A Study on Indian Rural Banking Industry-Issues and Challenges

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Introduction

Rural development occupies a significant place in the overall economic development of the country. Ghandiji Said “India lives in Villages”. He stressed a rural character of economy and the need for re-generation of rural life. Since independence, it has been constant endower of our policy maker to give adequate trust to rural development as the sector is directly related to agriculture. Rural banking in India started since the establishment of banking sector in India. Rural Banks in those days mainly focused upon the agro sector. Regional rural banks in India penetrated every corner of the country and extended a helping hand in the growth process of the country. SBI has 30 Regional Rural Banks in India known as RRBs. The rural banks of SBI is spread in 13 states extending from Kashmir to Karnataka and Himachal Pradesh to North East. The total number of SBIs Regional Rural Banks in India branches is 2349 (16%). Till date in rural banking in India, there are 14,475 rural banks in the country of which 2126 (91%) are located in remote rural areas.

Regional Rural Banks (RRB) were established under the provisions of an ordinance promulgated on the 26th September 1975 and the RRB Act, 1976 with an objective to ensure sufficient institutional credit for agriculture and other rural sectors. The RRBs mobilize financial resources from rural / semi-urban areas and grant loans and advances mostly to small and marginal farmers, agricultural laborers and rural artisans. The area of operation of RRBs is limited to the area as notified by Government of India (GoI) covering one or more districts in the State. RRBs are jointly owned by GoI, the concerned State Government and Sponsor Banks (27 scheduled commercial banks and one State Cooperative Bank); the issued capital of a RRB is shared by the owners in the proportion of 50%, 15% and 35% respectively.
Need of Rural Finance

India’s rural poor are overwhelmingly dependent on agriculture as their primary source of income; the majority is marginal or small farmers, and the poor holds are landless. The financial needs of India’s rural poor reflect the volatile, uncertain, and irregular income streams and expenditure patterns of these households. The recently completed World Bank-NCAER Rural Finance Access Survey of 2003 (henceforth referred to as RFAS 2003) indicates that while rural families are predominantly multiple-income households, their two main sources of income include the sale of agricultural products and wage labor. Irregular employment is the most important source of income from wage labor. For households with more than one source of income, agricultural income is the most important secondary source, with sales of farm produce and dairy products being the most prominent. Clearly, rural households depend on one or both of two types of income: seasonal (post-harvest sale) or highly irregular, due to irregular or part time wage labor, with the dependence on the latter being inversely proportional to the size of land holdings. The typical expenditure profile of the households is also of small, daily, or irregular expenses incurred throughout the month. Moreover, the overwhelming majority of rural households report having to deal with at least one unusual expense each year, which they are forced to finance either from cash at home or through informal loans from family, friends, or money lenders. Research shows that poor people value financial services and want these to be reliable, convenient, continuous, and flexible. They understand that financial services help them spend at one time the income they have earned at other times. And because those incomes tend to be small, irregular, and unreliable, they need the full armory of intermediating modes—saving up for future spending, taking advances against future savings, and building cash reserves that can be called on at any time. The poor need a wide range of financial services—from small advances to tide over consumption needs to loans for investment purposes to long-term savings that help them manage life-cycle needs.
Rural Finance Service Providers

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

Formal Providers.
In terms of their sheer size and spread of operations, formal-sector financial institutions dominate the rural finance landscape: Commercial banks, mostly public sector banks (but also some private-sector banks) and regional rural banks (RRBs) together have more than 32,000 rural branches India also has a vast network of rural cooperative banks, with a three-tiered structure at the state, district, and village levels. There are some 14,000 branches of rural cooperative banks and more that 98,000 grassroots retail outlets of Primary Agricultural Credit Societies (PACS), which are used by the cooperative system as channels for fund flows. The post office system adds to the physical service point network of the country with more than 154,000 post office branches handling more than 110 million money orders and administering 114 million savings accounts Formal financial institutions are regulated by the Reserve Bank of India (RBI), although it has delegated the task of supervising rural cooperative banks and RRBs to the National Bank for Agriculture and Rural Development (NABARD). 14 Development banks such as NABARD and the Small Industries Development Bank of India (SIDBI) provide support to both formal and semi-formal segments through funding refinancing arrangements. NABARD provides refinancing to banks’ lending in rural areas and SIDBI funds and supports MFIs.

The semi-formal/microfinance sector

While India is home to many microfinance innovations, in terms of people reached and the scale of financing, microfinance in India is still a drop in the ocean. It reaches between 5 and 6 percent of the country’s poor rural households, or about 30 percent of the rural poor, either directly or indirectly. Dominant among the microfinance models is Self-Help Group (SHG) – Bank linkage, whereby women’s SHGs are linked to the rural branches of commercial banks, RRBs, or cooperative banks, which often benefit from refinancing by NABARD. SHG-Bank linkage has reached out to around 12 million family’s interns of savings accounts. Credit outstanding remains low; disbursements in FY 2002–03 accounted
for only 2 percent of the formal-sector credit outstanding in rural areas. The other model is specialized Microfinance institutions (MFIs), which reach around 1 million clients. The total branches of MFIs are estimated to be in the range of a few thousand, compared to the vast numbers of bank branches. Recent developments have led to other inter linkages between the formal both public- and private sector banks and semi-formal sector initiatives, particularly in the context of SHG–Bank linkage, as well as through lending by SIDBI and commercial banks to MFIs. Moreover, a few private-sector commercial banks, such as ICICI Bank, have tried innovative ways of incorporating lessons from microfinance into their operations, and have made inroads in using micro finance methodologies to deliver rural financial services. Informal providers, Informal financiers include a range of actors-landlords, local shopkeepers, traders, professional moneylenders, etc. While there are no definite estimates of the number of informal-sector providers, these are spread very widely across the country. Survey data indicate that poor rural households rely heavily on informal finance to meet a range of financing needs: from consumption and emergency financing to investment loans.

**Review of literature:**

RRBs though operate with a rural focus are primarily scheduled commercial banks with a commercial orientation. Beginning with the seminal contribution of Haslem (1968), the literature probing into factors influencing performance of banks recognizes two broad sets of factors, *i.e.*, internal factors and factors external to the bank. The internal determinants originate from the balance sheets and/or profit and loss accounts of the bank concerned and are often termed as micro or bank-specific determinants of profitability. The external determinants are systemic forces that reflect the economic environment which conditions the operation and performance of financial institutions. A number of explanatory variables have been suggested in the literature for both the internal and external determinants. The typical internal determinants employed are variables, such as, size and capital [Akhavein et al. (1997)]

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

Need for the study:
The rural banking system in India has an essential role in the rural development of the country. Beginning with co-operative credit structure followed by rural branches of commercial banks and then RRB’s the institution structure has grown and expanded during the last 64 years since independence. In spite of these expansion programmes, a large segment of rural economy is still beyond the reach. The success of any bank depends on the facility what they provides to their customers.

Objective of the study
- To analyze the usage of bank facility by the rural customer
- To trace out the genesis and concepts of rural banking.
- To know the reasons for unprofitable of rural banking in India.
- To identify the cost per transaction of Indian Banks and purpose of borrowings.

Scope of the study
The study mainly deals with the elements issues and challenges of rural bank. The study is limited to the study of rural banks and to some extent of financial data. This information
helps to understand the performance of the rural banks in India. Study is limited to Rural Banking sector in India.

**KEY DRIVERS OF FINANCIAL EXCLUSION OF RURAL BANKING**

Approximately 245 million adults in rural India do not have a bank account today. As depicted in Following Table, this reflects 24% of the total population. While 60 million out of 245 million may not need banking services because they are below the poverty line, Diamond believes that approximately 185 million “potentially bankable” people do not use formal banking services because of reasons like poor access or usage.

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*Source: Census India; BSR 2008-Reserve Bank of India; World Bank & NCAER (2008).*

Access Issues for Rural Customers

Access is explained in terms of

- **Infrastructure**
- **Physical distance**
- **Limited delivery capabilities**
- **Regulatory constraints**
- **The economics of rural banking.**

The banking **infrastructure** in rural India is not encouraging, with just 7% of villages housing a bank branch. What’s more, the poor physical and social infrastructure also impacts the access to financial services, with 23% of villages going without electricity, 67% without a
Post Office, and an average rural literacy rate of 59% and secondary school penetration of 12%. This lack of physical and social infrastructure in rural India is a key issue impacting access to formal financial services. The average distance to a branch in India is approximately 3.8 Kms. While this compares favorably to the average distance to a branch in a developed market like the U.S. (which is 6 Kms), there are significant additional challenges in India in the form of unpaved roads and limited access to modern transportation. Most rural customers are likely to sacrifice an entire day’s wage to travel to a bank branch which is open between 10:00am and 5:00pm. While some banking transactions could be done over phone, this is rarely an option in a country with such low rural television-density. Limited delivery capability is a significant challenge. Much of rural India is serviced through branches because ATM penetration is low and other channels such as Phone and Internet Banking are non-existent. Intermediaries like Non-Governmental Organizations (NGOs), Self-Help Groups, and Micro Finance Institutions (MFIs) are being used by banks to improve access to credit and savings. However, these channels, in their current form, offer limited services. There are some regulatory constraints imposed by the Reserve Bank of India (RBI) which may inadvertently contribute further to the lack of formal banking services in rural areas. For example, the RBI does not allow banks to post any person other than a security guard at ATMs. Hence, banks cannot deploy many ATMs in rural areas as many rural customers require in-person support. A second regulatory inhibitor is that new banks planning to establish a branch in a rural area have to receive approval from the Lead Bank and District Collector of that district. Hence, banks choose not to open new branches in certain areas even when it is profitable to do so because there is no certainty of getting approvals. Many banks view the rural market as a regulatory requirement rather than an economic opportunity. Banks have from time to time borne the social cost of lending to the rural economy at rates below their costs. They have also faced capital erosion because of the write-off of loans, particularly agriculture loans. Banks are required via regulatory requirements to open branches in rural areas to provide loans to agriculture and other priority sectors.
REASONS FOR UNPROFITABLE OF RURAL BANKING IN INDIA

High Non-Performing Loans (NPL) Banks have higher non-performing loans in rural areas because rural households have irregular income and expenditure patterns. The issue is compounded by the dependence of the rural economy on monsoons, and loan waivers driven by political agendas. NPLs from the agriculture sector are 7.7%, compared to 3.5% across non-agriculture sectors. In order for banks to view rural India as a growth opportunity, rather than a regulatory requirement, a combination of these issues must be addressed. Increasing financial access to rural areas is contingent upon basic conditions such as proper infrastructure and an enabling regulatory framework, as well as innovative thinking on the part of commercial banks. Access issues, however, explain only one part of the problem. Usage is an equally important issue for rural customers.

Low Ticket Size: The average ticket size of both a deposit transaction and a credit transaction in rural areas is small. This means that banks need more customers per branch or channel to break even. Considering the small catchments area of a branch in rural areas, generating a customer base with critical mass is challenging.

High cost to serve: Branches are the most used channel in rural areas. This is because many rural people are not literate and are not comfortable using technology-driven channels such as ATMs, phone banking or internet banking. On the other hand, a branch is an expensive channel for banks (Following Table). In addition, rural people, whenever they have access to banks, have frequent low ticket and cash-based transactions, which increase the overall transaction cost for their bank.

Cost Per Transaction in Indian Banks

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<tr>
<th></th>
<th>Branch</th>
<th>Phone (Call Centre)</th>
<th>ATM</th>
<th>Phone (IVR)</th>
<th>Internet</th>
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<tr>
<td></td>
<td>48</td>
<td>25</td>
<td>18</td>
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Higher risk of credit: Rural households may have highly irregular and volatile income streams. Irregular wage labor and the sale of agricultural products are the two main sources of income for rural households. The poor rural households (landless and marginal farmers) are particularly dependent on irregular wage employment. Rural households also have irregular expenditure patterns. The typical expenditure profile of rural households is small, with daily or irregular expenses incurred through the month. Furthermore, a majority of households incur at least one unscheduled expenditure per year, with the most frequent reasons being medical or social emergency. In short, the rural customer is generally considered to be a risky one.

Information Asymmetry: Since many rural people do not have bank accounts, there is a lack of information on customer behavior in rural India. Absence of a Credit Information Bureau also complicates the problem as banks have to rely on informal sources to learn the credit history of rural customers. A lack of reliable information can result in either missed opportunities in not approving otherwise eligible loan candidates, or nonperforming loans.

Issues and Challenges
Even if access to formal banking is provided to rural customers, there is no guarantee that these services will be used. According to a study conducted by the World Bank, many households, even in developed countries, choose not to have a bank account as they do not engage in many financial transactions they collect wages in cash, spend in cash and do not wish to be burdened by a bank account. To compound the situation many customers in rural India, who have access to and would otherwise choose to use formal financial services, do
not do so because the product and service mixes do not meet their needs. The financial service needs of rural customers are not confined to just savings and credit, as is usually assumed. Their financial needs are linked to their life cycle needs, ranging from savings to credit to insurance to remittances. In fact, even the savings and credit products currently offered to rural customers do not entirely meet their needs.

Access to savings and investment facilities is critical for the poor. The two critical needs for the rural poor are micro-savings and frequent withdrawals. These needs facilitate a customer in building capital over the long term, as well as coping with income shocks in the near term. However, banks do not offer adequate services to address these needs. The lack of services, therefore, leaves the rural poor with little option than to transact with the informal banking market. A study conducted by Micro Save also concludes that the poor transact with the informal sector because it will accept small amounts, provide doorstep service, and ensure ease of enrolment. Rural customers need loans not only for productive purposes but also for consumption needs (Following Table). A part from agricultural support, rural customers need micro credit for consumption, education and emergencies. Though banks offer purpose free loans (personal loans and credit cards) in urban areas quite liberally, in rural areas sanction of such loans is significantly restricted. Therefore, the poor raise these loans through the informal financial system (it is worth noting that these loans taken from the informal system are almost always repaid or renewed). In addition, larger households need occasional high value micro-enterprise loans for small capital investment. Though banks offer these loans, they require excessive documentation and time-consuming processes which discourage customer applications.

**Purpose of borrowing**

1. Rural Household Borrowing
2. Bank Lending to Rural Households

**Rural Household Borrowing**

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<th>Agriculture Expenditure</th>
<th>Household Expenditure</th>
<th>Other Business Expenditure</th>
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<tr>
<td>Agriculture Expenditure</td>
<td>38%</td>
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<tr>
<td>Household Expenditure</td>
<td>48%</td>
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<tr>
<td>Other Business Expenditure</td>
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<td>14%</td>
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Insurance reduces the vulnerability of poor households by replacing the uncertain prospect of large losses with the certainty of payout against small, regular premium payments. It is integral to a comprehensive risk management strategy for poor households. This includes life, health, accident and asset (dwelling, crop, and livestock) insurance. Banks and insurance firms do not offer these services in many rural areas, leading the poor to rely on the informal financial system.

There are many rural households which depend on weekly or monthly remittances from their family members who have moved to urban areas. At present, they depend on informal channels to remit the money and consequently either risk the loss of money or pay high transaction fees. Banks do not offer seamless remittance facilities between urban and rural branches as many of the rural branches are not computerized and connected to the main bank’s computer systems. This often results in the beneficiary receiving the amount two
weeks after it has being transferred. This represents yet another key service which is not provided.

The **transaction cost** for a rural customer to receive credit primarily constitutes **four attributes:** the interest rate, loan amount received as a percentage of amount applied, bribes paid, and the lead time to process the loan. Though the formal banking system offers loans at interest rates lower than informal banking systems, the time taken for a loan to be sanctioned is high which increases uncertainty and opportunity cost. In addition, the customer needs to pay almost 10% of the loan amount in bribes and eventually receives an amount that is less than what was applied for. Therefore, while the interest rates are usurious in the informal financing system, rural customers still resort to this channel because the waiting time to receive the loan is negligible and there are no indirect costs or commission. Banks also insist on collateral security which many rural poor cannot afford.

As far as savings are concerned, though the formal banking system provides financial security, the cost of opening and operating an account is high. The overall cost of transacting with the formal financial system increases for a rural person because of additional costs such as expenses incurred to reach a branch and the opportunity cost of lost wages. Since rural banks are generally not within an accessible area and do not operate at convenient times, the rural customer must forgo a day’s wage to reach a branch. Informal systems, on the other hand, involve a lower transaction cost, but they are risky and in some cases result in the loss of one’s entire capital. In short, this leaves the rural customer to choose between two unfavorable options.

**Limitations:**

1. The study proposed to collect the data from a defined sector i.e. Banking sector.
2. The study is limited to the extent of issues and challenges in rural banking sector, but not with other cost and other sector.

However effort would be made to minimize the impact of all these limitations by incorporating appropriate measures.
Conclusion

There are 185 million bankable adults in rural India who are unbanked because of access and usage issues. This presents a significant opportunity for commercial banks. However, to reach this market and subsequently build an inclusive financial system, there must be a coordinated and concerted effort by the three key stakeholders: the Government of India, the Reserve Bank of India and the commercial banks. In addition, a partnership between banks and business correspondents, and collaboration amongst banks is critical. Furthermore, banks should tailor their product and service mix to meet rural.

Reference:

4. Reserve Bank of India, www.rbi.org.in
5. A project report on rural banking in India submitted by: Kinjal Prajapati, Aisha Shah.