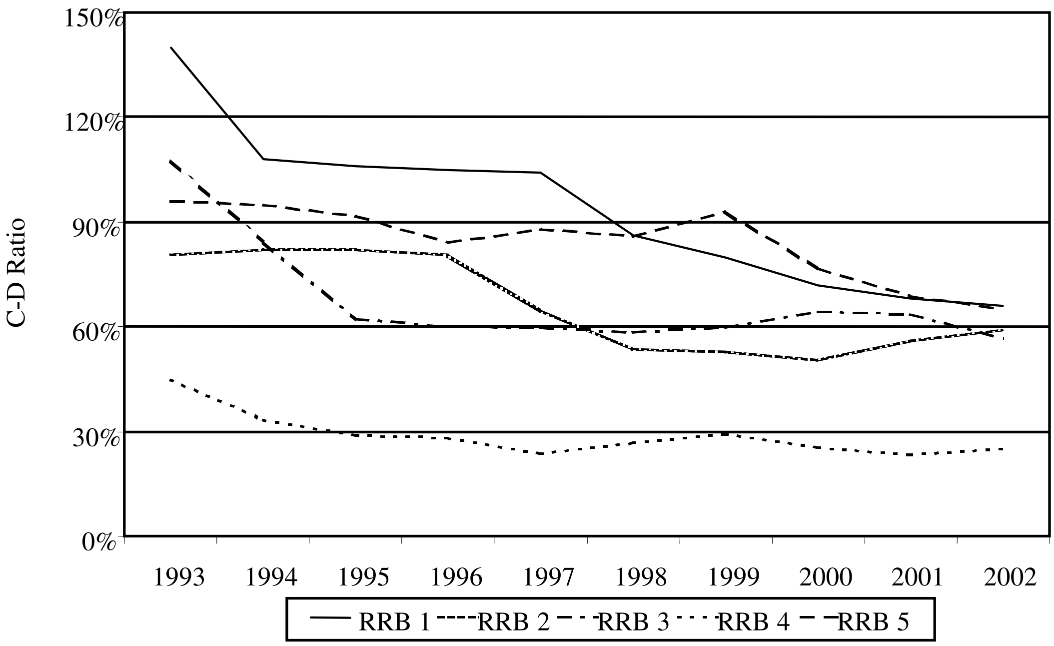
3.4 Financial performance trends: lending, investments, deposits and profitability

3.4.1 Credit-Deposit ratios: declining despite high liquidity

The banking sector has been characterised by high liquidity during the last few years, resulting from good deposit mobilisation but restrained lending by managements desperately attempting to improve portfolio quality. Part of this liquidity has been invested in the money markets – government securities and bonds, in particular – but, with falling real interest rates, the extent to which this is a profitable strategy is now open to question.

Four of the sample RRBs are leaders in their regions in terms of lending focus. As shown in Figure 9, RRBs 1–3 and 5 all slowed down their lending during the period until the late 1990s and shifted their funds into the high return investments available at the time. However, with a decline in investment yields their C-D ratios have, since, stabilised.

Figure 9 C-D ratio trends in sample RRBs



Source: Data from sample banks

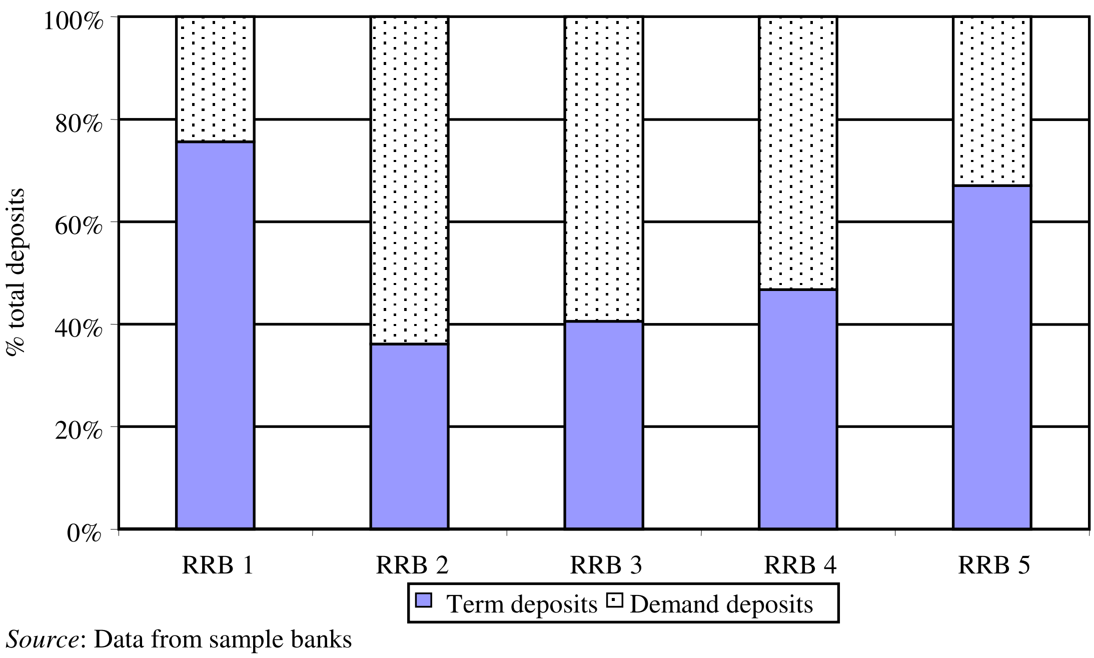
Three of the sample RRBs have even shown marginal improvement in this ratio during the last year (2001–2), with only one showing continued decline. This is likely to improve over the next few years, though a drought in many parts of the country during 2002 is likely to have reduced credit demand. RRB 4 had a very low C-D ratio throughout the period under study, clearly indicating that lending has not been the focus of the bank's operations since the 1990s. RRBs 1, 2 and 5 have been the most consistent in their credit dispensation efforts and this is reflected in their profitability performance as well.

Overall, four of the sample RRBs have current C-D ratios in the range 55–65%, in comparison with overall industry averages of 43% for RRBs and 53% for all scheduled commercial banks on 31 March 2002. Thus, these four sample RRBs had maintained a commitment to lending (and outreach) to a far greater extent than most other banks in the country, in general, and other RRBs, in particular.

3.4.2 Deposit collection and small savings accounts

The deposits mobilised by RRBs come overwhelmingly from the private savings of individual clients since, in most cases, government and private institutions prefer other banks to hold their funds. During the study it became apparent that government institutions are overwhelmingly inclined towards the 'lead bank' in their district for maintaining their accounts, whereas private commercial institutions are more inclined towards scheduled commercial banks on account of facilities like outstation cheque/draft clearances. The RRBs' deposit services form a major facility for rural populations since scheduled commercial banks often do not have any branches in these areas. The extent to which clients opt for term deposits provides an indication of the acceptance of RRBs by the public as a safe and convenient place for their savings. Figure 10 presents the proportion of term and demand deposits for the sample in March 2002.

Figure 10 Share of term and demand deposits



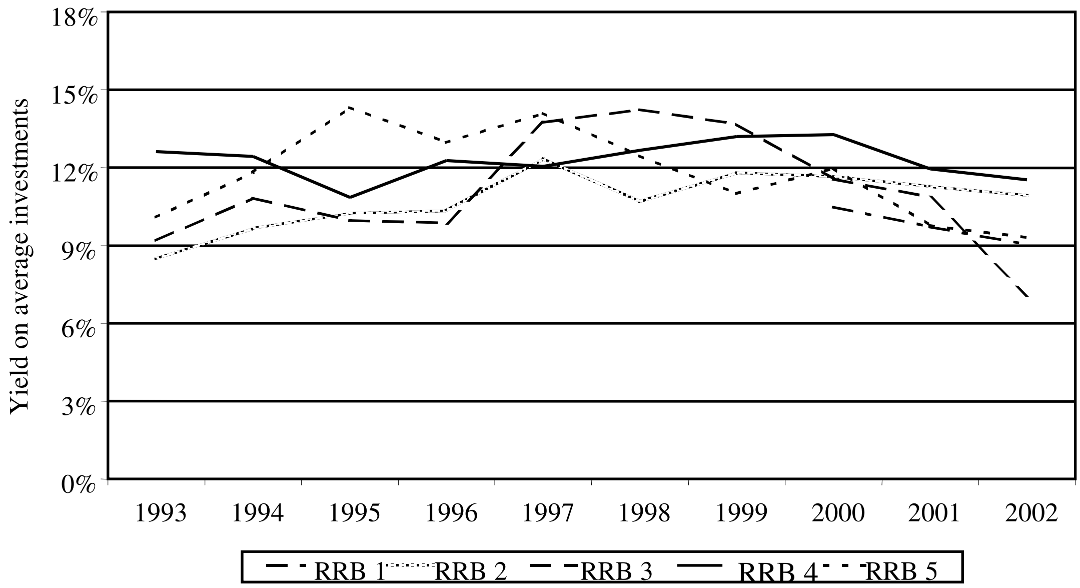
Source: Data from sample banks

RRBs 1 and 5 have followed a strategy of marketing term deposits aggressively, and have succeeded in mobilising high proportions of such deposits from the public. This has enabled them to plan their cash flows better, since the withdrawal of term deposits is more predictable. It also shows that these banks have established their credibility better with the public than the other RRBs. In absolute terms, RRB 2 has the second highest balance of term deposits in the sample, but the large current balances in the accounts of private sugar mills overshadow this. With identical products, the other RRBs have been less successful in mobilising long-term deposits from the public. The discussions with bank managers and interaction with clients during this study indicate that this is largely due to the lack of marketing effort on the part of these banks.

3.4.3 Investment and credit portfolio and yield movements

The extent to which investments formed an attractive option and diluted the RRBs' commitment to lending during the last 5–6 years becomes apparent from the trends in yield on investments (Figure 11), on the one hand, and those in the yield on advances (Figure 12), on the other.

Figure 11 Trends in yield on average investments



Source: Data from sample banks

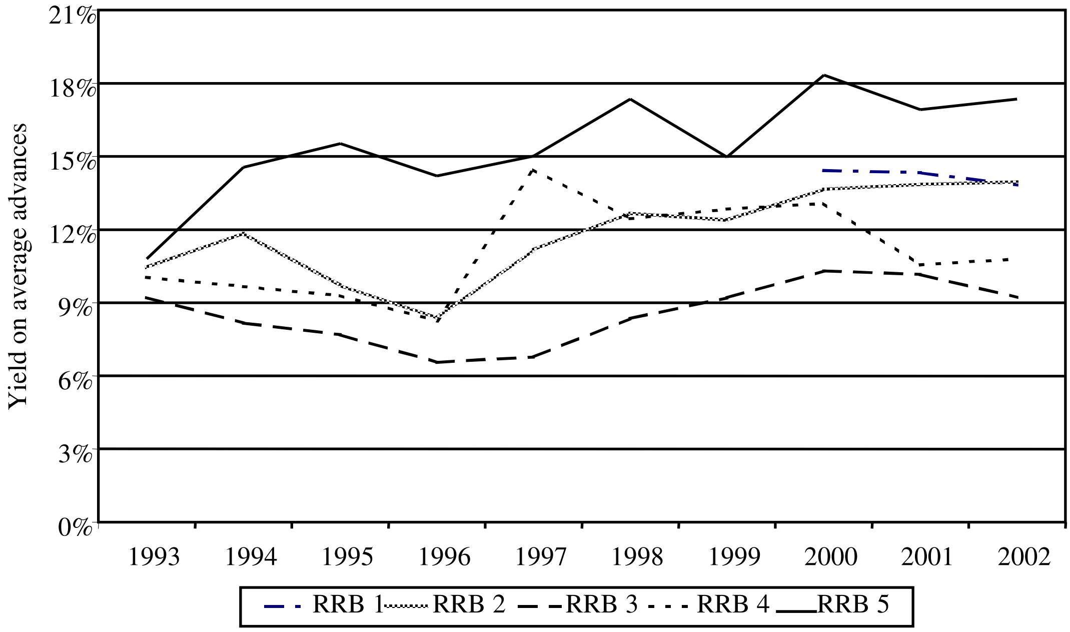
During 1997–9, most RRBs earned between 12–15% per annum on their average investment levels at a time when the rate of inflation in the country was around 5–6%. While most RRBs were not fully equipped to begin trading in the securities markets, some of them did try it with mixed results. However, investment at high real rates of return were seen as a good alternative to lending since the latter involves greater effort, far greater risks of default and the bother of litigation for realisation of collateral.

This market anomaly (high inflation-adjusted yields compared to the international market) has been largely set right over the past couple of years with interest rates having come down. Thus, the annual yields on gilts were down to around 5.5–6.5% by 2002, making investments less attractive for RRBs, many of which still raised deposits at rates higher than the commercial banks.

This situation has compounded the excess liquidity position of RRBs and has begun to affect their profitability, thereby forcing them to go back to their original activity of banking with rural clients. By contrast with earnings on investments, interest income from the lending portfolio has shown a growing trend in RRBs that have maintained good portfolio quality. Three of the 5 sample RRBs have NPAs of less than 10%, and these have healthy average yields on their advances (currently 14–17%), as indicated by Figure 12.[16]

[16] Trend data for RRB 1 is only available for three years.

Figure 12 Trends in yields on advances



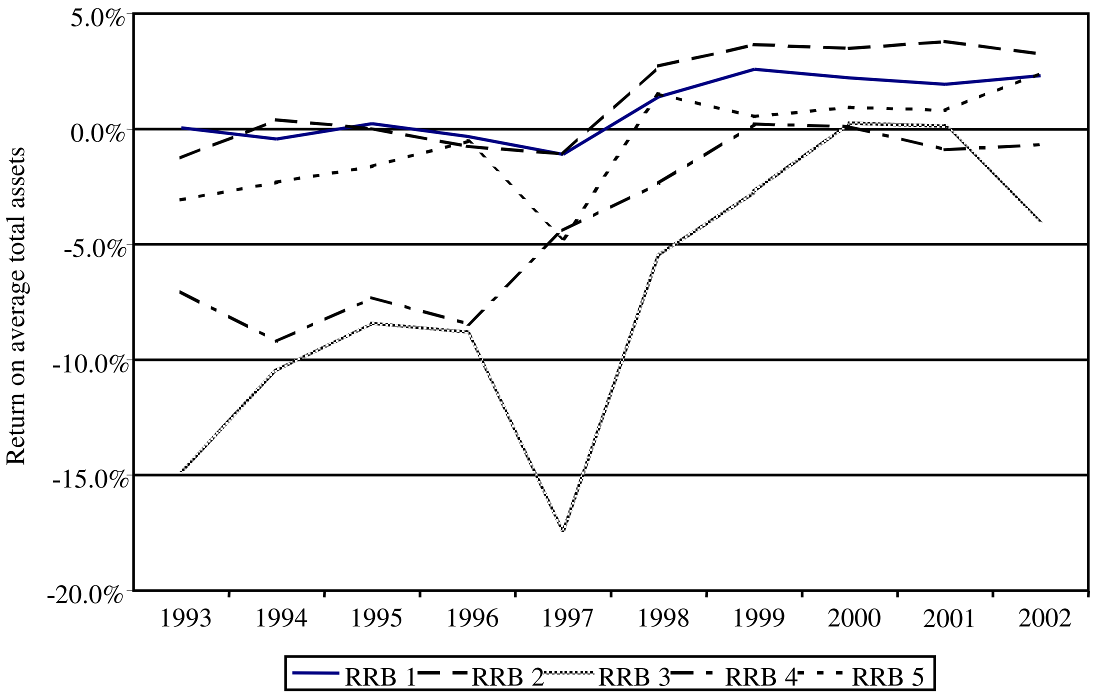
Source: Data from sample banks

While the high returns on investments in the late 1990s enabled many RRBs to improve their profitability, however, some of them also lost touch with the markets they were supposed to serve and failed to respond to the diverse credit demand of their rural clients. Now, when the exposure to investments is declining in the wake of lower returns, many RRBs find it difficult to switch back to the lending mode and compete effectively in their work areas. RRBs3 and 4, in particular, display such characteristics and have earned the lowest yields on advances of the sample RRBs.

3.4.4 Profitability and spread on operations

As discussed earlier, the performance of the sample RRBs is a function of major policy initiatives, strategic responses to these policies – in relation to operational strategies (including competition) – and could also be affected by the opportunities and challenges posed by the economic environment of the work area. This sub-section examines the extent to which RRBs can achieve operational viability even in the most difficult of operating environments. Figure 13 maps trends in the profitability of the sample RRBs.

Figure 13 Trends in profitability



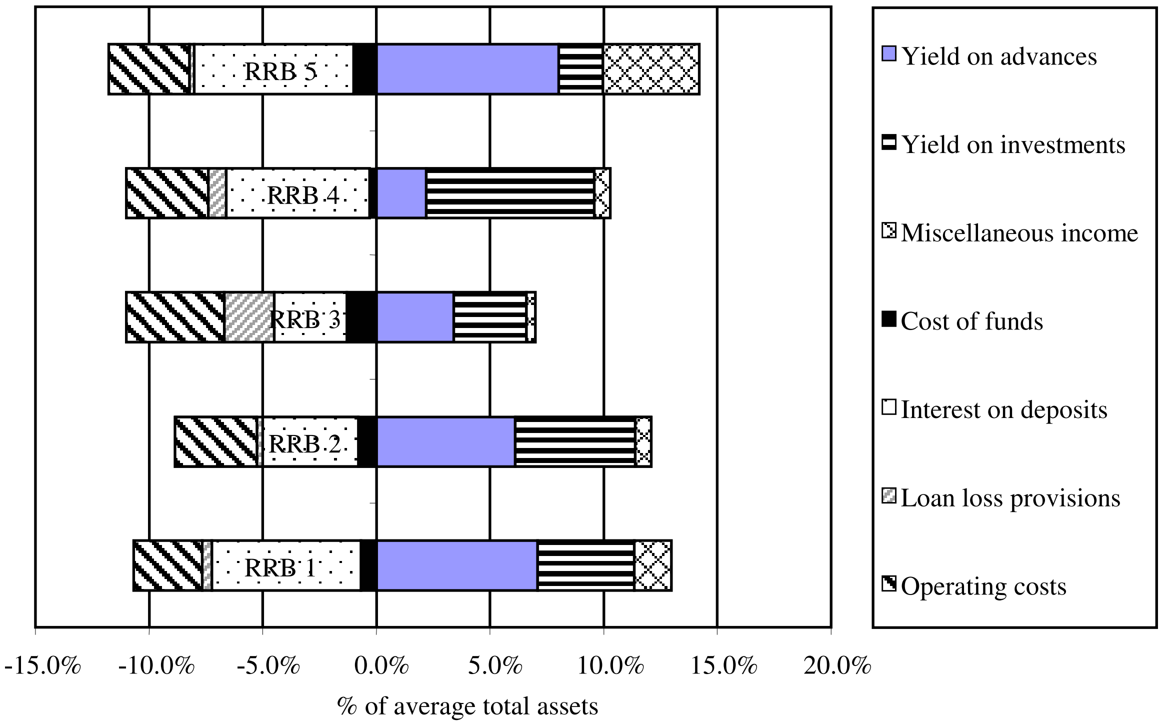
Source: Data from sample banks

RRBs 1, 2 and 5 show similar trends in profitability, indicating some uniformity in the impact of policy measures. The sharp decline in profitability in 1997 is a direct result of new asset classification norms and introduction of loan loss provisioning for RRBs. Even the most profitable RRBs reported losses in that year when they classified advances and created a reserve for the first time. RRB 3 presents a curious trend, marked by tremendous improvements during 1998–2001 with the bank actually registering profits for a couple of years, before it again slipped back into losses in 2002 as a result of the belated implementation of salary revisions for its staff.

Despite all the economic potential of its work area, RRB 4 has not managed a decent profitability performance on account of its limited lending, poor portfolio quality and only an average return on its very high levels of investment.

A more detailed analysis of revenue streams and cost parameters in Figure 14 indicates notable differences among the sample RRBs. RRBs 1, 2 and 5 show high yields on advances, emphasising the importance of appropriate lending levels and maintenance of portfolio quality. Though both RRBs 1 and 2 also show healthy income contributions from their investment portfolios, RRB 5 more than makes up for its lack of investment income through other (miscellaneous) income – the main contribution for which comes from its initiative to act as a commission agent for insurance companies. RRB 4's attempt to make up for its poor income from advances through investment income is clearly unsuccessful as its costs exceed revenues while RRB 3 performs poorly on income parameters because of poor portfolio quality, and with limited investment income, finds it difficult to break even.

Figure 14 Revenue and cost break-up for sample RRBs



Source: Data from sample banks

In terms of cost, RRB 5 again shows the way by paying very attractive rates on public deposits. It also manages its operating costs well, through initiatives such as allowing Branch Managers to be assessors of gold (for gold loans), thereby saving on the charges of a goldsmith and improving efficiency. In addition, RRBs 1 and 2 perform strongly on efficiency, indicating the degree of cost control possible in operations. RRB 1 is an attractive deposit option like RRB 5, with both banks able to make up for the cost of deposits through marginally higher interest rates on advances offered.

Like all other performance indicators, RRBs 3 and 4 remain weak on overall profitability. RRB 3 has a high provisioning burden due to the implementation of new salary levels for its staff, whereas RRB 4's lending operations have very poor outreach, which limits the income it is able to earn from advances. Both these banks have demonstrated that they can bounce back with improvements – RRB 3 showing profits for two years as a result of improvements in its portfolio quality after substantial write-offs and RRB 4 also showing profits for a couple of years through better treasury management. However, these profits have not been sustained as a result of the lack of an appropriate long-term operational strategy resulting from apparent failure of leadership.

3.5 Conclusion: outreach to rural clients is not an impediment to financial viability

The key conclusion emerging from the analysis in this section is that though there has been a shift away from serving low-income clients, neither outreach nor economic environment are substantial impediments to financial viability. The more successful RRBs continue to serve predominantly low-income clients and it is their better management incorporating a reasonable focus on lending and diversified portfolios with good repayment performance that enables them to perform better. The successful RRBs essentially outperform their peers on account of their superior operational strategies enabled by better leadership.

The financially strong RRBs in the sample – RRBs 1, 2 and 5 – have succeeded by entering new market segments and designing financial products that adapt to their local client profiles and work environs. In the present economic environment where the financial support of the government can no longer be taken for granted, RRBs need to achieve a stable and healthy financial profile, so that they can continue to serve their clients in a sustainable manner. While sustainability demands that financial health take precedence over other objectives, it is apparent that it can also come about through timely and efficient lending to increase outreach if portfolio quality is maintained through a mixture of secured and diversified lending. There is certainly no evidence to suggest that withdrawal from serving clients is a recipe for financial success. The next section examines the relationship between RRB product design and delivery, on the one hand, and financial performance, on the other, in the context of the concern for RRBs to strengthen the provision of financial services to low-income clients.

4 Impact of Product Viability on Outreach

4.1 The sample branches: rural branches with focus on low-income groups

The trends and consolidated financial data considered so far provide important insights into the performance and challenges faced by RRBs. A more detailed analysis of product design and delivery issues relative to the actual costs incurred and revenues obtained by banks in serving clients through specific product categories is undertaken in this section. This analysis is necessary to establish the credibility of the presumed RRB objective of providing financial services to low-income clients.

For this purpose, the study team examined product design, delivery methods, cost parameters and yields obtained by the RRBs at a sample of two to eight branches per bank. The deposit collection and lending operations of sample branches were categorised to reflect different client types, to the extent possible. Detailed feedback from branch staff on the time spent on each product category enabled an estimation of the actual costs incurred at the branch level in delivering each major product category.

4.2 Client coverage in RRB branches: indications from a wider sample

The detailed information from the sample branches was used to understand the determinants of cost and revenue in RRB operations. At the same time, a wider sample, including various other branches, was used for discussions on client coverage in relation to work areas. For lack of better information, a simple indicator, the number of accounts as a proportion of total adult population in the service areas of the sample branches, provides an indication of the degree of coverage by each RRB. The results of these discussions are presented in Table 9.

Table 9 Client coverage in sample branches

	RRB 1	RRB 2	RRB 3	RRB 4	RRB 5
Sample size: no. of branches, areas*	8,2	10,2	9,2	11,2	11,3
Coverage (deposit accounts/adult population)	35%	21%	13%	13%	17%

* All five RRBs operate through five to seven area offices, each area typically handling 20–30 branches
Source: Discussions with branch managers

Barring the popular RRB 1, the coverage level of the sample branches lies in the range 15–21% of the adult population of their service areas. The other financial service providers in the RRB markets include local moneylenders (about 25% coverage), cooperatives/cooperative banks (30–35% coverage in RRBs 1, 3 and 5, negligible in RRBs 2 and 4) and commercial banks (the remaining 15–25%). RRB 1 branches emerge the strongest in terms of overall coverage of clients in their work areas.

4.3 Outreach analysis: distribution of loan clients by sizes and sectors

As discussed in the previous section, despite an apparent shift away from very poor clients, the amounts deposited as well as the amounts borrowed by the average RRB client are still very small. The average for advances outstanding – at around Rs17,500[17] – is less than the average annual per

[17] At current prices, end of March 2002.

capita income of the country. This reinforces the finding that a majority of the clients of these banks belong to the lower income groups in their villages.

Table 10 provides the distribution of small loan accounts (below Rs25,000, $520) across loan categories. As the table shows, more than three-quarters of all advance accounts in the sample RRB branches are classified as small. The sectoral coverage of these small accounts varies from bank to bank, only one (RRB 2) has a small loan portfolio dominated by agriculture. All the others have a significant share of non-priority sector advances (jewel and deposit-linked loans).

Table 10 Distribution of small advances by sector in sample RRB branches, March 2002

Advances category	**Loan quantum <Rs25, 000 (% of outstanding accounts)**				
	RRB 1	**RRB 2**	**RRB 3**	**RRB 4**	**RRB 5**
Average size of outstanding loans for RRB, Rs	15,677	23,263	n.a.	14,696	13,903
Priority sector advances					
Agriculture and allied	33%	72%	26%	19%	38%
Loans to SHGs	1%	11%	2%	0%	6%
Industry, service and business loans	14%	5%	7%	23%	18%
Other	-	-	-	4%	-
Non-priority sector advances					
Jewel loans (public)	16%	-	33%	-	12%
Deposit-linked loans	27%	1%	9%	0.2%	9%
Staff loans and others	3%	0%	0%	8%	1%
Total					
% of total, sample branch	94%	89%	77%	55%	83%
Bank average	85%	92%[18]	n.a.	58%[19]	n.a.

Source: Data from sample branches

Thus, it is apparent that while much of the borrowing of low-income clients from RRBs is for agriculture, a substantial proportion is devoted to secured non-priority sector lending as well as to productive non-agricultural loans.

4.4 The costing of deposits

In considering the financial needs of low-income families there is a tendency to assume that it is loans rather than deposit services that are important. Recent research has, however, established that the availability of flexible deposit services is equally important in order to facilitate savings that are undertaken, on a regular basis, by such families.[20] RRBs offer two types of deposit services – demand and term deposits. Broadly, demand deposits are those which can be withdrawn at any time and thus have a high degree of flexibility while term deposits must be retained for a fixed term in order to earn a better return for the depositor.

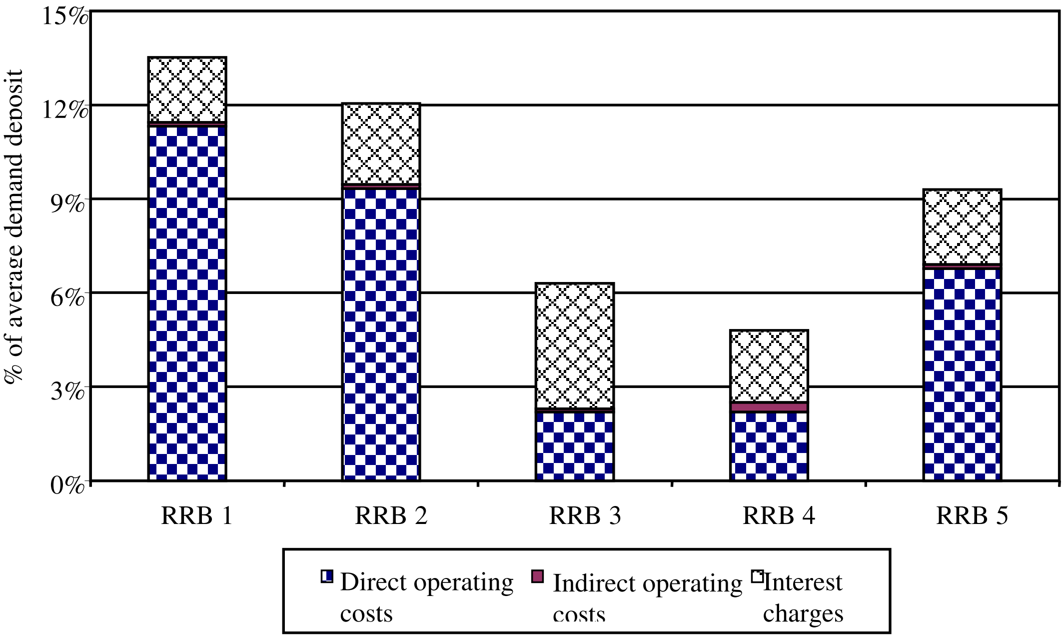
Though term deposits are a more stable source of funds for the bank, a majority of branch managers in the sample RRBs report a preference for demand deposits. This is based on the perceived lower cost burden of demand deposits since no interest is paid on current accounts and savings bank accounts incur a low financial cost. An analysis of branch operations, however, shows that it is

[18] A sample of 12 branches has been taken since this information for the entire bank was not available.
[19] A sample of 11 branches was taken as in RRB 2.
[20] Not least, research undertaken by the Financial Services Research Project of the Institute for Development Policy and Management, Manchester UK in collaboration with EDA Rural Systems, India. See papers emerging from the research, Ruthven and Kumar (2002) and Sinha and Patole (2002).

precisely because of their flexible terms that the actual handling (administrative) costs of demand deposits are not particularly low.

The total cost of demand deposits, shown in Figure 15 for the sample branches, varies from just 4.8% for RRB 4 to as much as 13.5% for RRB 1. The cost components consist of both direct and indirect operating costs, including marketing, the servicing of accounts, recording, reporting as well as other administrative functions at the branches. The interest costs of the sample branches are similar to the overall bank figures (2–3%) with RRB 3 incurring the highest cost at 4%.

Figure 15 Cost of mobilising and handling demand deposits

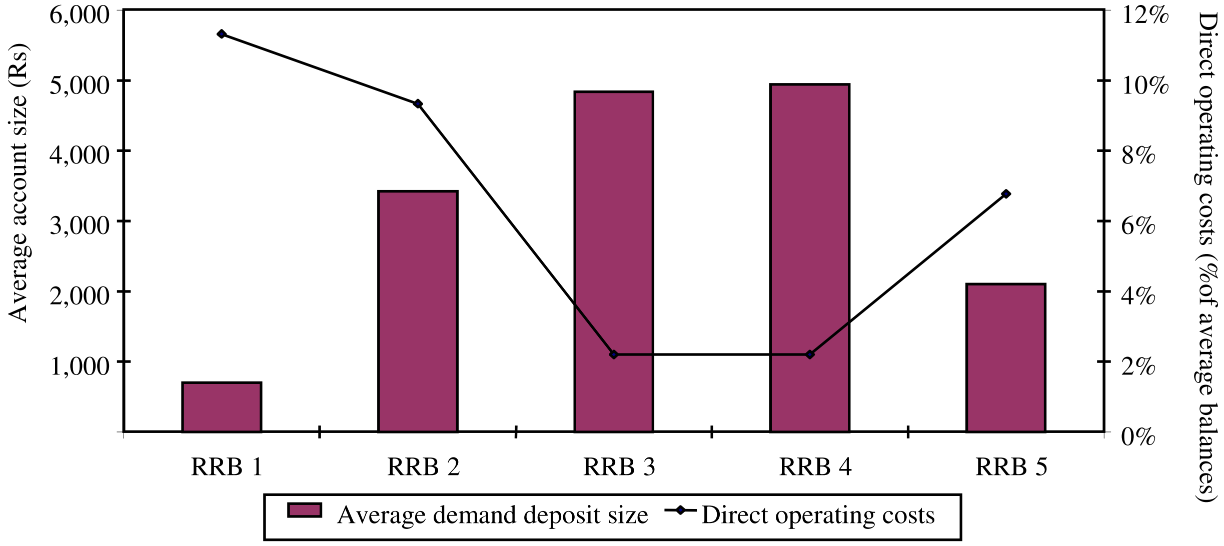


Source: Based on detailed costing at sample branches

RRBs 3 and 4 incur the lowest costs on managing demand deposits. This is explained by the fact that both banks have a high share of institutional deposits, sourced mainly from different government institutions (and schools in the RRB 4 branch). This is, however not the case with the other three RRBs in the sample, and officers of the latter sub-group clearly state the preference of government institutions for the 'lead bank' of the district. The salary accounts of institutions in RRBs 3 and 4, therefore, increase the average deposit balances and bring down the overall costs of mobilising and handling deposit accounts.

A comparison of operating costs incurred in handling demand deposits with average account sizes for the five sample branches is presented in Figure 16. It is not surprising perhaps that the figure indicates a direct inverse correlation between the two parameters. The RRB 1 branch handles the smallest accounts amongst the sample branches, and incurs the highest direct costs. The trend for the other branches in the sample also follows this logic. In comparison with RRB 2, however, RRB 5 incurs lower operating costs for lower account sizes. This is largely due to the more efficient operations of the RRB 5 sample branch – a characteristic that is typical of this bank in relation to the other sample RRBs.

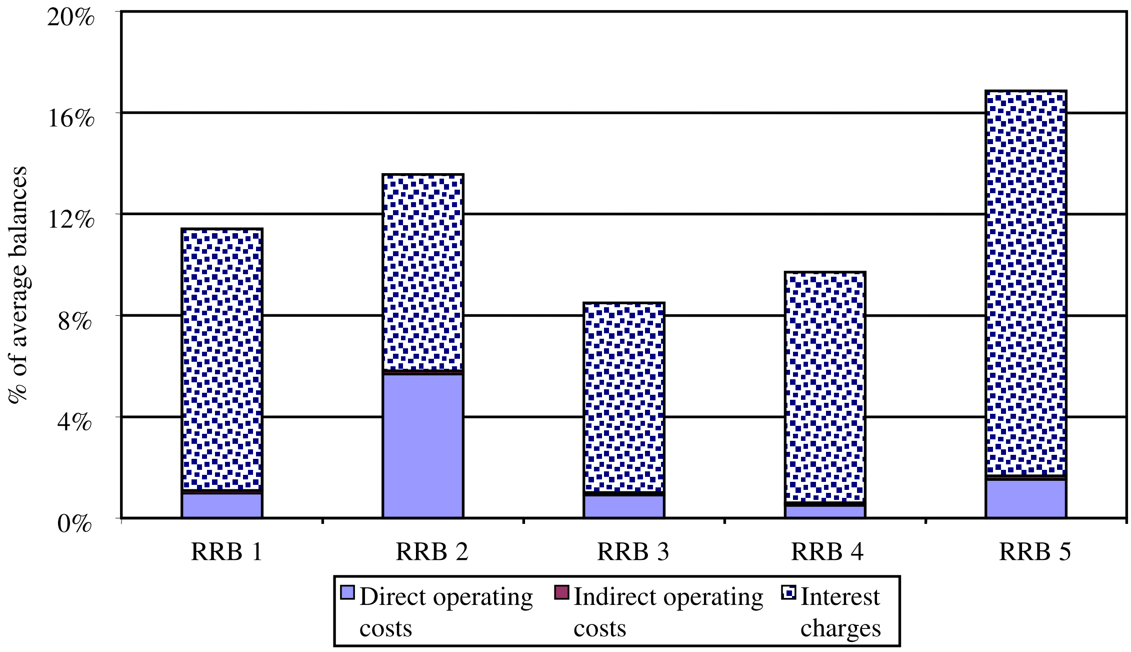
Figure 16 Direct operating costs and average account sizes for demand deposits



Source: Based on detailed costing at sample branches

A similar analysis for term deposits – Figures 17 and 18 – yields comparable results.

Figure 17 Cost of mobilising and handling term deposits

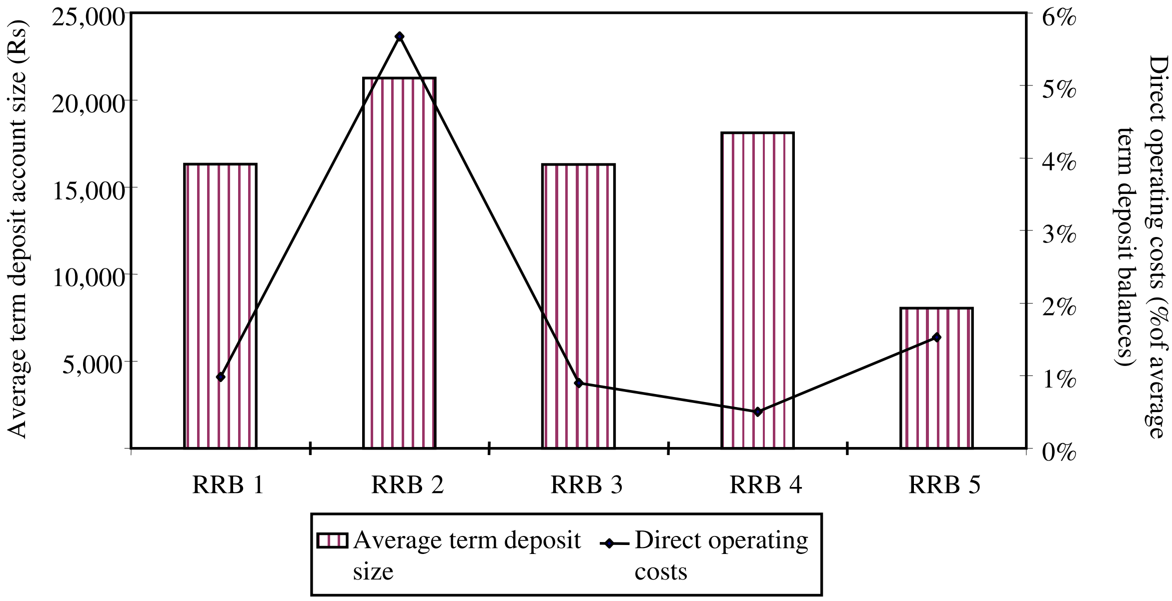


Source: Based on detailed costing at sample branches

The direct operating costs for term deposits are minimal, except for RRB 2 which shows a high cost of marketing term deposits to its farmer community. RRB 5 also shows a very high interest cost, however this is more than amply matched by interest rates charged on advances (discussed later). The overall costs of term deposits are in the range of 8.5–16.9% p.a., whereas the direct operating cost component is more comparable, around 1–2% of average balances (except for the outlier on this count, RRB 2).

As seen in the case of demand deposits, a similar inverse relationship between term deposit sizes and direct operating costs is not discernible in all RRBs, on account of greater marketing costs of such products in some banks. In proportion to account sizes, RRBs 2 and 5 show high relative direct operating costs on term deposits, since both sample branches need to make extra efforts in marketing their products in their areas of operation.

Figure 18 Direct operating costs relative to average account sizes of term deposits



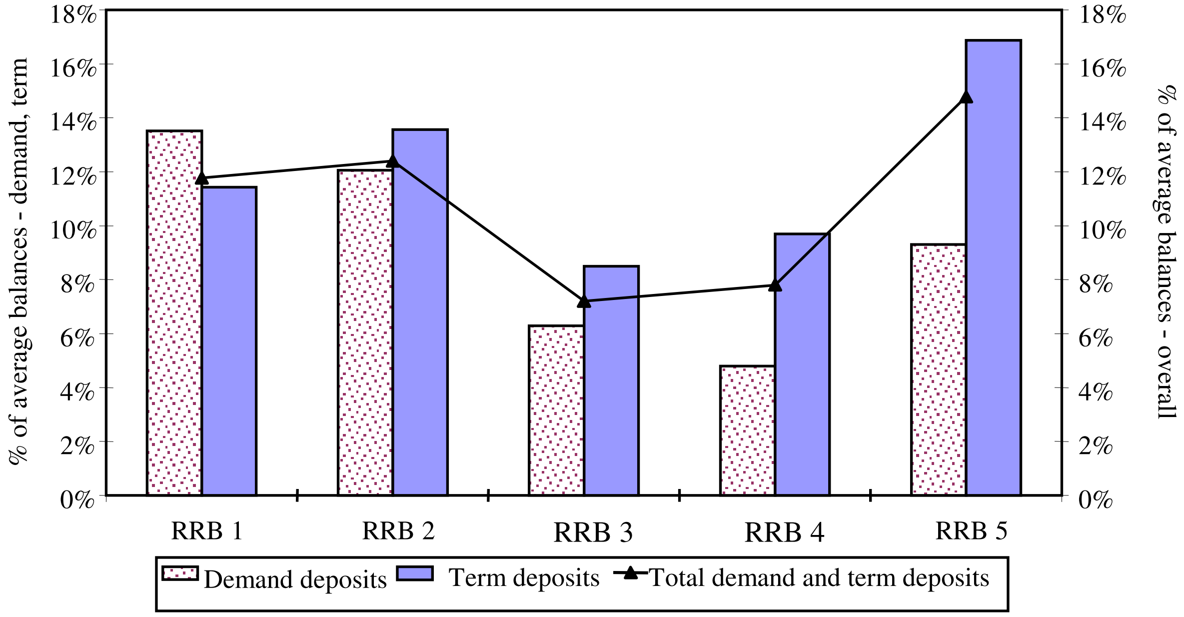
Source: Based on detailed costing at sample branches

RRB 5, as in the case of demand deposits, is an exception here. The sample branch has made considerable marketing efforts but – partly on account of a marked local preference for scheduled commercial banks – has not been successful in mobilising term deposits of sizes comparable to the other RRB branches.

In the context of the clear preference of managers for demand deposits, Figure 19 presents the relative cost of the two products for the sample RRBs. The figure indicates that, except for RRB 5, the total costs of marketing and handling demand deposits are similar to those for term deposits. Indeed in RRB 1, where average demand deposit sizes are significantly lower than term deposits, the cost of demand deposits is even higher than that of term deposits. The very much higher cost structure of RRB 5 term deposits is both on account of the relatively high marketing costs incurred and due to significantly higher interest rates offered by this bank in comparison with other RRBs. The average interest cost incurred on term deposits by RRB 5 in 2002 was 15% p.a. on account of a large number of old deposits that were reaching maturity at the time.

It is apparent from this cost comparison that the cost of demand deposits in RRB branches could sometimes be higher than that of term deposits, depending on the client profile (which affects the maturity period of the deposit and the resulting size of accounts). As such, a clear preference for demand deposits due to a lower cost structure does not seem entirely appropriate. For most banks, the fact that a more predictable cash flow results from term deposits would appear to suggest that it is these that are the more viable product. To the extent that demand deposits – particularly savings bank accounts – provide flexibility, however, this product is more likely to be preferred by low-income clients in spite of the lower interest they receive from such accounts.

Figure 19 Comparative cost structure for demand and term deposits



Source: Based on detailed costing at sample branches

4.5 Advances: the main product categories

For RRBs, the main product categories, as directed by the RBI, are classified in terms of lending to the priority sector at the primary level. Priority sector lending is defined as lending to agriculture and allied activities, small-scale industries, small business, retail and trade as well as activities such as education, housing, loans to self-employed persons, micro-credit, software and venture capital (RBI. 2002b). Of these, RRB lending is largely restricted to agriculture and allied, small business, retail and trade as well as consumption and micro-credit.

Within the two primary product classes – priority and non-priority sector – the products of the bank are categorised on the basis of procedures for appraisal, sanction, recovery and reporting. Broadly, the client type for whom it is intended can also delineate each product category. However, client types are certainly not mutually exclusive across categories.

4.5.1 Product category 1: agriculture and allied activities

Loan types
Kisan Credit Card (KCC) a credit line for farmers, agriculture term loans (ATL) long-term loans typically for purchase of farm equipment but also for tractors and loans for allied activities like animal husbandry and farm forestry.

Client types
Those who own agricultural land or are otherwise engaged in farm-related economic activities.

Loan characteristics
KCC is a three-year line of credit with annual renewal. It requires the mortgage of land titles as does the ATL. For animal husbandry, the animals are regarded as collateral.

4.5.2 Product category 2: industry, service and business (ISB) loans

Loan types
One to three year loans with regular repayment streams. Collateralised through the hypothecation of stock as well as of any new assets created through the loan.

Client types
Small traders and petty shop owners in rural areas.

Loan processes
Categorised as unsecured loans since hypothecation is not considered sufficient security. Loan appraisal involves, among other aspects, valuation of stock and assessment of business potential and can be time-consuming. At times, a reluctance to lend amounts greater than Rs25,000 is apparent on account of the floating nature of security and in order to meet priority sector targets since larger loans are often excluded from the priority sector classification (depending on the sector). In most cases, loan repayments are monthly/quarterly, and the bank has to make greater efforts in repayment tracking as compared to agricultural loans that typically have a bullet repayment facility.

4.5.3 Product category 3: self-help group (SHG) loans

Loan types
One to three year loans (or cash credit facilities) with regular repayment streams. Usually under Rs50,000 ($1,050) per group – though a recently-introduced government-sponsored scheme (SGSY)[21] has higher loan sizes and a subsidy component.

Client types
Groups (SHGs) of men/women with up to 20 members, selected from families with incomes less than the government delineated poverty line for SGSY. For others, the banks are free to select and support groups promoted by NGOs or the banks themselves.

Loan processes
Unsecured lending to groups after observation of their book-keeping and functioning for a period of six months. However, in practice loans are often secured (informally) against the deposits of group members. Loan appraisals and observation of group processes and bookkeeping is relatively more time consuming for the RRB branches, and so is recovery management, since repayment streams are monthly in most cases.

4.5.4 Product category 4: other non-priority sector advances

Loan types
Short-term (one year) loans secured against deposits or gold as well as loans to salaried employees. Repayment streams are variable.

Client types
Most RRBs have negligible exposure to salary-based consumer loans since those in regular employment generally go to the public sector scheduled commercial banks. As a result, these

[21] Swarnajayanti Gram Swarozgar Yojana – a scheme of the central government that envisages lending to self-help groups (or individuals) for income generation. It also carries a 30–50% subsidy on completion of the loan, and RRBs are under pressure to meet their annual targets under the scheme as specified in the district credit plan of the area.

products provide either consumption or production credit to those relatively low-income families that are able to offer jewellery or deposits as security for short-term loans to meet periodic cash-flow constraints.

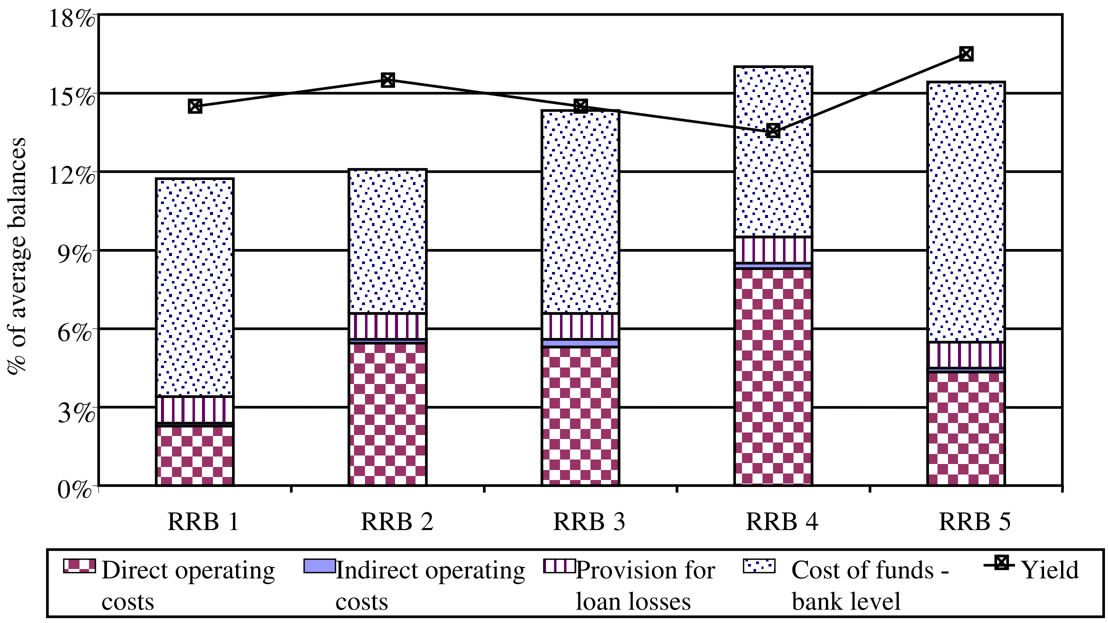
Loan processes
Easiest amongst the four categories of loans, since the security taken is liquid and the bank does not need to worry unduly about repayments. Gold valuation in some banks is an issue because of the difficulty of identifying reliable goldsmiths, but others (such as RRB 5) have passed on this responsibility to their managers. Thus, these products are characterised by minimal paperwork and need little staff time for appraisals, disbursement or recovery.

4.6 Agriculture and allied advances: the success of the KCC

With the advent of the Kisan Credit Card (KCC), the lending portfolio of the RRBs has seen an important change in terms of costs of delivery compared to the processes required for short-term agricultural loans. The concept of a credit line for farmers has made borrowing easier and more cost-effective for both the clients as well as the bank. This innovative product has replaced all crop loans for the purchase of agricultural inputs.

As for other banks, the quality of RRB portfolios has improved along with improved margins on this product. Agricultural term loans, which typically comprise a smaller share of the agriculture portfolio of RRBs, have also become more focused, though the product targets more prosperous clients. The overall performance of sample branches under this product is shown in Figure 20.

Figure 20 Costs and margins on agricultural lending



Source: Based on detailed costing at sample branches

All the sample branches, except RRB 4 earn a margin on agricultural lending, with RRB 2 showing the best spread. The low costs of delivery and high lending rates in relation to other products allows RRB 2 to earn as much as 3% on its agriculture portfolio, whereas RRBs 1 and 5 are also able to make a decent spread for the same reason. Even RRBs 3 that performs poorly on overall profitability is able to earn a margin on this product. More details about the product and factors that affect its performance under the sample RRBs are provided in Box 4. To the extent that the KCC has simplified crop-lending procedures it has greatly reduced transaction costs and improved the access of small and marginal farmers to bank credit.

Box 4 The success of Agri (Kisan) Credit Card

RRBs, like other banks in the country, have responded enthusiastically to the Kisan Credit Card, a line-of-credit facility designed and introduced by NABARD. This product has now become the main driver of the lending operations of a number of RRBs.

The KCC does away with many constraints of the traditional agricultural loans offered by banks. Since it provides a three-year credit limit to the borrower, tedious loan appraisals every season are not necessary. The credit limit is decided on the basis of the borrower's landholding, type of land, main crops in the area, expected yields and revenue. As in any line-of-credit facility, the borrower can repay according to convenience and can draw any amount within the specified credit limit.

The interest charged on the KCC is variable, with smaller clients being offered preferential interest rates. Borrowers can use the loans for any activity of agricultural production and direct bank payments to fertiliser or equipment providers are not needed. All these aspects result in bringing down delivery costs and help the RRBs to earn spreads up to 3–4% on the product.

Indeed, in the study sample, RRBs 1, 3 and 5 are able to generate a surplus on the KCC despite the fact that they operate in areas where agriculture does not thrive as much as in RRBs 2 and 4. More particular is the case of RRBs 2 and 3, which operate in distinctly different work environments with respect to agriculture. Whereas RRB 2's area is an agricultural goldmine, RRB 3's area suffers from poor irrigation and infrastructure facilities. Despite this difference, the only aspect that differentiates the profitability of agricultural lending in these two banks is the cost of funds. Otherwise, RRB 3 could have shown similarly high profit levels on its agriculture portfolio, which otherwise has good portfolio quality and low operating costs as well. It is apparent that this product enables banks to reach a large number of small and marginal farmers in a client-friendly manner in the most difficult operating environs.

Through the KCC and with the assistance of NABARD, the banks have been able to demonstrate that good product design can improve the efficiency of delivery systems and ensure the profitability of lending operations.

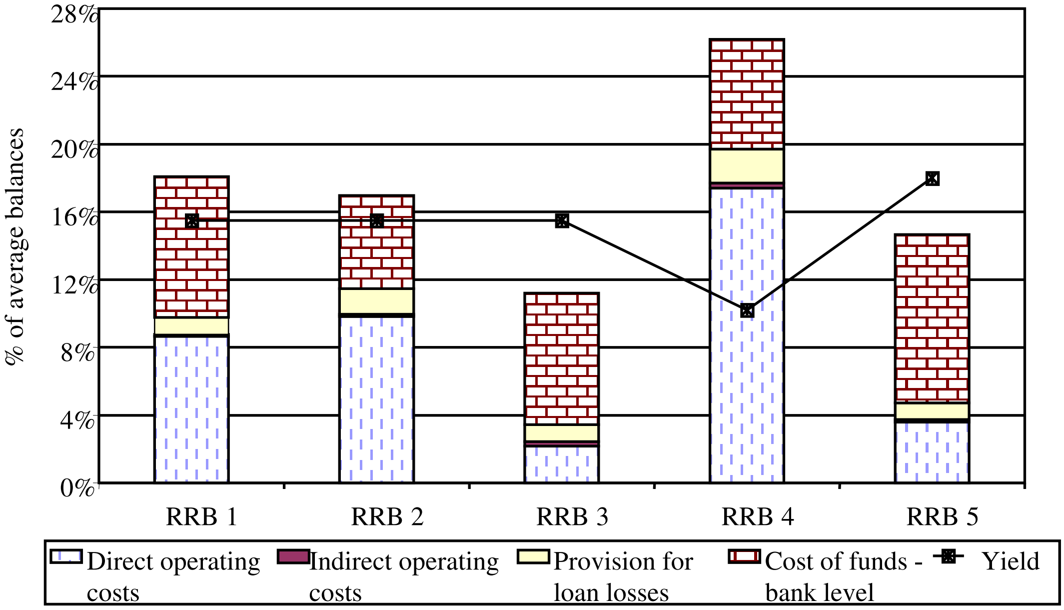
Only RRB 4, despite being in an agriculturally prosperous area, fails to show positive returns on this product. Operating inefficiency and lack of initiative in lending are the primary reasons for this, which is reflected in all the loan products of the bank.

4.7 Industry, service and business loans: variable efficiency limits access

Unlike agricultural lending, ISB loans are much more labour-intensive and require the branch to take an active interest in the sector to achieve both outreach and profitability objectives. The process of appraising such loans involves business assessments for feasibility and scale of lending, valuation of stock and verification of turnover to fulfil asset hypothecation requirements. These loans also require regular monitoring of repayment to ensure immediate follow up of delinquency. Since the market for ISB lending is not as large as that for agricultural lending, an RRB branch that typically handles 10–15 villages would, in practice, make such loans in not more than 3–5 villages in its area.

However, loans to this sector are typically of higher value than agricultural loans, and have a faster circulation potential. Both these factors are important for banks – one improves profitability whereas the other contributes to cash flow management. Depending on the businesses in their respective areas and their own initiatives, RRBs provide significant coverage to small businesses, except RRB 2 which is in an economically vibrant area but has taken little interest in any form of non-agricultural lending. The costs of marketing and managing ISB loan accounts and the yields from these are presented in Figure 21.

Figure 21 Costs and margins on ISB loans



Source: Based on detailed costing at sample branches

Bank branches that are efficient in conducting operations (RRBs 3 and 5) are able to earn healthy returns from this product. RRBs 1 and 2 have high direct costs related to appraisals, sanctions and recovery management. Bank branches also show clear signs of economies of scale on this product, since the best margins have accrued to RRBs 3 and 5, which have high exposure levels of 47% and 31%, respectively. This apparently translates into a better understanding of product delivery issues and, thereby, into lower operating costs as the bank staff become more skilled and confident at making good and quick appraisals of such loans.

For the other RRB branches, operating efficiency on ISB loans would need to be improved for them to be able to earn a margin on the product. The second route would be to increase interest rates by 2–3% so that they do not incur a loss on such loans.

This is reinforced by the experience of RRB 5 which, again, underlines the importance of efficient delivery and tops it with appropriate interest charges – sufficient to neutralise the effects of its own high cost of funds. The net result is a healthy spread of 3.3% on its substantial ISB portfolio.

RRB 4, however does not succeed in even covering its direct operating costs on this product. The sample branch has failed to deliver most products in an efficient manner to its clients, and shows the poorest returns on ISB loans as well. Inefficiencies in loan appraisal, tracking and poor repayment performance has been responsible for the high cost of this product, despite a high coverage.

4.8 Self-help group advances: unsustainable pricing limits outreach

During the late 1990s, SHG lending came to be established as the primary strategy of the banks and the government for reaching poor rural households. The National Bank for Agriculture and Rural Development (NABARD) triggered the initial efforts of RRBs in SHG lending, providing them with technical, managerial and financial support for testing products and developing the delivery channels for this purpose.

Many RRBs have adopted the SHG-bank linkage programme with vigour, and some have excelled at its delivery in terms of the numbers of SHGs linked. A few of those that are well-regarded in this context are part of our sample since government strategies are based on the assumption that SHG-bank linkages are perhaps the most effective way to provide financial services to the poor. The latter often have no agricultural land or any other form of collateral required for gaining access to the other products of the bank.

RRBs have adopted a variety of strategies for the SHG-linkage programme:

- identifying NGOs as facilitators and providing linkages to SHGs promoted by NGOs – RRBs 1,3 and 5;
- promoting women's groups by themselves – RRBs 2, 5;
- promoting farmer's groups – RRB 2;
- linking groups promoted by government development agencies – RRBs 1 and 5.

One RRB in the study sample, RRB 4, has not ventured into SHG linkages at all. The extent of exposure to SHGs through different mechanisms is summarised in Table 11. It is apparent from this that the only bank to have used multiple mechanisms extensively for promoting SHGs for the purpose of this programme is RRB 5. The costs incurred and the yields obtained on SHG lending are determined to a large extent by the strategic choices made by the RRBs for this product.

Table 11 Lending strategies for SHGs – estimated exposure levels[22]

RRB	Government agencies	NGO-promoted groups	Bank-promoted groups	Bank-promoted farmer groups
RRB 1	95%	-	5%	-
RRB 2	-	2%	18%	80%
RRB 3	-	95%	5%	-
RRB 4	-	-	-	-
RRB 5	15%	40%	45%	-

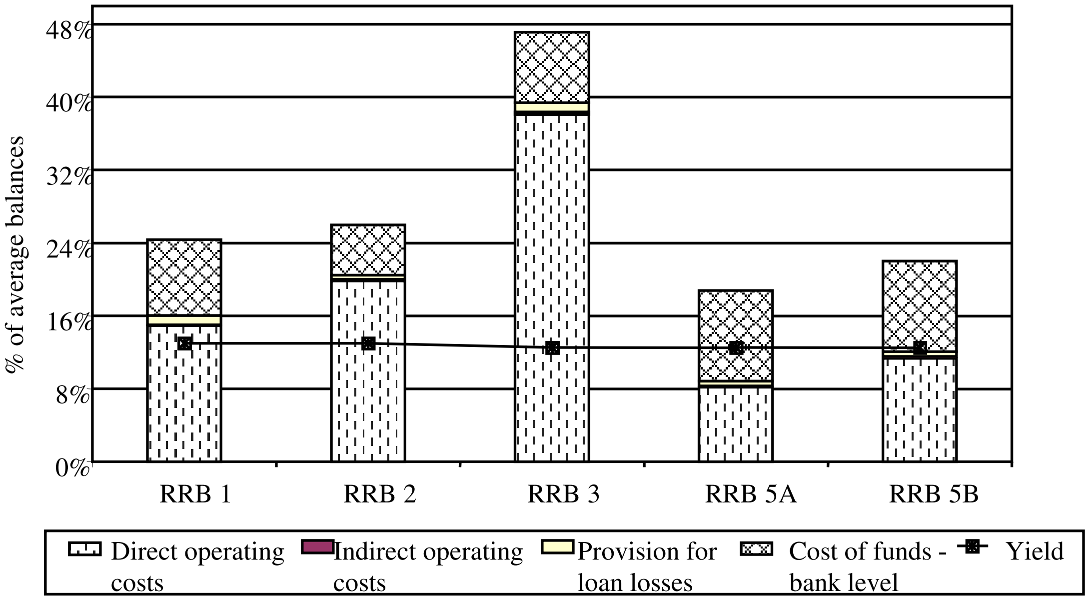
Source: Based on data obtained from sample branches

The following sample was used for analysing the costs and revenues associated with SHG lending:

- **RRB 1** – branch with SHGs promoted by government agencies;
- **RRB 2** – branch with self-promoted farmer's groups;
- **RRB 3** – branch with SHGs promoted by NGOs;
- **RRB 5A** – branch with self-promoted women's groups;
- **RRB 5B** – branch with SHGs promoted by an NGO.

[22] Since data by lending strategy is not computed, these are broad estimates based on field observations and discussions.

Figure 22 Costs and yields on SHG lending



Source: Based on detailed costing at sample branches

Figure 22 (above) shows that all the bank branches, irrespective of SHG promotion mechanisms are making substantial losses on this product. RRB 5 which has the most efficient operations in the sample for most products, is again the most efficient in lending to SHGs. However, both its branches (RRB 5A and RRB 5B covered for the purpose of the above figure) are still clearly losing money on their SHG advances.

All banks in the sample (except the uninterested RRB 4) have invested time, effort and a lot of energy in SHG lending. However, this effort has neither translated into substantial outreach – in absolute terms – nor has it been a useful income source for the banks. The exposure to SHG loans of the sample RRBs – some branches of which are leaders in SHG lending in their respective banks – ranges from 2% in RRBs 1 and 3 to 17% in RRB 2, with RRB 5 branches having exposure levels of 4% and 7% of total average balances for the year respectively.

This analysis as well as discussions with branch managers indicates little, if any, evidence of economies of scale in SHG lending. This is because banks prefer to carry out the entire scrutiny/appraisal process with each new SHG prior to lending, irrespective of the mechanism of promotion. Even when renewing credit lines, the banks undertake a complete check of the books and systems all over again. This high level of scrutiny arises from the fact that SHG loans are formally unsecured and bankers, therefore, feel obliged to ascertain the safety of lending in more detail than otherwise. This issue is highlighted in the case of the sample branches discussed in **Box 5**.

The cost and yield analysis indicates that it is not practical to expect RRBs to cut down on delivery and management costs on SHG loans beyond a point. Total operating costs of 19% on SHG lending by a relatively efficient bank branch underlines the high cost of promoting SHGs relative to the 12.5–13% interest the banks feel able to charge. In this situation, it is difficult to envisage any substantial commitment by the banks to this product.

Box 5 SHG linkage strategies and their effect on costs

RRBs 1 and 3 work with groups promoted by government agencies (such as DRDAs) and small NGOs. The operating costs for the bank managers result from frequent field visits to observe the functioning of the groups and their decision-making processes as well as for inspection of their book-keeping and evaluation of the economic activities proposed. A gestation period of at least six months from the date of formation (as advised by NABARD) is strictly observed and lending begins in very small amounts (group loans of less than Rs25,000). It is only after three to four cycles that larger loans are provided.

Therefore, the bank branches incur significant costs in appraising and later in monitoring these loans. Since this process is repeated fully with all new SHGs, the cost structure is not altered even with higher exposure levels.

The lack of confidence of these two banks in the quality of groups promoted by other agencies, therefore, is the main reason for high costs. However, RRB 3 may be considered an outlier in this sample because it shows exceptionally high costs that are affected as much by the lack of local infrastructure as by overall operational inefficiency.

RRB 2 has gone out to its prosperous farming community and promoted SHGs amongst them. While the outreach and client profiles of SHGs promoted by RRB 2 do not always meet the objective of reaching poor families, the bank is a leader and innovator on SHG lending strategies among RRBs.

Groups are promoted, nurtured and handled by branch staff. Often the bulk of the responsibility is handled by the Manager-Advances in the branch. At times, the local Vikas Volunteer Vahini members lent a helping hand. Both men’s and women’s SHGs are promoted, including a small proportion of poor families. The branch staff spends significant time and effort on group formation. As a result, having formed the groups themselves, overall operating costs are lower than in other banks because the bank is more comfortable with the quality of the groups.

While account handling costs are minimised in RRB 2, formation and regular monitoring costs are significant, and more than make-up for the costs saved on the handling of accounts. Issues like splits in groups and decision making for loans involve the branch staff and result in higher costs. Moreover, these costs are directly proportional to the number of groups handled, and, therefore, do not allow for any economies of scale either.

One lending strategy of RRB 5 (sample branch RRB 5A) is that of promoting SHGs itself before providing loan support. With improved operating efficiency and prudent practices, RRB 5A records better performance with this promotional mechanism than other RRB branches in the sample.

Unlike RRB 2, the clients of this branch are exclusively from poor households who borrow for small economic activities such as animal husbandry, production and the trade of eatables.

However, even with significant operational efficiency, the branch is unable to earn a margin on this product. The management cost incurred by the branch is still around 9%, leading to operating costs of around 19%.

RRB 5B also lends to SHGs promoted by a very well-known NGO in south India. Over time, the working relationship between this NGO (which is often considered the pioneer of the SHG-linking strategy) and the bank has stabilised and, in principle, RRB 5 is quite comfortable with the quality of groups promoted by the NGO.

At the branch level, however, this does not translate into lower monitoring and handling costs. RRB 5B staff (and those in other similar branches) still like to complete their own appraisals of the prospective borrowers and take decisions based on their own observations. This means that neither does the outreach increase in these branches at a fast rate, nor are the operating costs reduced to any significant extent.

Furthermore, it became apparent during the field visits to the sample branches that SHG loans are usually provided to groups that include existing individual clients of the banks. Coverage of additional low-income households through this mechanism is not as great as expected. RRB 5 and, to some extent, RRBs 1 and 3 have managed to reach out to some new clients through this product, but barring RRB 5, none of the banks in the sample can claim significant outreach to the landless poor through SHG linkage.

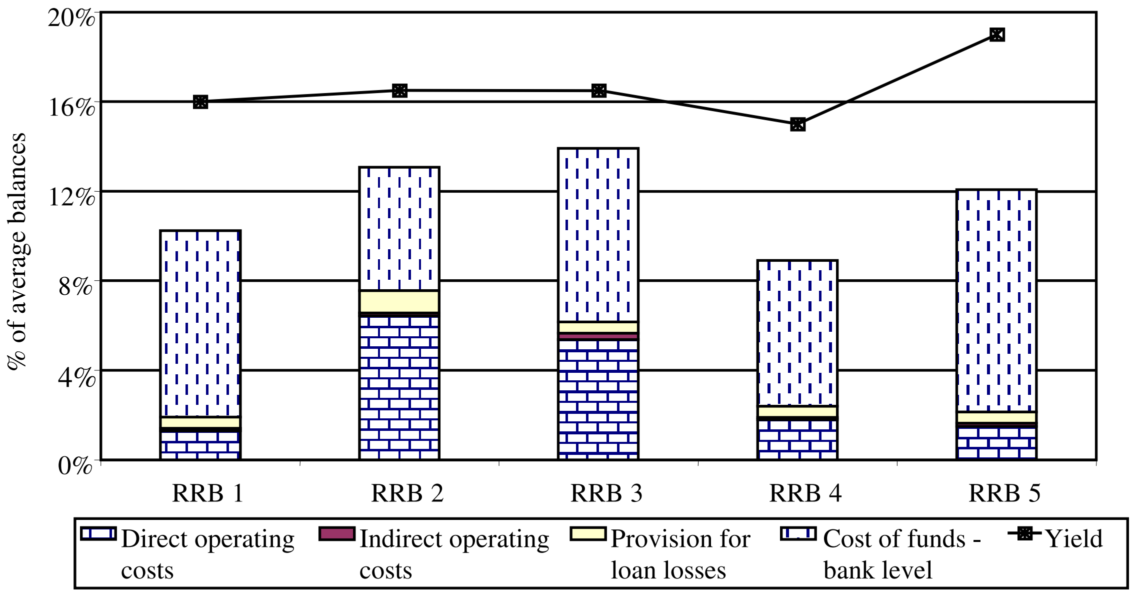
The key issue of product design that emerges out of this analysis is that of the pricing of SHG loans. These loans carry the lowest interest rates of all products in all the sample banks (12.5–13% p.a.) and it is apparent from the discussion above that this does not allow the banks to earn a spread even with the most efficient operating system. Microfinance orthodoxy consistently highlights the relatively low importance of cost for the poor clients in comparison with timely access to credit of the right amounts. It is apparent that it is only the pricing of SHG loans in accordance with their overall cost that will result in substantial and sustainable outreach to low-income clients being achieved through this mechanism in the long run. For this purpose, the indications from the experience of the sample banks are that the minimum interest charge on SHG loans needs to be around 20–22%. (Interestingly, this finding is consistent with the experience of some of the leading MFIs in India that have also found it unsustainable to lend to SHGs at lower interest rates).

At the same time, it is apparent that low-income clients cannot be expected to bear the brunt of any inefficiencies in the banks' delivery mechanisms. Thus, efficiency improvements in operations would need to be a prerequisite to a pricing review. For this purpose, both RRBs 2 and 3 would need to improve the processes employed by them for group linkages and be more generous in aligning lending limits with client demands in order to improve cost efficiency in managing the portfolio.

4.9 NPS advances: better as the priority

While much is made of lending to SHGs as a way of increasing outreach to the poor, other lending mechanisms for low-income clients have, more discreetly, become a far more important credit channel from banks to low-income households in general and landless households in particular. These advances – classified as non-priority sector – comprise fully secured loans against (relatively liquid) assets like gold and small deposits. Such loans provide smoothening injections of funds into the (relatively) variable cash flows of low-income client households. This is borne out by interaction with a number of the sample RRBs' NPS clients during the study. At the same time, as Figure 23 shows, NPS advances are an important contributor to such surpluses as are earned by RRBs. It is a win-win situation in the RRB outreach matrix.

Figure 23 Costs and yields on NPS advances



Source: Based on detailed costing at sample branches

As the figure shows, all bank branches (including the weak performer, RRB 4) earn healthy returns on such products. The reason for this lies partly in the simplification of the appraisal process by the liquid nature of the collateral. RRBs 2 and 3 have relatively high operating costs for these products on account of the greater paperwork required by them. RRBs 1 and 5, on the other hand, manage this product with the minimum of fuss as is indicated by their very low direct operating costs. Above all, the pricing of these loans – ironically freed from the shackles of 'social control' on interest rates by their very classification as non-priority sector (NPS) despite the fact that they serve mainly the poor – is sufficient to earn high spreads of 2.5–7% for different branches in the sample.

While RRB 5's profitability on this product is understandable in the light of its operating efficiency, RRB 4's performance is a revelation in comparison with its profitability performance on other loan products. RRB 4 has achieved this through the performance of deposit-linked loans. This deviation in the performance of RRB 4, which has otherwise performed quite poorly on all other loan products, can be understood through a situational analysis of the sample branch.

It is apparent that because of the low interest of the RRB 4 branch in lending, the only recourse to clients who do not have alternate sources of loan funds is to borrow from the bank against fully secure, liquid assets (their own deposits). Thus, the branch has not responded to the actual demand for loans in its region, and despite earning a return on NPS advances, has probably lost out on a number of other clients who could have been covered under KCC, Agricultural Term Loans or ISB loans. Only a small share of the demand, therefore, has been met through deposit-linked loans, and because of the design strengths of this product, the sample branch shows good returns on this product category, but loses out on all other loan products that it offers. Thus, in an overall analysis of the products offered by RRB 4 – and their coverage and profitability – the good performance on NPS advances is understandable, but not praiseworthy despite their profitability.

Due to the nature of the clientele in rural RRB branches, a substantial share of NPS advances go to low-income families. The share of up-market products such as housing and consumer loans is negligible and it is the less well-off customers who pledge either their old fixed deposits or jewellery as security to tide over cash flow constraints. The importance of these products for low-income groups in a situation where the local moneylender is the only alternative is considerable. Despite the relatively high cost of these products they account for an overall 25–35% share of accounts in the sample branches. Good returns on these products are an encouraging indicator of the potential for the viability of the rural banking industry. The indications are that – despite their NPS classification, indeed perhaps because of it – such advances could emerge as the principal banking products for low-income groups over the next few years.

4.10 Conclusions: KCC and NPS returns mask losses from SHG lending

The analysis in this section underlines the importance of product design and delivery systems, efficient operations and appropriate pricing for combining outreach to clients with viability. While the success of KCC and NPS advances has been brought about through practical product design, ISB loans have done well only in efficient branches. Together, these factors – and the freedom to charge cost covering interest rates on NPS advances – determine the profitability of the bank and the viability of specific product categories.

SHG loans, on the other hand, are basically a high-cost product on account of the time-intensive nature of the group formation, capacity-building and appraisal processes necessary to substitute for the collateral that traditionally provides comfort to bankers. Whatever the level of efficiency of RRB operations, achievement of sustainable outreach to low-income clients through the SHG loan product is a virtual impossibility in the present low-interest regime governing the ‘priority sector’ products of the banks.

Overall, the sample branches – especially RRB 5 but also RRBs 1 and 2 – show good operational efficiency and profitability. RRBs 3 and 4, on the other hand, need to bring about significant structural and functional changes in their operations to emerge stronger in terms of profitability and, thereby, to facilitate outreach. Further, the RRB 5 branch highlights the possibility of offering good returns on deposits to clients if the bank operates at high efficiency levels. This provides low-income clients with an attractive saving option which, in turn, over a period of time, provides security to the bank for its high-yield NPS advances, thereby boosting its business and its profitability.

5 The Outreach/Viability Conundrum

5.1 The policy framework, operating strategies and outreach

The policies introduced during the reform period – starting in the early 1990s – have been instrumental in reorienting RRBs towards financial viability, an objective that was lost midway through their evolution – particularly in the 1980s. These policy changes have enabled RRBs to explore new markets and operating procedures with the aim of achieving viability. While policies allowing relocation of branches, improved remuneration and incentives for RRB staff and liberalised lending arrangements (lending to the 'non-priority' sectors, deregulation of interest rates) have all had a positive effect on RRBs' operations, this is not a complete solution. The introduction of income recognition and asset classification norms had a negative short-term impact on viability and such measures have not been backed by a supporting regulatory framework that enables participation in cheque clearing and issuing of drafts and operational measures like the computerisation of branches. Thus, while the RBI and NABARD deserve credit for introducing changes aim at professionalising RRB operations, the basic character of the RRBs' business – which has traditionally been with small rural clients – remains largely unchanged.

The trend analysis in Section 3 of the sizes of loan and deposit accounts indicates very low growth in the overall number of accounts handled and some shift away from outreach to low-income groups in recent years. The growth in average loan and deposit sizes has been significant but, nevertheless, RRB business continues to be geared to providing financial services to small clients. Thus, an overwhelming proportion (more than 80%) of loan accounts have outstandings of less than Rs25,000 ($520).

Along with the policy environment, the macro-economic situation has also been altered during the past few years. A decline in market deposit rates from 14–15% a few years ago to just 5–6% now has resulted in the initial post-reform recourse to investments as a safe income option being arrested. RRBs are again looking at their lending portfolios to earn incomes and achieve or sustain viability. This is a positive development for the outreach objective since, by the very nature of their compulsion to locate most of their branches in rural areas, RRBs must serve increasing numbers of low-income clients in order to increase their business.

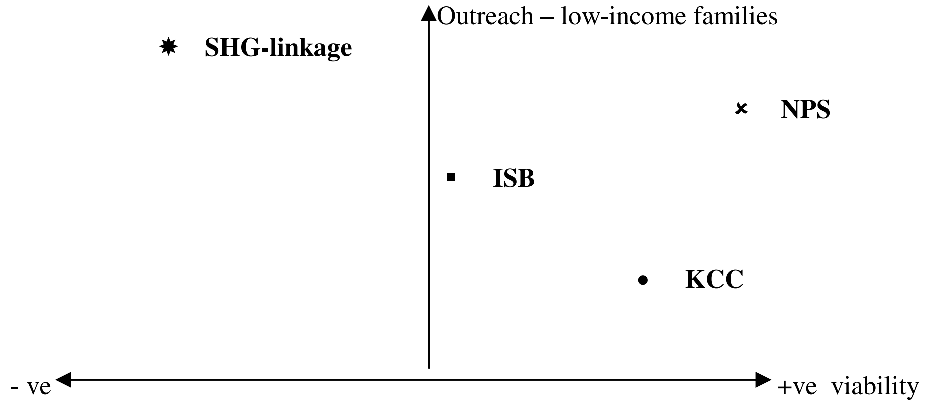
The analysis of sample RRBs covered by this study demonstrates that there is no inherent contradiction between the viability and outreach objectives. RRBs that have focused on operational efficiency have achieved good operating results even while continuing to serve significant numbers of low-income clients. These developments could be instrumental in ensuring the establishment of the RRBs as the major financial service provider in rural areas.

It is in this context that this study undertook a detailed analysis of the design, costs and yields of products presently offered by RRBs and related these to the operational policies and performance of the sample banks.

5.2 Product viability and outreach: what needs to be done

An analysis of the main product categories of RRBs indicates varying viability, based on product design and efficiency in operations. The findings of this study – using feedback and detailed cost information from the five sample RRBs – on the four main products relevant to low-income rural households in the outreach/viability trade-off are illustrated in Figure 24.

Figure 24 RRB products and the outreach/viability trade-off



Source: Study team's assessment

Products like the Kisan Credit Card (KCC) and non-priority sector (NPS) advances show uniform viability characteristics, which may largely be a credit to the design of these products. Both show good portfolio quality and positive returns though the agricultural land base of the KCC makes it clearly inaccessible to clients who do not own agricultural land. The spread on NPS advances – mainly comprising gold- and deposit-linked loans – is the highest, on account of low operating costs and high interest earnings of 16–19% p.a. Similarly, the RRBs' KCC portfolio yields positive returns despite a lower interest rate (13–16% pa). From the banks' perspective, both products are characterised by simple appraisal procedures and comfortable collateral.

ISB loans show fluctuating fortunes for the sample branches where the critical differentiator seems to be operating efficiency. Thus, RRB 5, that shows the best operating efficiency in the sample, makes a reasonable margin on these loans whereas most others suffer on account of high appraisal and handling costs. In terms of potential, branches have high exposure levels, indicating significant demand for the product.

SHG loans, however, fare poorly even in the most efficient of branches. Despite a wide array of lending strategies and inclusion of some of the best known RRBs (in relation to SHG lending) in the study sample, none of the sample branches is able to cover its costs on SHG loans. Even branches with proven operational efficiency find that SHG lending is more work-intensive than other products as it requires the staff to spend more time and effort than in managing other products. As a result, the operating costs on SHG loans incurred by even the most efficient branches were found by the study to be of the order of 19% (with 9% required for managing the loans). By contrast, RRBs presently charge 12.5–13% on SHG loans. Since the overall bank exposure to such loans is quite low (less than 5% of the total loan portfolio in all sample RRBs), these losses do not really affect the viability of the banks. However, it is apparent that this deficit situation is an impediment to the achievement of the vital outreach objective of this product and particularly in the context of potential clients with the lowest incomes. To enable this product to achieve its goals, therefore, RRBs will need to transcend the 'social control' on interest rates on 'loans to the poor' and charge the 20–22% interest (depending on local conditions) that will make the product sustainable at least for the most efficient branches.

Thus, the **conclusions and recommendations** emerging from this study are that:

- **It is possible for RRBs to maintain viability while serving low-income clients.** Indeed, in the study sample, it is the banks with the higher C-D ratios and better outreach to such clients that perform better on profitability parameters.

- **On management:** The most effective and efficient RRBs are the ones with the most professional leadership and the most pro-active approach to adjusting operations and products to match with local economic conditions. Therefore, in the present policy framework it is quite possible for most RRBs to become viable providers of financial services to the poor.
- **On products:** Product design along with operating efficiency is the key factor in the ability of RRBs to achieve both outreach and viability objectives. An analysis of product design, client demand patterns and establishment of appropriate delivery mechanisms is needed for this purpose. Products that need immediate attention to ensure viability are SHG and ISB advances. While operating efficiency must be improved and made more consistent across RRBs for both products, the SHG product is hampered by 'social control' on the interest charges that can be levied by the banks. KCC and deposit-linked NPS advances are clear winners in this regard and innovations in the latter, in particular, could even be encouraged to improve the RRBs' outreach to low-income clients while strengthening their viability.

References

Deolalkar, G.H. (1999) 'The Indian Banking Sector – On the Road to Progress' in *Rising to the Challenge: A Study of Financial Markets, Volume 5: INDIA*. Manila: Asian Development Bank.

IES (2002) *Economic Survey, 2002*, New Delhi: Ministry of Finance, Government of India.

NABARD (2002) 'Review of the Performance of RRBs as on 31 March 2002', Mumbai: National Bank for Agriculture and Rural Development.

NABARD (2001) 'Regional Rural Banks – Key Statistics, 31 March 2001', Mumbai: National Bank for Agriculture and Rural Development.

RBI (2002a) 'Report on Trends in the Indian Banking Sector, November 2002', Mumbai: Reserve Bank of India

RBI (2002b) 'Master Circular, Rural Planning and Credit Department, 11 November 2002', Mumbai: Reserve Bank of India

RBI (2001) 'Basic Statistical Returns, March 2001', Mumbai: Reserve Bank of India.

Ruthven, O. and Kumar, S. (2002) 'Fine-grain Finance: Financial Choice and Strategy among the Poor in Rural North India', *Working Paper* 57, Manchester: Institute of Development Policy and Management, University of Manchester.

Sinha, S. and Patole, M. (2002) 'Microfinance and the Poverty of Financial Services: How the Poor in India could be Better Served', *Working Paper* 56, Manchester: Institute of Development Policy and Management, University of Manchester.