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Reforms in Institutional Finance for Inclusive Growth in India

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Abstract: *This paper analyses the need, significance and the advantages of 'reforms in institutional finance for inclusive growth' in the context of Indian economy and offers some practical suggestions from the functional perspective. India's rural financial architecture (RFA) is subject to systemic policy issues and pervasive institutional weaknesses. Lack of autonomy and weak governance and 'unseen' accountability have affected the sustainability of rural financial institutions (RFI) and resulted in constrained outreach. The importance of access to institutional finance for the poor arises from the problem of financial exclusion of nearly 3 billion people from the formal financial services across the world. With only 34% of the population engaged in formal banking, this paper finds that the reforms in institutional finance coupled with governance reforms in India's RFA would greatly benefit the economy in making available the much-needed financial services to the poor and the neglected sections of the society, and facilitate efforts towards achieving inclusive growth.*

Keywords: development finance; financial system, rural financial institutions, poverty; governance; reforms

JEL Classifications: D53, G2, G21, G28, O16, O43, P21, Q14

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1. Introduction

Studies note that efficient, broad-based and deepened financial markets can lead to increased economic growth by improving allocation and utilisation of savings in the economy (Beck, Georgiadis, & Straub, 2014; Cournède & Denk, 2015). Better functioning financial systems ease external financing constraints that impede firm and industrial expansion and establish strong, positive link between the functioning of the financial system and long-term economic growth.

Three dimensions of effective financial systems are first, an institutional dimension which includes the regulatory and judicial framework and the quality of institutions. Second, the market dimension which includes the traditional measures of size and access to finance; financial innovation; and residents' access to finance. The third dimension is market performance that

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includes measures of technical efficiency, liquidity, and distribution of domestic assets base. A well-developed financial sector performs important functions such as promoting overall savings of the economy by providing alternative instruments; allocating resources efficiently among the sectors, and providing an effective channel for the transmission of policy impulses. A typical competitive financial sector has the following characteristics: (i) there should be large number of buyers and sellers of the financial product; (ii) the price of the product is determined by demand and supply; (iii) a secondary market for the instrument; (iv) turnover of the instruments in both primary and secondary markets should be fairly large; and (iv) agencies involved in the process of intermediation between buyers and sellers should provide intermediation services at a minimum spread.

India is one of the five countries (along with China, Indonesia, Brazil, and Russia) categorised as big emerging market economies (EMEs) by the World Bank as these countries have made the critical transition from a developing country to an emerging market. The World Bank has predicted that these big five EMEs' share of world output would have more than doubled from 7.8% in 1992 to 16.1% by 2020. Financial sector reforms committee (Narasimham, 1991) which recommended deregulation of the financial sector in India is the starting point of the reform process which has since then rolled forward in several directions. The underlying philosophy of the reforms measures have been to develop the different segments of the financial market into an integrated one so that their interlinkages can reduce arbitrage opportunities, and help achieve a higher level of operational efficiency and monetary policy effectiveness. Even though significant progress has been achieved during the past two decades in terms of policy and institutional reforms, the Indian financial sector suffers from various institutional inadequacies in propelling financial development towards the much-desired inclusive growth. This study examines how far have the reform initiatives have resulted in (i) narrowing the inter-market divergences; (ii) expansion of financial services to the far and needy in society; (iii) provision of basic financial products such as savings, credit, insurance, and payment and transfer facilities; (iv) reduction of transaction costs of financial intermediation both for the institutions and the clients; and (v) reasonable degree of market integration.

Though India's financial institutions and regulatory structures are evolving gradually, the time has come to make a more concerted effort towards the next generation of financial reforms in institutional finance. India's institutional finance is not providing adequate services to the majority of rural and poor customers. Nearly three-quarters of farm households have no access to formal sources of credit and lack instruments to insure against adverse events such as low crop yields due to bad weather. A vast majority of India's rural poor still do not have access to formal finance. The rural banks in India serve primarily the needs of richer rural borrowers, with 66 percent of big farmers having a

deposit account and about a 44 percent having access to credit. According to World Bank – National Council of Applied Economic Research, India (NCAER) study, 70 percent of marginal/landless farmers do not have a bank account; 87 percent have no access to credit from a formal finance source (Rural Finance Access Survey (RFAS), 2003). About 87 percent of the poorest households, mostly marginal farmers, do not have access to credit, and 71 percent do not have access to savings from a formal source. The poor encounter several problems in meeting their unforeseen expenditure, and the difficulty in accessing formal finance has led them to rely on informal finance — mostly moneylenders and shopkeepers (Basu, 2006). There is a need to encourage banks, especially smaller, well-capitalised and well-governed private banks, to operate and deliver retail services in order to improve access to finance (Prasad & Rajan, 2008). All India Rural Credit Survey in 1954, had documented that the credit needs of the financially excluded households are met by the informal, non-institutional sources rather than formal institutions (Kamat, Mukherjee, & Sandstorm, 2010). In order to herald a new paradigm of equitable development, reforms in institutional finance for inclusive growth should aim at (i) broadening financial inclusion, (ii) address the challenges of breadth, (iii) address the issues of depth, and (iv) remove structural barriers including social, economic and political barriers. Reforms in institutional finance is required to aim at sustainable and inclusive growth through stability, efficiency, inclusion, and depth. Indeed, reforms in institutional finance for rural finance are expected to offer enormous multiplier effect on economic growth.

This article analyses the need for institutional reforms in development finance in making services work for the Indian poor. In section 2, theoretical considerations based on literature review in the context of development economics in support of the institutional reforms drawn from the new institutional economics are discussed. Section 3 presents the current state of affairs of the rural financial sector in India with a focus on financing for the rural and agricultural sector; particularly the structure and performance of commercial banks (SCBs), regional rural banks (RRBs), rural credit cooperatives and microfinance institutions (MFIs). In section 4, the need for reforming the Indian RFA is discussed followed by some valuable suggestions, and finally, section 5 provides the summary and conclusion.

2. Literature Review

New Institutional Economics (NIE) which endeavours to integrate theory of institutions in economics claims that institutions matter, the relationship between institutional structure and economic behaviour requires attention, and the determinants of institutions can be analysed with the aid of economic

theory (Gambacorta, Yang, & Tsatsaronis, 2014). It was led by renowned economists such as Ronald Coase, who explicitly introduced transaction costs into the economic analysis (Coase, 1937), Williamson (1975), who introduced the term 'transaction costs in economic analysis (1975), and Richter (2005). Unlike neoclassical economics, the institutional framework is not assumed as given but is explicitly treated as an object of research, and the implications of any given institutional arrangements for economic behaviour are taken into account (Richter, 2005).

Many empirical studies have established the significant role of the formal banking sector for inclusive growth (Rajan & Zingales, 1998; Beck, Levine, and Loayza 2000; Levine, 2005; Beck, Demirguc-Kunt, and Levine 2007). Few studies have examined this issue by focusing directly on banking service providers (Beck, Demirguc-Kunt, and Martinez Peria, 2007; Genesis, 2005). Most of the existing research focuses on country case studies that aim at measuring and analysing access to financial services at the household or firm level (Claessens, 2006; Claessens & Demirguc-Kunt, 2006). Below is a discussion of literature related to efficient institutions and economic performance, governance reform for institutional development, financial development and poverty reduction, governance and financial regulatory agencies, the role of the state in financial infrastructure, and credit information as a public good.

2.1 Efficient institutions and economic performance

Only efficient institutions are growth-promoting as they encourage individuals to engage in productive activities by offering appropriate incentives and establishing a stable structure of human interactions that reduce uncertainty. There are two types of efficiency: (i) substantive efficiency (i.e., a rule promotes allocative efficiency), and (ii) procedural efficiency (i.e., a rule is designed to reduce the cost or increase the accuracy of using the system of rules). Chu (2003) states that affluence in developed countries is a cumulative result of 'efficient institutions' while poverty in poor countries is a result of 'inefficient institutions'. Efficient financial institutions facilitate monetary policy by strengthening financial transactions although sometimes at the cost of greater risks to financial stability (Cournede, Ahrend, & Price, 2008). Further, inefficiencies in financial intermediation result in huge economic costs (Trew, 2008; Bazot, 2014);

The successful institutions are believed to be those that contract enforcing as well as coercion constraining; that is, they reward production and exchange rather than mere expropriation and redistribution. However, in developing countries, institutional frameworks are found to overwhelmingly favour activities that promote redistributive rather than productive activity, that create monopolies rather than competitive conditions, and that restrict

opportunities rather than expand them (North, 1990). According to NIE, countries need two distinct and (not necessarily) complementary sets of institutions: (i) those that promote exchange by lowering transaction costs and promoting trust, and (ii) those that induce the state to protect rather than expropriate private property, to cope with the challenges of development.

2.2 Governance reform for institutional development

Over the last two decades, the issue of institutional development or "governance reform" has taken centre stage (Chang, 2005). Developing countries are poor because their current institutions provide weak incentives that promote growth. This argument raises the question of not only of what type of institutions they should design, but also more importantly, how they could develop such institutions. There exist complex interactions between the different typologies of institutions (i.e., the interaction between formal and informal institutions, between different levels of institutions, and between economic and political institutions), which have different horizons for change and are therefore, subject to very different evolutionary dynamics. Institutional reforms typically deal with formal institutions, which can be changed immediately (Cournede & Dink, 2015). However, informal institutions that serve to legitimise any set of formal rules, such as beliefs and norms, will change only gradually.

As such, if a country opts to adopt the formal rules of another country, it will have very different performance characteristics compared with the country of origin if both the informal norms and the enforcement characteristics are different. This implies that transferring successful western market economies formal political and economic rules to developing economies is not a sufficient condition for generating good economic performance (North, 1992). Another reason why underdevelopment cannot be overcome by simply importing institutions that were successful in other countries is institutional path dependency. That is, those who make policy and design institutions have a stake in the framework they created, and will, therefore, resist changes that may rob them of power or property (Shirley, 2005).

However, the dynamics of institutional change, especially the interplay between economic and political markets, is a complex aspect that needs to be understood before embarking upon institutional reforms. Since institutions are, by nature, deeply embedded in society, and if growth truly necessitates the major institutional transformation in such areas as rule of law, property rights protection and governance, among others, then the prospects for growth would appear to be dismal in poor countries. In explaining why "good" economic policies based on "correct" economic theories have so consistently failed; orthodox economists now invoke

institutions. That is, the countries that implemented their policies did not have the right institutions, which is why they did not work and not because they were wrong to begin with. As a result, the original Washington Consensus of "stabilise, privatise, and liberalise" has now been augmented by a long list of so-called "second generation" reforms that are heavily institutional in nature (Rodrik, 2006). The World Bank and the IMF have been emphasising the role of institutions in economic development.

2.3 Financial development and poverty reduction

Some studies have highlighted hat beyond long-run growth, finance can also lessen the gap between the rich and the poor and the degree to which that gap persists across generations (Gennaioli, Shleifer, & Vishny, 2014). This has potentially profound implications for poverty and income distribution by affecting the allocation of capital, as it can alter both the rate of economic growth and the demand for labour. There is an emerging body of empirical research, suggesting that in practice, improvements in financial contracts, markets, and intermediaries actually do tend to expand economic opportunities and reduce persistent income inequality (Delis, Hasan, & Kazakis, 2014; Bahmani-Oskooee, & Zhang, 2015). As such, it is important to care about the process of financial development as it has a well-documented nexus with economic and social development and a significant role in attaining sustainable long-term growth and poverty alleviation and thereby, enhancing social welfare.

Financial development through institutional reforms facilitates efficient allocation of productive resources and can potentially reduce the cost of capital. An inclusive financial system can help in reducing the growth of informal sources of credit (Sharma, 2010). There is a need to target Bottom of the Pyramid (BoP) customers to achieve inclusive banking and in turn to achieve inclusive growth (Beck, Demirguc-Kunt & Martinez Peria, 2008). Growth is good, sustained high growth is better and sustained high growth with inclusiveness is best of all. Inclusive growth in the economy can only be achieved when all the weaker sections of the society, including agriculture and small-scale industries, are nurtured and brought on par with other sections of society in terms of economic development (Swamy, 2010).

2.4 Governance and financial regulatory agencies

Governance is a concept that has evolved since the late 1980s. Multinational organisations such as the World Bank, International Monetary Fund (IMF), European Union (EU), United Nations Development Programme (UNDP), and Asian Development Bank (ADB) have their own definition of governance. The UNDP defines governance as the exercise of political,

economic, and administrative authority to manage a society's affairs, while ADB defines governance as the manner in which power is exercised in the management of a country's social and economic resources for development. The World Bank uses the same definition. On the other hand, for EU, 'governable means "rules, processes, and behavior that affect the way in which powers are exercised at European level, particularly as regards openness, accountability, effectiveness, and coherence. Levine (2011) argues in favour of an effective institutional mechanism as the absence of an informed, expertly staffed, and independent institutions that evaluate financial regulation from the public's perspective is a critical defect in the governance of financial regulation as governance is associated with selecting, enforcing, and reforming financial policies.

2.5 The role of the state in financial infrastructure

Financial infrastructure, as defined by the World Bank, refers to credit reporting institutions (credit registries and bureaus), payment and settlement systems, and the legal framework that governs financial transactions. A well-developed financial infrastructure provides a sound platform for more efficient credit markets by reducing information asymmetries and legal uncertainties that may hamper the supply of new credit. This enhances the depth of credit market transactions and broadens access to finance. The global financial crisis has triggered the attention of researchers as well as policymakers to renew their interest in the role of the financial infrastructure in supporting systemic stability. Financial infrastructure promotes financial stability in several ways: (i) transparent credit reporting supports the internal risk management of financial institutions and provides the financial regulators with timely information on the risk profile of systemically important financial institutions, and (ii) well-designed payment and security settlement systems enhance financial stability by reducing counterparty risk in the interbank markets and complex securities and derivatives transactions.

Active involvement of the state in the financial sector helps to maintain economic stability, drive growth and create jobs. Experience suggests a crucial role for the state in promoting transparency of information and reducing counterparty risk (World Bank, 2013). The global financial crisis highlighted the need for a resilient financial infrastructure for financial stability, thus necessitating the crucial role of the state, particularly in promoting the provision of high-quality credit information and in ensuring equitable provision of the much-needed credit for the needy sectors in the economy. As the financial systems are multidimensional, the state has to ensure that the financial architecture has adequate depth, sufficient access, improved efficiency, and financial stability. The role of the state in supporting financial infrastructure has diverged over time and across

countries. The state's endeavour should be to improve how state agencies and central banks can operate, regulate, and oversee financial infrastructure. The focus needs to be on two areas: (a) the state's role in developing and using credit information systems, (b) the state's role in improving payment and securities settlement systems, (c) the state's role in broadening and strengthening retail payment systems, and (d) the states inevitable role in providing a stable legal framework that governs financial transactions.

2.6 Credit information as a public good

The open and transparent exchange of credit information has several characteristics of a public good that benefits both borrowers and lenders. How does a well-functioning credit-reporting infrastructure perform the role of a public good? First, credit reporting benefits banks and nonbank lenders by mitigating problems of moral hazard and adverse selection. This, in turn, reduces the cost of financial intermediation and allows banks to price, target, and monitor loans more effectively. Second, credit reporting supports financial stability by making it easier for financial regulators to assess and monitor systemic risks. Despite the traditional approaches to financial oversight that focused on risks at the level of individual financial institutions, a key advantage of comprehensive credit information systems is that they allow regulators to monitor the interconnected risks of systemically important financial institutions. Third, open and transparent credit reporting benefits customers by promoting credit market competition. The exchange of credit information enables customers to build reputational collateral and to access credit outside established lending relationships. This reduces the ability of established lenders to exploit their privileged knowledge of clients' credit histories.

The state, therefore, needs to play an important role in promoting the exchange of credit information and in protecting open and equal access to the market for credit information. Some of the examples to support this argument: (1) Argentina as a state uses the credit registry information for prudential supervision of its financial institutions, (ii) Egypt removed the regulatory barriers to the development of the private credit bureau, (iii) Mexico employs the state interventions to prevent market fragmentation and closed user groups, and (iv) Morocco offers public support for the development of a private credit bureau. Transparent credit information is also a prerequisite for sound risk management and financial stability. However, due to the prevalence of monopoly rents in the market for credit information, information sharing among private lenders may not arise naturally. This creates an important rationale for the involvement of the state.

3. The Indian Financial Sector – An Overview

India has a bank dominated financial system with more than 75 percent of financial assets held by scheduled commercial banks (SCBs). Thus, it is desirable to strengthen and stabilise the banking sector. Though India indulges in self-praise of its stable banking system, its performance is not satisfactory, when compared with other banking systems which have made significant strides in their structure as well as their performance (Table 1). India is way behind many of its peers when compared in terms of ATMs per 100,000 adults (8.90); Indonesia (16.47), Malaysia (56.43), South Africa (60.01), and Brazil (119.25). The banking systems in Australia (166.92), UK (122.77) and USA (173.43) are far more advanced. In terms of outstanding loans from commercial banks as a percentage of GDP, India (51.75%) is a laggard when compared with China (108%), Malaysia (104%), South Africa (74%) and Russia (64%).

Table 1: Structure and performance of banking systems around the world

Sl. No.	Country	Commercial bank branches per 100,000 adults	ATMs per 100,000 adults	Outstanding deposits with commercial banks (% of GDP)	Outstanding loans from commercial banks (% of GDP)	Return on Assets (ROA) (%)
1	Australia	29.6	166.9	107.1	128.7	0.1
2	Brazil	46.1	119.6	53.2	40.2	1.5
3	China	…	…	159.2	108.7	1.3
4	France	41.5	109.8	34.7	42.8	N/A
5	Germany	15.7	122.2	27.6	24.2	N/A
6	**India**	**10.6**	**8.9**	**68.4**	**51.7**	**0.9**
7	Indonesia	8.5	16.4	43.3	34.2	1.3
8	Malaysia	10.4	56.4	130.8	104.2	1.5
9	Russia	37.0	152.9	45.0	63.8	2.5
10	South Africa	10.7	60.0	45.8	74.4	1.5
11	U. K	24.8	122.7	422.7	459.9	0.1
12	USA	35.4	173.4	57.7	46.8	0.3

Source: Compiled from IMF data

When compared with the OECD benchmark the Indian banking parameters are way behind based on the following indicators; (i) branches per 1000 Sq. Kms, (ii) ATMs per 0.1 million; and ATMs per 1000 Sq. Kms (refer Table 2).

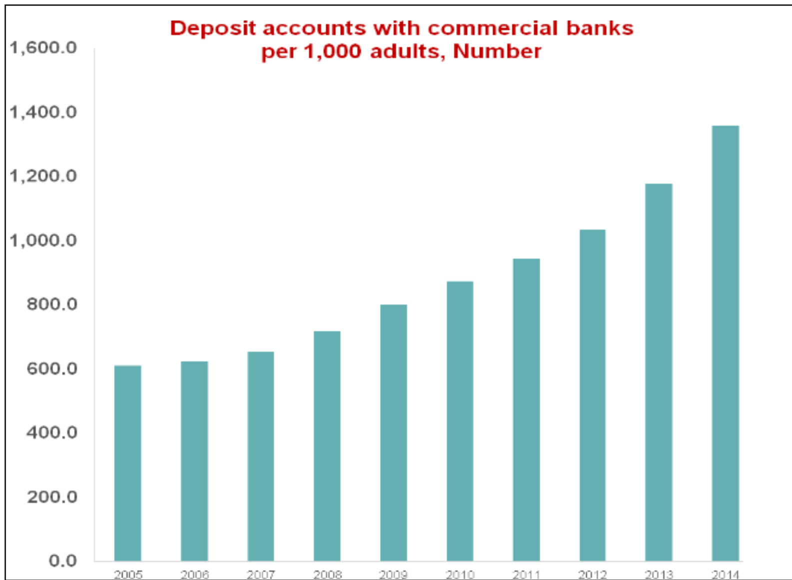
Table 2: Access to & use of financial services - 2014

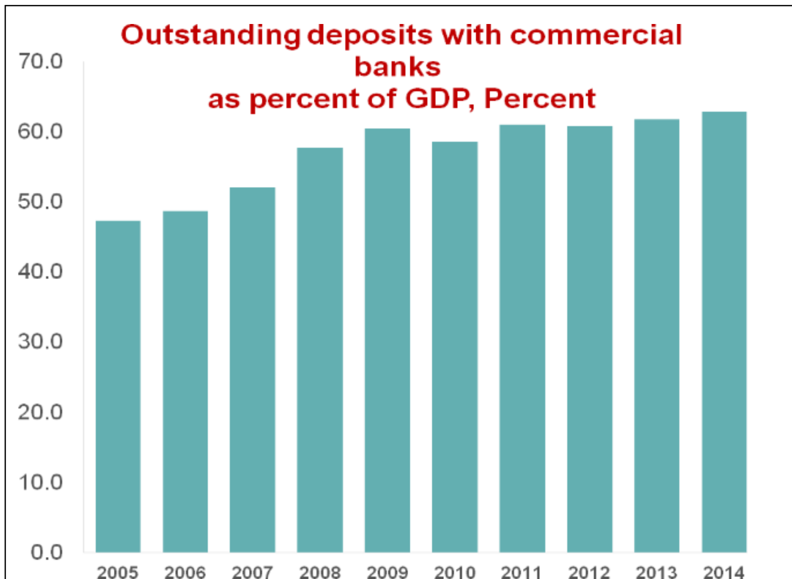
Indicator	Value
ATMs per 100,000 adults, Number	18.07
ATMs per 1,000 km2, Number	54.90
Commercial bank branches per 100,000 adults, Number	13.04
Commercial bank branches per 1,000 km2, Number	39.59
Deposit accounts with commercial banks per 1,000 adults, Number	1,358.38
Loan accounts with commercial banks per 1,000 adults, Number	153.64
Outstanding deposits with commercial banks as percent of GDP, Percent	62.87
Outstanding loans from commercial banks as percent of GDP, Percent	49.65

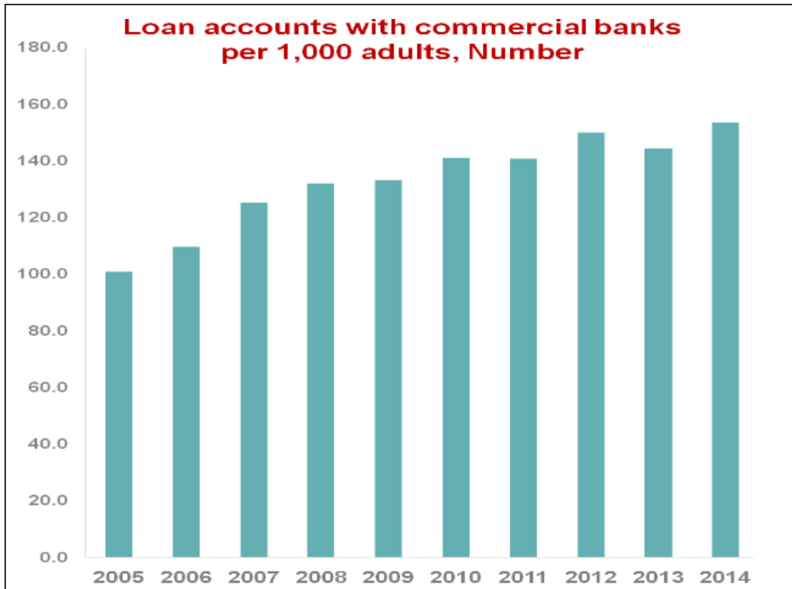
Source: Financial Access Survey of IMF - 2015

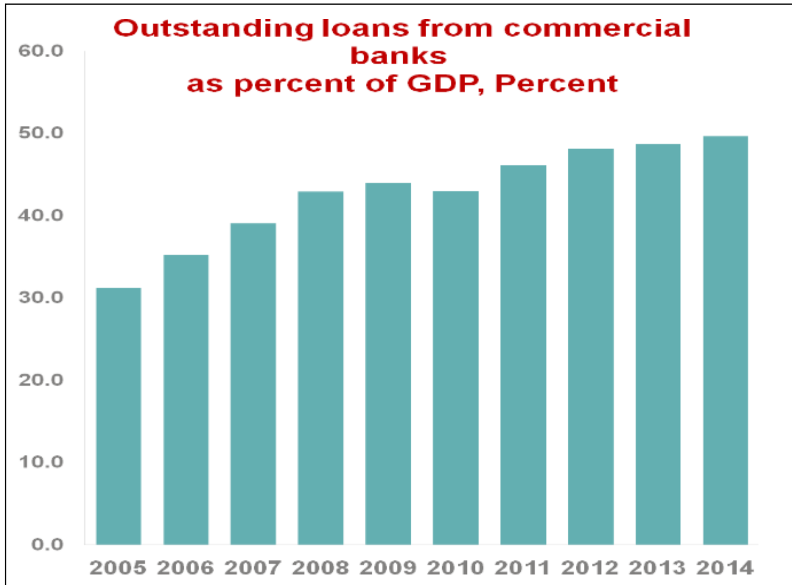
Access to finance for the poor is all the more important when considering the problem of financial exclusion of nearly 3 billion people from the formal financial services across the world. With only 34% of the population engaged in formal banking, India has 135 million financially excluded households, the second highest after China. Select indicators of access to finance in India are presented in Figure 1. Further, the real rate of financial inclusion in India is also very low and about 40% of the bank account holders use their accounts hardly once a month. Banking data reveals that 139 districts in the country face credit exclusion. In these districts, only 10 percent or less out of 100 persons have access to credit; although the exclusion is serious, there is a wide variation across regions, social groups, and asset holdings. The poorer the group, the greater is the exclusion (Rangarajan, 2008). The results of the All-India Debt and Investment Survey of 2002, also indicate that the share of the non-institutional sources, in the total credit to the cultivator households, had increased from 30.6 percent in 1991 to 38.9 percent in 2002 (Karmakar, 2002). According to the NSSO Survey 59th Round; 51.4% of farmer households are financially excluded from both formal/informal sources (459 lakh out of 893 lakh), of the total farmer households, only 27% access formal sources of credit; one-third of this group also borrow from non-formal sources and overall, 73% of farmer households have no access to formal sources of credit.

Figure 1: Access to finance – select indicators in India









Source: Financial Access Survey of IMF - 2015

In spite of the credit policy of the government, India continues to suffer from inadequate flow of finance to rural and agricultural sectors, with the overall credit to deposit ratio (CDR) still hovering around 70 percent. Food credit, which often is directed towards rural and agricultural sectors, is experiencing unsatisfactory and unsteady growth rates (Table 3).

Table 3: Select macroeconomic aggregates of SCBs in India (INR billion)

Year	Deposits	Food Credit	Non-Food Credit	Bank Credit	Assets with banks
2014-15	85332.85	944.18	64420.02	65364.20	2217.70
2013-14	77055.60	984.77	58956.19	59940.96	1950.49
2012-13	67504.54	964.22	51640.37	52604.59	2199.48
2011-12	59090.82	813.04	45305.48	46118.52	1779.12
2010-11	52079.69	642.82	38778.01	39420.83	1543.86
2009-10	44928.26	484.89	31962.99	32447.88	1344.44
2008-09	38341.10	462.11	27293.38	27755.49	1225.71
2007-08	31969.39	443.99	23175.15	23619.14	908.77
2006-07	26119.33	465.21	18846.69	19311.89	774.42
2005-06	21090.49	406.91	14663.86	15070.77	543.92
2004-05	17001.98	411.21	10593.08	11004.28	512.97
2003-04	15044.16	359.61	8048.24	8407.85	481.79
2002-03	12808.53	494.79	6797.36	7292.15	590.19
2001-02	11033.60	539.78	5357.45	5897.23	528.64
2000-01	9626.18	399.91	4714.43	5114.34	623.55
1999-00	8133.45	256.91	4102.67	4359.58	434.48
1998-99	7140.25	168.16	3520.21	3688.37	347.87
1997-98	5984.85	124.85	3115.94	3240.79	242.43
1996-97	5055.99	75.97	2708.04	2784.01	198.92
1995-96	4338.19	97.91	2442.24	2540.15	165.71
1994-95	3868.59	122.75	1992.85	2115.60	142.77
1993-94	3151.32	109.07	1535.11	1644.18	114.23
1992-93	2685.72	67.43	1452.39	1519.82	110.43

Source: Compiled from RBI Database

3.1 Rural finance by commercial banks

Credit flow to agricultural sector, the main source of employment in rural India, has been unsteady in spite of the renewed focus by policy makers and experts on the Indian economy. Though the institutional lenders continue to cite their own concerns and constraints such as vagaries of rainfall; chronic defaults; inadequate collaterals; problems in the marketing of Agri-produce; exploitation by middlemen among others, an inadequate flow of credit to agriculture (refer Table 4) still remains a huge concern for economic development in India. There is a need to reform institutional finance to agriculture and ensure steady flow of credit to this vital sector to achieve inclusive growth.

Table 4: Flow of credit to agriculture from SCBs

Year	Credit to Agriculture (INR Billion)			Growth in Credit to Agriculture (in Percent)		
	Direct	Indirect	Total	Direct Growth	Indirect Growth	Total Growth
2013-14	6273.11	2647.56	8920.67	17.40	138.30	38.21
2012-13	5343.31	1111.02	6454.33	21.23	-22.08	10.64
2011-12	4407.58	1425.85	5833.43	22.35	-2.95	15.02
2010-11	3602.53	1469.23	5071.76	13.37	0.94	9.47
2009-10	3177.67	1455.54	4633.21	19.96	31.48	23.36
2008-09	2648.93	1107.02	3755.95	23.41	18.47	21.91
2007-08	2146.44	934.43	3080.87	24.70	13.18	20.96
2006-07	1721.28	825.64	2546.92	27.69	44.41	32.67
2005-06	1347.98	571.75	1919.73	41.05	58.51	45.84
2004-05	955.65	360.71	1316.36	35.02	26.48	32.56
2003-04	707.81	285.20	993.01	24.49	20.39	23.28
2002-03	568.57	236.90	805.47	22.06	29.89	24.26
2001-02	465.81	182.38	648.19	15.06	-3.12	9.29
2000-01	404.85	188.25	593.10	11.02	45.17	19.98
1999-00	364.66	129.68	494.34	10.19	59.76	19.95
1998-99	330.94	81.17	412.11	12.40	28.13	15.19
1997-98	294.43	63.35	357.78	7.27	27.06	10.31
1996-97	274.48	49.86	324.34	15.26	35.71	17.99
1995-96	238.14	36.74	274.88	11.62	28.24	13.59
1994-95	213.34	28.65	241.99	9.60	36.49	12.22
1993-94	194.65	20.99	215.64	2.72	35.24	5.19
1992-93	189.49	15.52	205.01	8.92	8.30	8.87
1991-92	173.97	14.33	188.30	7.75	20.52	8.63
1990-91	161.45	11.89	173.34	4.16	-16.79	2.39

Source: Indian Economy database of RBI

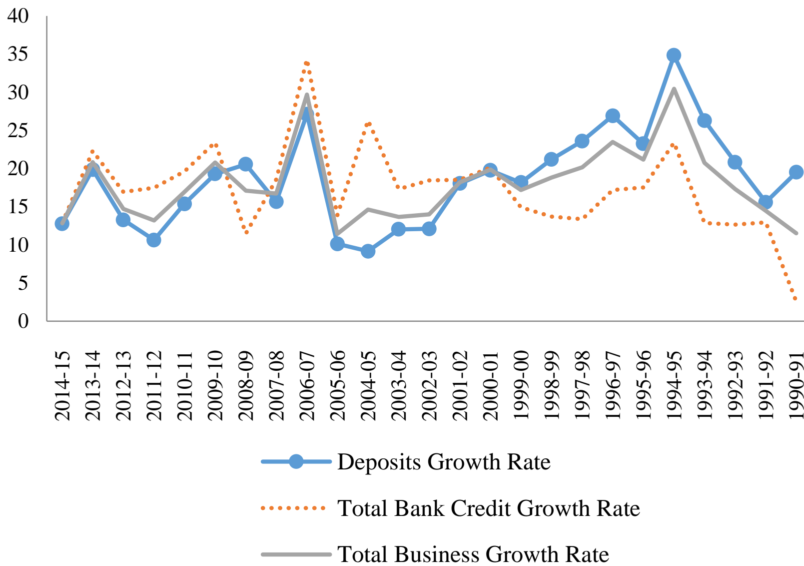
Note: RBI Reference Rate 1 USD = INR 67.3398 as of 29.05.2016

Further, region-wise exclusion is most acute in central, eastern, and north-eastern regions – having a concentration of 64% of all financially excluded farmer households (from formal sources) in the country (41.561 million households out of 64.954 million households). Overall, indebtedness to formal sources of finance alone is only 19.66% in these three regions (4.09% in North-Eastern Region, 18.74% in Eastern Region and 22.41% for Central Region). The unbanked population is higher in the North Eastern and Eastern regions (Thorat, 2007). Exclusion among the Occupational Groups is marginal farmer households that constitute 66% of total farm households. Only 45% of these households are indebted to either formal or non-formal sources of finance (small farmers – 51%, medium farmers – 65.1% and large farmers – 66.4%). About 20% of indebted marginal farmer households have access to formal sources of credit (medium farmers – 57.6% and large farmers – around 65%). Among non-cultivator households, nearly 80% do not access credit from any source. The financially excluded sections largely comprise marginal farmers, landless labourers, oral lessees, self-employed and unorganised sector enterprises, urban slum dwellers, migrants, ethnic minorities and socially excluded groups, senior citizens, and more importantly women. Thus, financial exclusion is a serious concern among low-income households, mainly located in rural areas.

3.2 Rural finance by RRBs

Regional rural banks (RRBs), formed in 1975, are state-owned banks with a mandate to finance rural sectors and with a clear focus on agriculture and weaker sections but they too have not met with any great success even after their existence for almost four decades. In spite of coaching support from the government, the business of RRBs continues to be meagre, in the range of 15 to 20 percent (Figure 2). Although RRB branch presence is remarkable in the rural areas, their performance in the provision of financial services is not commensurate. At present, RRBs' share of agriculture credit is 8%, while that of commercial banks is about 50% and that of CCS is 42%. Such low market share coupled with poor financial performance raise serious issues about the RRB model. Studies have also pointed out that in an effort to meet financial performance expectations of shareholders, RRBs appear to be drifting from their mission to serve the under-served and the un-reached in a cost-effective way.

Figure 2: Business of RRBs



Source: Author's compilations from RBI database

3.3 Rural finance by cooperatives

Credit cooperatives in India claim their formal origin since 1904 from the Cooperative Societies Act and quite a long history even greater than that of their Chinese counterparts, which came into formal existence only in 1958. However, in terms of their loan outreach, Indian credit cooperatives have failed miserably compared with their Chinese counterparts. While the annual growth rate of flow credit from Indian Cooperatives is in the negative range (Table 5), the Chinese credit cooperatives are experiencing growth in the range of 45 to 55 percent.

Table 5: Flow of credit by cooperatives

	PACS	SCARDBs	PCARDBs	Total	Total Growth Rate
2012-13	1619.00	36.52	37.18	1692.70	
2011-12	1073.00	41.59	33.41	1148.00	47.45
2010-11	913.04	39.11	33.24	985.39	16.50
2009-10	749.35	32.05	24.65	806.05	22.25
2008-09	587.87	25.85	20.45	634.17	27.10
2007-08	576.43	22.21	18.22	616.86	2.81
2006-07	496.13	24.36	19.70	540.19	14.19
2005-06	429.20	29.07	22.96	481.23	12.25
2004-05	392.11	22.91	25.06	440.08	9.35

Table 5: (Continued)

2003-04	351.19	29.42	21.97	402.58	9.31
2002-03	339.96	29.62	21.51	391.09	2.94
2001-02	307.70	27.46	20.45	355.61	9.98
2000-01	256.98	25.86	18.66	301.50	17.95
1999-00	236.62	25.32	18.18	280.12	7.63
1998-99	127.43	24.37	16.92	168.72	66.03
1997-98	121.37	22.95	15.93	160.25	5.29
1996-97	112.92	21.51	14.55	148.98	7.56
1995-96	105.52	17.98	12.19	135.69	9.79
1994-95	83.12	5.66	6.51	95.29	42.40
1993-94	71.58	4.69	6.12	82.39	15.66
1992-93	62.23	4.15	5.42	71.80	14.75
1991-92	55.75	3.00	4.44	63.19	13.63
1990-91	43.11	3.84	3.76	50.71	24.61
1989-90	45.13	4.21	3.51	52.85	-4.05

Source: Indian Economy database of RBI
Note: Amount in INR Billion
RBI Reference Rate 1 USD = INR 67.3398 as of 29.05.2016

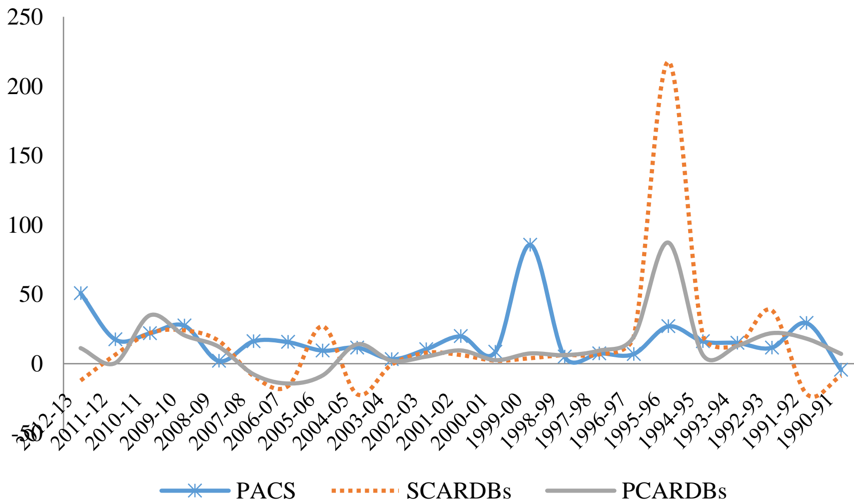
Indian credit cooperative sector is a three-tier structure comprising primary agricultural credit societies (PACSs); primary cooperative agricultural and rural development banks (PCARDBs); and state cooperative agricultural and rural development banks (SCARDBs). While district central cooperative banks (DCCBs) fund the PACSs, PCARDBs are funded by SCARDBs. Though on an average, there is one PACS for every 6 villages, the growth rate of overall credit by credit cooperatives is indeed in the negative range which is a much-concerning factor. Despite being in existence for more than a century, cooperatives have not been successful in terms of either financial sustainability or outreach. Figure 3 presents the trend of institutional credit by cooperatives including PACSs, PCARDBs, SCARDBs and the overall cooperative sector during the post-reform period. It is concerning to note that the annual growth rate in terms of outstanding credit is experiencing a negative growth during most part of the post-reform period (almost up to 2009-10).

3.4 Problem of demand – supply gap

India's rural financial sector (RFS) is subject to systemic policy issues and pervasive institutional weaknesses. Lack of autonomy and weak governance have affected the sustainability of rural financial institutions (RFIs) and constrained outreach. This, among others, impedes diversification to non-farm activities for supporting value addition and employment generation. Further, the risks in RFS due to droughts and floods are accentuated by the weak rural infrastructure and by production and marketing bottlenecks. The resulting low prices, productivity, and profitability make it difficult for the rural sector to

compete for capital with urban areas. Rural credit is only 10% of total commercial bank advances. Thus, a demand and supply gap exists, despite the extensive RFS. The rural poor and women in particular, have inadequate access to financial services and the disadvantages that the rural poor face due to limited access to finance are accentuated by the inadequacy of risk-mitigating instruments to insure against the risk they face.

Figure 3: Growth rates of institutional credit by cooperative

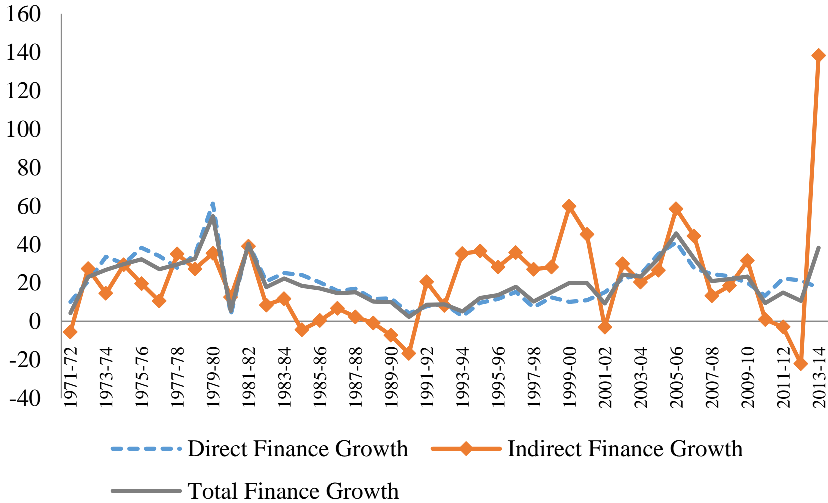


Source: Author's compilations from RBI database

4. Financial Services towards Inclusive Growth

Developing responsive institutions, those located in rural areas and those that affect the rural poor is a crucial question for economic policy-making as governments try to accelerate rural development and poverty reduction in economies that are increasingly market-based (IFAD, 2008). It has been well established that strong and widely accepted institutions – organisations and rules – that respond to the needs and priorities of poor groups, especially the rural poor and women, are essential for rapid poverty reduction. Nevertheless, the reverse is perhaps even truer. Weak, ineffective, corrupt or narrowly based institutions create uncertainty and unfairness, discourage savings and investment, and record lower growth rates.

Figure 4: Growth rates of institutional finance to agriculture



Source: Author's compilations from RBI database

In order to achieve sustainable and inclusive economic growth, it is important to bring the under-served sectors/sections of society within the domain of institutional finance. In the Indian context, the institutional finance to help the agriculture (refer Figure 4) has been skewed and uneven in terms of both period and quantum.

4.1 Reforming the rural financial architecture

Keeping in view the dynamics of the changing economy, there is a strong need to reform the rural financial system. The present system that was enshrined in the late 70s needs to be rigorously examined. Reforms in the rural financial architecture should be focused towards evolving a new financial architecture to suit the needs of inclusive growth. Regional rural banks (RRBs) – the unfinished agenda of the Indian rural financial system need to be revitalised: (i) by liberating them from the clutches of their sponsor banks; (ii) Government of India has to become proactive like China in the case of its policies towards achieving the larger goals of inclusive growth; (iii) bring in new talent at the senior management level for professionalism and focus on their operations instead of continuing them as the retiring rooms of the sponsor bank executives. The RRBs had failed to fulfil their vision.

4.2 Is privatisation of RRBs good?

A mad rush towards privatisation, particularly in the Indian context, is harmful given the experience of privatisation in the Indian financial sector since 1992. Indian privatisation saga has failed to demonstrate their commitment to the provision of services to the needy and the poor. Besides, the private banks have not made any inroads into rural areas for the provision of financial services which is a clear indication of their biased approach.

Even after two decades of liberalisation and the opening of the banking sector for new generation banks, their penetration levels have not been satisfactory. The closure of several private sector banks such as Global Trust Bank and a number of fraudulent NBFCs indicate that private firms have focused only on profit maximisation by ignoring customer service and customer welfare. Against this backdrop, the following institutional reform measures for RRBs are discussed below.

Table 6: Institutional reform measures for RRBs

Domain	Current measure	Suggested reform measure
Legal Framework	RRB Act, 1976	Merger with BR Act 1949
Regulation and Supervision	Multiple regulators like; Sponsor Banks, NABARD, RBI etc.,	Single regulator i.e. RBI
Governance	RRB Boards lack professionalism as it is subject to the whims and fancies of the sponsor bank official (with conflict of interest) on the board whose bank, in turn, is a competitor to the same RRB for which he is the director.	Boards must consist of qualified professionals and experts along with the nominated members. Many RRB staff complain about the high handedness of Sponsor Bank officials. As such, measures need to be taken to free the RRBs from the clutches of sponsor banks. RRB Chairmen should be recruited based on merit, suitability, expertise, experience, and worthiness rather than on seniority
Benchmarking	Currently, no benchmarking has been possible due to the inherent diversities and heterogeneities.	Benchmarking could be done once uniform and relevant measures are introduced for benchmarking.

Table 6: (Continued)

Technology induction for MIS and Customer Service	Technology has been inducted haphazardly in their own individualistic approach.	Uniform and standard computer technology needs to be inducted across all the RRBs on par with commercial banks
Human Resource Development	Most of the RRBs suffer from incapable and untrained staff that seems to be inefficient.	Rigorous training and management development programmes must be offered to the current staff and up gradation of their skills is foremost in carrying out their responsibilities. Career path must be based on merit and performance instead of on seniority alone. Accordingly, relevant laws need to be amended.

Source: Author

4.3 Reforming the cooperatives

The cooperative sector needs revitalisation (Vaidyanathan, 2004). The revival package based on the Vaidyanathan Committee recommendations and after due deliberations was a combination of legal and institutional reforms, capital infusion and technical support for capacity building. The implementation of the Action Plan (ADB, 2010) of the revival package was perceived to result in the emergence of a strong, self-reliant and well-knit network of rural cooperative credit system. The implementation of the revival package involved planning and execution of a series of action plans for (i) facilitating legal, regulatory and governance framework; (ii) institutional reforms for sustainability; (iii) financial package and; and (iv) eligibility norms. However, no perceptible change has been felt on the ground, which perhaps could be due to lack of political will in the implementation of the reforms. Given this background, some plausible institutional reform measures for credit cooperatives are suggested in Table 7.

Table 7: Institutional reform measures for credit cooperatives

Domain	Current measure	Suggested reform measure
Legal Framework	State Cooperative Laws	Enact new national cooperative laws and measures to encompass the state laws

Table 7: (Continued)

Regulation and Supervision	Multiple regulators like; state governments, NABARD, RBI etc.,	Single regulator i.e. NABARD
Accounting Standards	Different standards, age-old and archaic, not smooth and transparent for audit and supervision.	Transparent and uniform accounting standards in accordance with the international practices
Auditing	Currently, state government officials perform the audit	Instead, the audit responsibilities have to be vested with the regulator/supervisor i.e. NABARD
Governance	Local boards are dominated by the whims and fancies of politicians and state government officials	Boards must consist of qualified professionals and experts along with the elected members.
Recruitment of Staff	Locally appointed under the influence of the local politicians and state government officials resulting in heterogeneity.	National level recruitment boards with uniformity in standards of qualification and expertise for recruitment of staff. National cooperative service to develop specialised cadre for the sector.
Financial Packages	Under the discretion of the state governments and national governments	Need to be decided by the supervising and regulatory bodies such as NABARD.
Benchmarking	Currently, no benchmarking has been possible due to the inherent diversities and heterogeneities.	Benchmarking could be done once uniform measures are introduced and relevant measures are implemented for benchmarking.
Technology induction for MIS	Technology has been inducted haphazardly in their own individualistic approach.	Uniform and standard computer technology needs to be introduced across all the credit cooperatives
Human Resource Development	Most of the credit cooperatives suffer from inefficient and untrained staff.	Rigorous training and management development programmes offered to the staff and

		upgrading their skills is foremost in carrying out their responsibilities.
Corruption control	Complaints of huge misuse of office for personal gain impairs operating efficiency, misallocation of resources from the efficient to the dishonest and hurts mostly the poor	Measures need to be integrated into the system so that there is significant reduction in the scope for corruption with adequate checks and balances built in

Source: Reserve Bank of India database

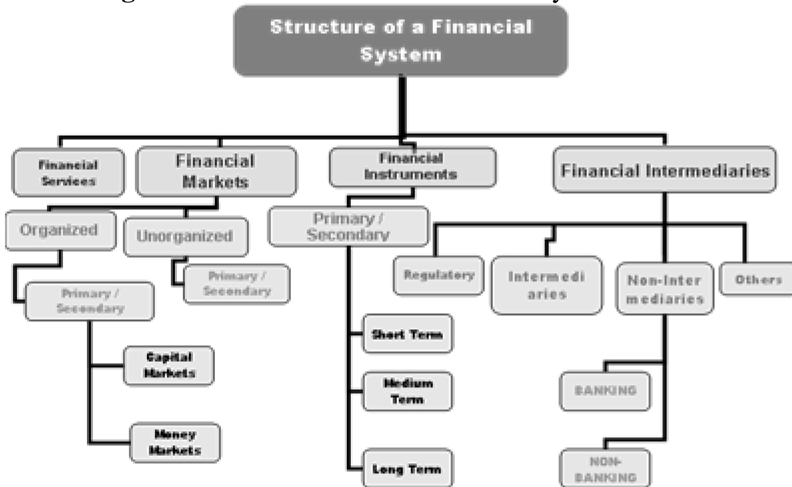
4.4 Institutional reforms in commercial banks

The scheduled commercial banks (SCBs) in view of their massive presence continue to play a significant role in the provision of financial services to the poor, particularly the rural population. However, due to apathy of bank staff and other attitudinal issues in serving their rural clientele, lack of basic infrastructure as well as supervisory and regulatory issues, the commercial banks are unable to provide effective financial services. The current structure of Indian banking needs to be strengthened by providing financial services to the rural poor. The SCBs need to comply with statutory finance regulations up to 40 % of their annual net credit disbursements towards rural finance. Additionally, various sub-targets such as provision of finance to weaker sections of the community such as women and agriculture are required to be rigorously implemented in order to channel the much-needed credit to the rural sector.

4.5 Reforming the regulatory architecture and strengthening inter-regulatory coordination

There is a need to reform the regulatory structure. As shown in Figure 5, the current system involves half a dozen apex regulatory agencies such as RBI, NABARD, SEBI, IRDA, PFRDA, FMC, EPFO, SIDBI, NHB among others apart from several ministries in the government that retain direct regulatory powers. This structure results in a major regulatory overlap and regulatory gap. Sometimes this structure also can lead to regulatory arbitrage as institutions come under different regulators and are therefore, subject to different regulatory requirements may offer similar financial services.

Figure 5: Present structure of financial system in India



The overlapping regulatory structure also becomes a barrier to innovation as any new product may need approval from more than one regulator. In some cases, it is not even clear which regulator has primary jurisdiction over the product. In addition, a multiplicity of regulators creates problems in terms of interagency coordination. In India, these coordination mechanisms are not formalised, and though these mechanisms can be effective during emergencies, they are not quite as effective at other times. Coordination problems are aggravated by the skills and experience which are not standard across regulators. This structure needs to be re-examined with the perspective of regulatory integration as practised in many countries.

Table 8: Pros and cons of integrating financial sector supervision

Potential Pros	Potential cons
Easier to achieve efficiency in supervision of financial conglomerates	If objectives are not clearly specified, it be may be more ineffective than the sectoral supervisors
Could achieve possible economies of scale	Possibilities of diseconomies of scale if any organisation is too large to manage
Could improve accountability	Possibilities of moral hazard problems and across the financial sector resulting in less accountability
Helpful in elimination of duplicities and turf wars of sectoral supervisors and speeds up decision making as well as implementation	Sometimes the process of integration may be influenced by political/extraneous vested interest motivated changes in supervisory framework

Table 8: (Continued)

Easier to ensure a level playing field across market segments	The process of integration if not managed properly may lead to loss of key staff or to other problems

Source: Author

4.6 Provision of financial services to the poor by microfinance institutions

The Indian microfinance sector can be categorised into three main groups: (i) the SHG-Bank linkage model accounting for about 58% of the outstanding loan portfolio, (ii) non-banking finance companies, accounting for about 34% of the outstanding loan portfolio (iii) others including trusts, societies, etc., accounting for the rest of the outstanding loan portfolio. The borrowers are particularly from the vulnerable sections of society and they suffer from lack of bargaining power, inadequate financial literacy, fragile economic environment. Additionally, they are exposed to external shocks which they are ill-equipped to handle. Hence, financiers and MFI-NBFCs can easily exploit them.

Figure 6: Microfinance under SHG-bank linkage model

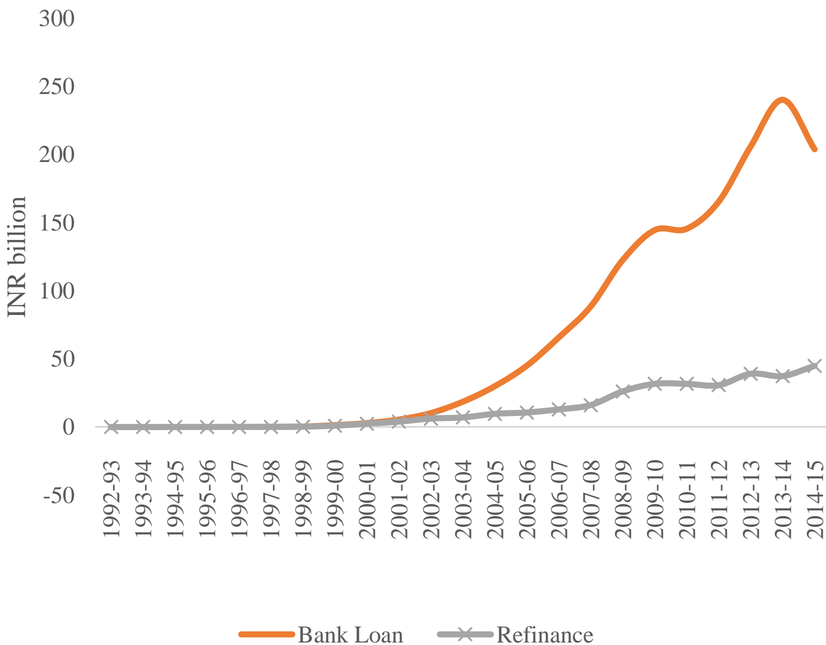
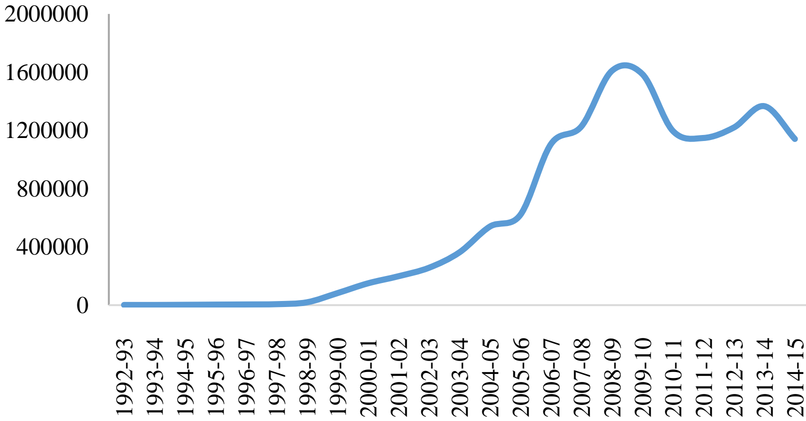
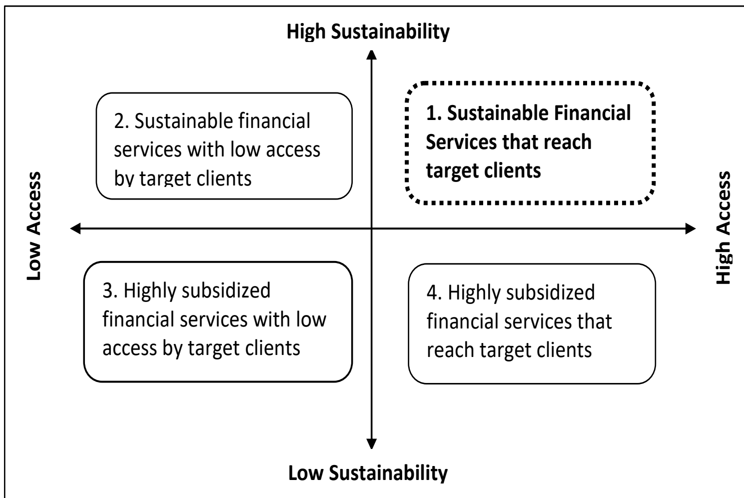


Figure 7: SHGs financed



Further, Malegam Committee (2011) on Microfinance set up by RBI has suggested that the size of an individual loan should be restricted to INR 25,000 and to prevent over-borrowing, the aggregate value of all outstanding loans of an individual borrower should also be restricted to INR 25,000. However, keeping in view the unabated rise in inflation, which usually affects the poor first, the limit for MFI loan should be raised to INR 50000. However, an issue of concern is that of optimising the performance of microfinance institutions, which are dependent on the access and sustainability of the financial services offered by these institutions (refer Figure 8).

Figure 8: Optimizing performance of financial institutions



One important aspect that needs to be built into the institutional structure of Microfinance particularly with the MFI-NBFCs is to provide the micro-insurance services to the poor in a package approach with micro credit. The regulation of Microfinance sector needs to be prioritised with the following objectives, viz (i) improving transparency; (ii) accountability; (iii) reduction of transaction costs; (iv) better-operating systems; (iv) simplification of documentation and procedures; (v) better corporate governance; (vi) increasing healthy competition. Further, the regulatory responsibilities of the microfinance sector should be vested with RBI instead of NABARD as it has failed to evolve itself into a visible, proactive regulator in spite of its existence since 1982. Some of the critics have indeed referred to the functioning of NABARD as that of 'white elephant' in view of its ineffectiveness, but only as a refinancing accountant under the shadow of RBI.

4.7 Institutional reforms designed for poverty alleviation

The most direct channel through which governance affects poverty is its impact on service delivery. Poverty reduction depends on improvements in the quality and accessibility for poor people to basic education, health, potable water and other social and infrastructure services. Perhaps the most profound impact of institutional reform on poverty comes via the potential for an increase in citizen participation. There is a variety of ways in which strengthening "voice" in general—and the voice of the poor in particular—can improve public performance. At the micro-level, they include fostering the participation of parents in the governance of schools or working with communities to provide access to water. At the macro-level, they include well-designed models of decentralisation and, various forms of representative decision-making and political oversight.

Accountability must be enhanced in order to improve service delivery. Mechanisms need to be imbibed into the systems so that there is no scope for misuse of the official position or ignorance or indifference or apathy by the employees. However, the suggested reform measures need to accompany with concomitant research in key areas such as (i) what is the true nature of these policies and their potential to affect the working of rural financial markets? (ii) What are the measures initiated to overcome some of the negative consequences of reforms like the exclusion of poor and small borrowers, increasing the cost of borrowing and growing influence of informal sources? How far have these measures helped to reverse negative consequences? (iii) What is the evolving institutional structure in rural areas to meet emerging credit needs? What are the merits and demerits of institutional changes for ensuring affordable and hassle-free access to financial services by the rural households in general and small and marginal

farmers in particular? (iv) What are the innovative product and services developed by the RFIs to meet the diverse financial service needs of rural households? In what way have these innovations proved beneficial. How far have some of the controversial innovations like commodity futures and derivatives delivered to the farmers? (v) What is the impact of these reforms and innovations on the economy? How have these measures contributed to mitigating the agrarian crisis?

5. Conclusion

Inclusion, growth, and stability are the three objectives of any institutional reform process, though these objectives sometimes appear to be contradictory. With the right reforms, the financial sector can be an enormous source of job creation both directly as well as indirectly, through the enterprise and consumption it can support with financing particularly for the poor. The institutional reforms in the Indian financial sector should hence, be motivated with the prime objective of making the services work for the poor and enable them to steer out of their abject poverty. Without reforms, however, the financial sector could become an increasing source of risk as mismatches between capacity and needs of the real economy and the capabilities of the financial sector widen. India has been a case study of how financial sector reforms can play a supporting role in the growth of an emerging market economy. The challenge is how to bootstrap from these past successes to escalate to the next level of financial sector development so that it can continue to support growth in general, and inclusive growth in particular.

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Appendix 1

Annexure 1: A glimpse of banking sector in India

Important Indicators	1969	2007	2008	2009	2010	2011	2012	2013	2014	2015
No. of Commercial Banks	89	183	175	170	169	169	173	155	151	152
Scheduled Commercial Banks (SCBs)	73	179	171	166	165	165	169	151	146	148
Regional Rural Banks	-	96	91	86	82	82	82	64	57	56
Non-SCBs	16	4	4	4	4	4	4	4	5	4
Number of Offices of SCBs	8262	71839	76050	80547	85393	90263	98330	105437	117280	125672
(a) Rural	1833	30551	31076	31667	32624	33683	36356	39195	45177	48498
(b) Semi-Urban	3342	16361	17675	18969	20740	22843	25797	28165	31442	33703
(c) Urban	1584	12970	14391	15733	17003	17490	18781	19902	21448	22997
(d) Metropolitan	1503	11957	12908	14178	15026	16247	17396	18175	19213	20474
Population per office (in thousands)	64.0	15.0	15.0	14.5	13.8	13.4	12.3	11.9	10.8	10.3
Deposits of SCBs (INR Billion)	46.46	26119.33	31969.39	38341.10	44928.26	52079.69	59090.82	69342.80	79134.43	88989.01
(a) Demand	21.04	4297.31	5243.10	5230.85	6456.10	6417.05	6253.30	7671.61	8272.11	7800.53
(b) Time	25.42	21822.03	26726.30	33110.25	38472.16	45662.64	52837.52	61671.19	70862.32	81188.48
Credit of SCBs (INR Billion)	36	19311.89	23619.14	27755.49	32447.88	39420.82	46118.52	53931.58	61390.45	64998.29
Deposits of SCBs per office (INR Million)	5.6	363.1	420.4	476.0	526.1	577.0	600.9	657.7	674.7	708.1
Credit of SCBs per office (INR mn)	4.4	268.5	310.6	344.6	380.0	436.7	469.0	511.5	523.5	517.2
Per Capita Deposits of SCBs (INR)	88	23468	28327	33471	38062	43034	48732	55445	62252	68576
Per Capita Credit of SCBs (INR)	68	17355	20928	24230	27489	32574	38033	43123	48294	50089
Share of Priority Sector Advances in Total Credit of SCBs (per cent)	14.0	36.5	34.9	34.8	35.1	33.9	32.3	33.7	35.1	36.6
Share of Priority Sector Advances in Total Non-Food Credit of SCBs (per cent)	15.0	37.4	35.6	35.4	35.6	34.5	32.9	34.3	35.7	37.2

Annexure 1: (Continued)

Credit Deposit Ratio	77.5	73.9	73.9	72.4	72.2	75.7	78.0	77.8	77.6	73.0
Investment Deposit Ratio	29.3	30.3	30.4	30.4	30.8	28.8	29.4	28.8	28.3	29.2
Cash Deposit Ratio	8.2	7.5	8.6	6.7	6.8	6.7	6.1	5.6	5.4	5.6
Deposits of SCBs as percentage of National Income (NNP at Market Prices, at current prices)	16	79	84	88	87	82	81	84	86	80
SCBs Advances to Priority Sector (INR Billion)	5.04	7037.56	8247.73	9674.14	11384.06	13373.33	14909.15	18179.70	21549.17	23781.71