India's Regional Rural Banks:

The Institutional Dimension of Reforms

by Nitin Bhatt and Y. S. P. Thorat

Abstract: Efforts to reform India's failing Regional Rural Banks (RRBs) have had limited impact, because reformers have paid little attention to the institutional dimensions of the problems facing the banks. Few efforts were made to redesign the perverse institutional arrangements that gave rise to incompatible incentive structures for key stakeholders, such as political leaders, policy makers, stockholders, bank staff, and clients. We recommend that the next leg of reforms focus on aligning the incentives of these stakeholders by giving greater importance to the RRBs' internal organizational contexts and larger policy environments.

Introduction

Financial sector reform has been a major component of the structural adjustments being implemented in India since 1991. A key focus of these efforts has been on reforming the Regional Rural Banks (RRBs)—India's state-owned development finance vehicles charged with serving the rural poor, especially microentrepreneurs, in the agricultural and nonfarm sectors.

Originally established to drive the moneylender "out of business" and bridge the capital gap supposedly unfilled by the rural cooperatives and commercial banks, these "social banking" institutions have expanded remarkably throughout the country during the last two decades.[1] In 1991, for instance, there were

196 RRBs with over 14,000 branches in 375 districts nationwide,[2] with an average coverage of three villages per branch.[3] The banks had disbursed over Rs. 35,000 million in credit and mobilized over Rs. 49,000 million in deposits.[4]

Despite this impressive geographic coverage and intermediation activity, however, the RRBs suffered from poor financial health, especially because of mounting loan losses. As of June 1993, 172 RRBs were unprofitable, and aggregate loan recovery performance was at 40.8 percent.[5] While loan losses had wiped out the equity and reserves of some banks, they were eating into the deposits of others, underscoring the need for fundamental changes in the way RRBs conducted business (Joshi & Little, 1996; Mudgil & Thorat, 1995).

Although a series of banking reforms have been initiated since 1993 to make the RRB system viable, recent assessments suggest that the performance of the banks in the postreform period has been less encouraging than expected (Gupta, 1998; Kaladhar, 1997). While aggregate profitability seems to have improved slightly, becoming less negative, the overall quality of loan portfolio management, administration and collection still remains a matter of grave concern (R. Rosenberg, Senior Advisor, CGAP, personal communication, May 20, 1999). For instance, accumulated RRB losses through March 31, 1998, were reported at almost Rs. 27,870 million; losses for the year ending that date were Rs. 736.5 million.

Some of the reports of better viability are actually erroneous, because they result from inappropriate techniques for measuring loan recovery.[6] Further, many RRBs are actually achieving better results by moving away from their mission of serving the poor—either by putting their money into investments rather than lending it,[7] or by lending to nonpoor clients (Mosley, 1996; Rosenberg, 1999). The latter is partly evidenced

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by a gradual increase in the average loan size and the continued bias against women borrowers (Ghosh, 1998; Kaladhar, 1997).[8] As a result, the dependence of the rural poor on informal credit continues to be significant (Machiraju, 1999; World Bank, 1998). This has seemingly defeated a central objective of the government's rural development strategy, which is to deepen and widen the availability of finance to India's historically excluded communities.

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

The remainder of this paper is divided into four sections. The first section discusses the role of institutions and incentives in shaping the performance of development finance programs. The second section highlights the impact of institutional arrangements facing key stakeholders in the prereform era. The third section argues that the reforms introduced since 1993 have not adequately addressed the incompatibility of these incentives, and provides recommendations for getting the incentives right. Finally, the fourth section draws some general policy implications, and concludes that ultimately, political support for the reform process will be the key determinant of the extent to which the RRBs can be turned around.

Institutions, Incentives, and Performance

Institutions and incentives are important determinants of organizational performance in development finance initiatives (Stiglitz, 1990; Williamson, 1995).

Institutions and Incentives

Institutions are key to understanding the performance of economic development programs (Lin & Nugent, 1995). Conceptualized as constraints that shape the behavioral relations among individuals and groups, institutions can be either formal or informal (North, 1990). For example, they can include a region's formal constitution and laws, as well as its informal customs, culture, and norms of day-to-day conduct. Institutional arrangements, defined as specific and mutually agreed upon constraints, have the ability to govern relationships in social, economic, and political interactions (Bates, 1990; Ferris & Tang, 1993). Such constraints can either be voluntarily accepted through traditional values and prevailing societal norms, or enforced and policed through an external authority, such as a country's judicial system.

In analyzing the performance of development finance programs, it is important to examine constraints at the policy, program, and client levels (see Table 1). For example, policy-level constraints might include a country's laws and regulatory statutes. Program-level constraints include criteria formulated by board members and used by program managers to screen borrowers, make lending decisions, collect loans, and assess program performance. Finally, client-level constraints take into account rules faced by borrowers and savers in accessing and using financial services.

Each of the three levels of constraints is characterized by players who are accountable to a set of stakeholders (the principals) on the one hand, and who on the other hand monitor the performance of another set of stakeholders (the agents). For example, although politicians are agents of the public, they serve as lawmakers and hence as principals for the government arms that oversee development finance programs. Similarly, a program's management might be accountable to different owners/sponsors, regulators, and governing bodies, such as the board of directors (principals), while simultaneously overseeing lending and deposit-taking activities with its clients (agents). Since these clients are part of the larger population that elects the politicians, they also, at least theoretically, serve as principals for the politicians.

The aggregate performance of the "system" depends on the extent to which the incentives faced by principals and agents are compatible (Sappington, 1991). The standard way to align incentives is to increase the agent's return when the principal's objective is achieved and vice versa.

Table 1: Constraints Facing Stakeholders in Development Finance Programs

Constraints	Public Interest Groups
Policy-level constraints	Sponsors, Governments, Boards, Regulators
Program-level constraints	Development Finance Programs
Client-level constraints	Borrowers, Savers

Program Performance

When one considers that development finance programs are often characterized by players at different levels of bureaucratic and political interaction (Braverman & Guasch, 1993; Hulme & Mosley, 1996), it becomes immediately apparent that changes in opportunities and constraints faced by players at one level can change the incentives structures they face. This further changes opportunities, constraints, and incentives at the next level, and so on. Indeed, it is the "failure of policy-makers to account for multiple agency problems in lending institutions [that] bears responsibility for a large part of the poor performance of government rural credit programs in the last three decades" (Braverman & Guasch, 1993, p. 54).

Research by the present authors (accepted for publication in *Policy Studies Journal*) highlights the need to identify agency problems. It provides an example of how incentive incompatibility among multiple levels of institutional arrangements can render development finance programs ineffective. If shareholders or donors insist on increasing lending volume and outreach, program officers can feel pressured to make larger loans without appropriate screening. In many such instances, influence and patronage bias the distribution of credit in favor of wealthier and well-connected landholders, who do not feel obligated to repay the loans. This leads to high loan defaults and lax collection efforts, especially when the lending agency has few incentives to engage in intensive loan collection. Poor repayment performance often sends a signal to the community that nonrepayment will be pardoned; and as a result, borrowers have incentives to willfully default on the loans.

Inappropriate institutional arrangements between politicians and administrators also result in perverse incentives, for example, in state-owned banks. Since most bureaucracies are bound to serve the law and elected officials, they may find themselves faced with new rules and constraints when a new political party comes to power and wants to fulfill its campaign promises. For instance, if a politician advocates the delivery of cheap credit or promises the waiver of past due loans to buy votes, those commitments may take the form of new policies. Bankers in turn are instructed to implement the policies at the program and client levels, by reducing interest rates or writing off unpaid loan balances.

Finally, lack of appropriate institutional arrangements for punishing and rewarding program staff can also undermine the performance of development finance initiatives (Hulme & Mosley, 1996). This is especially true when civil service personnel policies do not sanction inferior performance and reward superior performance in an appropriate and timely fashion. Reports of successful development finance initiatives from around the world indicate that staff incentive structures, especially those that incorporate proper mixes of fixed salary and bonuses, can go a long way in enhancing a program's efficiency and productivity (Baydas, Graham, & Valenzuela, 1997; Hulme & Mosley, 1996).

In the next section, we analyze the performance of India's Regional Rural Banks in the prereform period by considering how institutional arrangements and incentives have impacted various stakeholders in the RRB system.

Institutional Challenges and RRB Performance

Institutional constraints within the RRB system might be analyzed at two interfaces: the policy-program level, and the program-field level.

Policy-Program-Level Constraints

The poor performance of the RRBs was largely rooted in their adverse policy environment. Specifically, constraints imposed by the banks' objectives, governance structures, and business model were key determinants of their nonviability.

Objectives

The original objective of the RRBs was to bring progress with social justice to the rural poor, who were generally denied access to financial services from rural cooperatives as well as commercial banks (Machiraju, 1999). The rationale was that during the 60s and 70s, rural cooperatives were dominated by wealthy farmers, and the commercial banks had an urban bias. Therefore, most poor people turned to informal sources for their financing needs. In an effort to provide credit to the poor from institutional sources, the RRBs were established in 1975. It was thought that these banks would combine the rural focus of the cooperatives with the business orientation of the commercial banks, to make credit widely available to rural India's disadvantaged communities.

Given the initial objective of policy makers to increase outreach, the following two decades saw a large-scale effort to increase the number of banks, bank branches, and disbursements nationwide (Table 1). As a result, the number of RRBs increased from 6 in 1976 to 196 in 1999, and the number of branches increased from 17 to over 14,000 during the same period. Most significantly, perhaps, loan amounts jumped from Rs. 1 million in 1975 to over Rs. 93,670 million in 1998–99.

Table 2. Expansion of RRB System, 1975–1999

Period ending	Banks	Branches	Loans (in Rs. Million)	Deposits (in Rs. Million)	CD Ratio
Dec. 1975	6	17	1.0	2.0	50
Dec. 1980	85	3,279	2433.8	1998.3	122
Dec. 1985	188	12,606	1,4076.7	12868.2	109
Mar. 1990	196	14,443	3,5540.4	41505.2	86
Mar. 1995	196	14,509	6,2909.7	11,1500.1	56
Mar. 1997	196	14,508	7,8526.6	15,4234.2	51
Mar. 1998	196	14,508	8,4866.2	19,3256.5	44
Mar. 1999	196	14,508	9,3672.1	23,5976.1	40

Scource: NABARD Reports

However, this portfolio growth was accompanied by loan losses that made the RRB system highly unprofitable. For example, accumulated losses amounted to Rs. 1263 million at the end of 1987, with 151 unprofitable banks. These losses increased to Rs. 2,1520.9 million by March 1996, with 152 banks losing money. But despite its nonviability, the RRB system was widely celebrated in political and administrative circles as a success, largely because of its immense outreach.

A key reason for this optimism was language contained in a report issued by the Narasimhan Committee in 1976, which stated that any losses incurred by the RRBs would be a price worth paying, given the social benefits that would be attained. The report suggested, for instance, that RRB losses “in the initial years . . . would need to be subsidized” (Reserve Bank of India, 1997, p. 29). Since the RRBs were established on this committee’s recommendation, most stakeholders deemed the losses incurred by the banks over the next two decades as acceptable. In fact, many evaluators even provided a rationale for providing ongoing subsidies to support the RRB system. For instance, some observers argued that "RRBs have become an important instrument for bringing about primary income distribution. This role of RRBs cannot be lost sight of, given the national objective of development with social justice. . . . The expenditure incurred on RRBs should be viewed as investment in weaker sections" (Velayudham & Sankaranarayanan, 1990, p. 2161).

Thus, from its very inception, the focus of the RRB system was to promote social justice through credit disbursement. Serving the poor and making a profit were seen as inherently contradictory. Since increasing outreach and covering costs was neither a stated objective nor a performance measure, financial viability was never made a priority by any stakeholder.

Governance Structures

The challenge of RRB governance needs to be understood in terms of constraints related to its ownership, control, and management.

In principle, each RRB was capitalized and owned 50 percent by the Government of India, 15 percent by the state government, and 35 percent by the (state-owned) commercial bank which agreed to "sponsor" it. In practice, the owners, usually the state governments, were in default on their capital contributions, thus weakening the equity base of the banks. The lack of interest in investing on the part of the shareholders resulted from the lack of incentives in contributing to ownership. Specifically, since the RRBs were a money-losing proposition from the very beginning, the prospect of participating in future profits was dim for the investors.

The multiple ownership of the RRBs led to a range of bureaucratic controls. These were specially pronounced in the case of RRB schemes, such as the Indian Rural Development Program (IRDP), in which a combination of government subsidy and term credit (in the ratio of 1:2) was provided to farmers and artisans to foster self-employment.[9] Although IRDP schemes were formally "housed" within the RRBs, and any lending conducted under the scheme affected the banks' financial statements, the program was implemented through separate district-level entities known as District Rural Development Agencies (DRDAs). The governing body of the DRDAs included locally elected representatives at the national, state, and district level governments, as well as the heads of various district development departments. A separate State-Level Coordination Committee (SLCC) monitored the program at the state level, while the Ministry of Rural Areas and Employment was responsible for program funding, monitoring, and evaluation.

While some “controls” from these various entities translated into faulty business policies (discussed in detail in the next section), others resulted in a thicket of reporting rules and regulations issued by “higher” government bodies and departments, such as the Reserve Bank of India (RBI, India’s Central Bank), and the National Bank for Agriculture and Rural Development (NABARD, India’s apex refinancing agency for rural finance institutions owned by the Ministry of Finance and the Reserve Bank of India), the Ministry of Finance, and the state governments. Many such reports overlapped in their requirements, wasting time and effort for the bank staff. For instance, during his field study of constraints faced by commercial bank staff nationwide, Gupta (1998, p. 32) found a “high degree of overlap in the reporting formats of the various government agencies” and recommended modifications in forms and reporting requirements to allow bank staff to devote more attention to “core banking business.” Because the reporting requirements for RRBs are identical, Gupta’s conclusion is equally valid for RRB staff.

The multiple policies imposed by the various government entities led to inefficient management practices (Reserve Bank of India, 1997). For instance, the government units controlled whom the RRBs lent to (including sectors, groups, and often specific individuals), what they lent for, the design and price of products, office locations, organizational structure, and human resource development issues (including recruitment, promotion, salaries, and disciplinary action). Given the top-down and static nature of these policies, the owners' representatives on the board of directors,[10] as well as the sponsor bank and the RRB managers, had virtually no authority to make any strategic decision regarding the RRBs.

Devoid of freedom to make any "commercial" improvements to the system, most stakeholders, especially the sponsor banks, became apathetic towards RRB issues.[11] A study conducted by Government of India's (1989) Khusro Committee noted that the RRB boards did a poor job of monitoring their performance, simply because they had no interest in the affairs of the banks. In a large number of cases, boards consisted of political appointees unfamiliar with the technical aspects of banking and finance. Therefore, the informally accepted norm at the irregularly held board meetings was to skirt any issues related to lending policies or financial performance. Instead, they spent time discussing either personal issues or those related to "policy neutral" areas, such as staff recruitment (Mudgil & Thorat, 1995).

Lack of a single owner with clear ownership and control, and no prospects for profits, diffused accountability and weakened oversight of the RRBs, seriously impairing the governance of the banks.

Business Model

Rural banking policies, especially those prescribed by the RRB Act, made it difficult for the bankers to build a viable business model. For example, the RRBs were required to maintain high Statutory Liquidity Ratios (SLR) of 25 percent,12 a constraint that reduced the availability of capital. Also, the yields on SLR were lower than prevailing lending rates and thus implicitly taxed the RRBs. Further, unstandardized norms for income recognition made it difficult to assess accurately the financial performance of the banks, since income on loans included both interest that was paid as well as interest that was due. Not knowing how long interest payments had been in arrears, most managers found it difficult to provide for nonperforming assets.

In addition, constraints with respect to selecting borrowers, defining geographic markets, opening and closing branches, making and collecting loans, containing administrative costs, and setting interest rates were key barriers to enhancing financial sustainability.

For example, loans were to be disbursed in the absence of collateral to economically weaker sections of the rural population—households with land holdings less than 6.5 acres and incomes less than Rs. 10,000—located in specific and restricted geographic areas.[13] Banks were allowed to lend only predetermined amounts for specified lending terms. Loans were disbursed for production purposes only; consumption credit was seldom granted.[14] In the case of the IRDP scheme, the eligibility criteria were even more restrictive. For example, it was stipulated that at least 50 percent of assisted families belong to "lower status" castes and tribes, 40 percent of the clients be women, and 3 percent of the credit be disbursed to handicapped individuals. The actual selection of such "borrowers" was done not by lending officers, but by local government officials, who sent lists of "approved" individuals to the banks for loan disbursal.

One outcome of these restrictive policies was an increase in loan losses because of bad lending decisions. Those in need of credit for consumption often falsified loan requests. Given the pressure from government authorities to increase loan volume to meet quantitative targets, bank staff had little authority or incentive to engage in due diligence and assess the risks of lending to such individuals. Thus, lending decisions were often reduced to making superficial matches between individuals' socioeconomic profiles and the available schemes.

Further, since many schemes, including IRDP, called for the disbursement of a one-time loan, neither the lenders nor the borrowers were interested in maintaining a long-term relationship. Even though many poor borrowers did not have the ability to be productive entrepreneurs or the capacity to repay the loans, they participated in the programs to access what they thought was “free money” from the government. In most cases, it was the wealthier sections of the community, with connections and political patronage, who benefited from the schemes. These well-to-do borrowers felt little pressure to repay their debts.

Finally, the lack of incentives among bank staff to engage in intensive loan collection, the unwillingness of state governments to assist in recovery procedures,[15] and the “blanket” loan waivers granted by the government further boosted loan losses. As a result, willful loan defaults became a norm over the years.[16]

In addition to the high risks associated with lending, the high cost of administration also constrained the RRBs’ financial viability. For example, many bank branches were often forced to remain open even if areas had sparse populations and little potential for entrepreneurial activities. Further, a 1993 court victory by the bank workers’ labor union granted RRB staff the same remuneration as their counterparts in sponsor banks and added to the banks’ already escalating costs.

While the above factors hurt the banks’ cost structure, it was the government-imposed ceiling on interest rates that dealt a severe blow to the banks’ financial viability. Since these rates were fixed at 12 percent on loans below Rs. 200,000, and most of the RRB portfolio was confined to loans of this size, the banks were unable to charge for the high costs of making and servicing the small loans. According to Mosley (1996), the RRBs’ Subsidy Dependence Index was 153 percent for 1992. This means that that the banks would have had to more than double their average lending rates of 16.6 percent or more than half overdues, just to break even during that year.[17]

But given the high profile and political stature of the RRBs, most observers felt that the implementation of high interest rates was “clearly not possible in view of the mandated role of these institutions for financing the weaker sections at concessional rates” (Mudgill & Thorat, 1995, p. 7).

Program-Field-Level Constraints

The challenges related to the RRBs' objectives, governance structures, and business model triggered additional constraints at the bank-client level. These constraints were related to the lack of appropriate infrastructure, low levels of motivation among RRB staff, and an inefficient loan delivery system.

Infrastructure

Since the RRBs were originally envisioned to serve as low-cost rural extensions of the banking system, few investments were made in their infrastructure development. According to field studies, for example, many bank buildings were unsecure and lacked appropriate roofing and access to basic amenities, such as water and electricity (Reserve Bank of India, 1997). Equipped with old furniture and dilapidated filing cabinets, storage space within many branches was lacking, and loan documents and records were often found stacked across the floor. Bank staff were neither provided vehicles nor a vehicle allowance to visit clients. A lack of calculators in some branches adversely affected the productivity, efficiency, and morale of the staff (Marguirite Robinson, HIID, personal communication, April 22, 1999).

Lack of appropriate infrastructure made working at the banks, and living in the villages, difficult propositions (Gupta, 1998). Many staff members abstained from work to avoid the adverse work environment, choosing to live in semiurban areas outside of the RRB villages. As a result, some bank branches were open for only 18 hours a week, while others closed down several times a month to "catch up" on internal paperwork. These practices were inconvenient for clients, who often took their business elsewhere.

Staff Motivation

Given the lack of basic infrastructure within bank branches, the lack of appropriate residential facilities in most villages, and perhaps most important, the money-losing business model of the RRBs, many sponsor banks assigned their junior officers—

who lacked appropriate loan underwriting or business management skills—to head the rural bank branches. In cases where senior managers were placed at the RRBs the officers' peers saw the placement as a punishment for possible inferior performance in the urban sponsor banks. It was well known by staff that since RRB assets were a very small percentage of sponsor-bank assets, and since the RRBs were ultimately loss leaders, the "parent" banks did not want to invest any significant time and money toward their maintenance or improvement.

Therefore, officers who were posted at RRBs generally had low morale to begin with. This was often reflected in their lack of willingness to be innovative and entrepreneurial, as well as in their belief that the RRBs could ultimately do little to improve the situation of the poor.

The day-to-day work requirements at the RRBs did little to boost motivation of such workers. With a plethora of reporting requirements and the redundancy of multiple forms and procedures, bank staff found themselves engaged in banal housekeeping activities most of the time. A focus on bureaucratic compliance displaced the need to make good loans, monitor their performance, and emphasize the need for timely repayment. Despite the strong focus on reporting, however, it took from three to six months for the branch mangers to identify borrowers in default (Gupta, 1998, p. 26). When defaulting borrowers were not contacted for consecutive months, they assumed that the banks did not care about collecting on the loans. This further reinforced the "culture" of loan defaults.

Finally, since RRB pay scales—which until recently were lower than those of their peers in sponsor banks—were not linked to performance, bank staff had little reason to improve efficiency or to "push hard" and collect on nonperforming loans. In fact, the unattractive compensation scale created strong incentives for corruption, which, over the years, became systemic within the RRBs.

Loan Delivery System

Inefficiencies in the loan-delivery system resulted from inflexible lending practices and high transaction costs for clients (World Bank, 1998). For example, loan products were usually long term, required balloon repayments, and were tied to specific types of investments that were assumed to have predetermined cash flows. Even applicants with good credit histories and collateral could be turned down if their requests did not "fit" the various RRB schemes. Since such schemes laid out the terms and conditions of the loan, the unique financial conditions of applicants, especially in terms of the complexities of their families' cashflows and their repayment capacity, were never a consideration in lending decisions.

In addition to inflexibility in lending, high transaction costs also created disincentives for borrowing (Kaladhar, 1997). For instance, loan applicants were required to produce a "no dues" certificate which served as proof of good credit standing, before they could receive loans. Acquiring this document often took several weeks. Also, applicants were required to submit a photograph as part of their loan proposal, but no technology to obtain a photograph existed in villages. Further, if individuals wanted to do business with an RRB outside their service area, a "no objection" certificate had to be obtained from the bank within their service area. These practices accounted in part for the long time—sometimes nearly a month—that it took for loan applicants to get approved and funded (Hunte, 1996). Finally, many prospective borrowers, especially those who were illiterate, approached middlemen to facilitate access to funds. These middlemen charged significant commissions—"fixed" transaction costs that diluted the value of the ultimate loan amounts to the borrowers.[18]

Borrowers faced transaction costs that were much higher compared to other financing sources. Indeed, it is not surprising that many rural farmers and small scale entrepreneurs, who generally value convenience as compared to the cost of credit, turned to informal sources for their credit needs (World Bank, 1998). Further, many borrowers who incurred high transaction costs may have avoided repaying loans as a way to shift some costs back to the RRBs, thus contributing to their nonviability.

Enhancing the Viability of the RRBs

Have banking reforms addressed these institutional constraints and perverse incentives in the RRB system? What additional reforms are needed to make the RRBs viable?

Key RRB Reforms

Based on the recommendations of the Narasimhan Committee Report (1992), reforms were initiated in 1993 to turn the failing RRBs around. To enhance financial viability, a new set of prudential accounting norms of income recognition, asset classification, provisioning, and capital adequacy were implemented. Banks were also required to make full provisioning for bulk of their nonperforming assets.[19] Further, they were permitted to lend to nontarget group borrowers up to 60 percent of new loans beginning in 1993–94. Permission was also granted to introduce new services, such as loans for consumer durables.

In 1994–95, a major recapitalization program was initiated to strengthen the balance sheets of failing banks. Seventy weak RRBs were relieved of their service area obligations and permitted to either relocate their loss-making branches at specified locations, such as village markets and agricultural produce centers, or to merge them with other close-by branches. Also, all RRBs were permitted to invest surplus funds in more profitable avenues, such as the money market. Further, business plans for achieving financial viability in five years were formulated in the form of performance contracts between the RRBs and NABARD. Finally, in 1997, RBI and NABARD delegated the responsibility of RRB management to their sponsor banks, although there was no change in the multiple-ownership structure.

While it was expected that these initiatives would enhance the efficiency of the financial sector, turn the failing banks around, and ultimately expand the delivery of financial services in rural India,[20] this has not been the case. A number of studies indicate that while the reforms have introduced an enabling environment for efficient financial transactions, they have done little to increase the internal efficiency of the RRBs (Gupta, 1998; Kaladhar, 1997; Reserve Bank of India, 1997). Specifically, a two-decade administrative culture has stifled creativity and made the banks' staff "paper pushers" who became experts at handling the multiple reporting demands of regulatory bodies. A key reason for this is that the basic incentive problems facing the RRB system have not been resolved.

Getting the Incentives Right

For the 70,000 plus RRB employees, then, the new institutional arrangements triggered by the reforms probably impose yet another set of rules that require compliance. Since attaining financial viability is their new constraint, it is natural for RRB managers to take advantage of the new rules of the game and engage in activities that allow them to maximize performance with the least risks and costs.

Thus, it is not surprising that RRB managers seem to have reduced their lending to disadvantaged groups and increased their money market investments. Doing so is only rational, for a number of reasons. First, managers understand that without reduced transaction costs, incentives for repayment, and innovative loan products in place, it is difficult to expect previous borrowers, who are not accustomed to a culture of loan repayment, to change their behavior and repay new loans on time. Therefore, lending to old clients is risky. Second, although it is possible for them to make loans to nontarget group clients from outside of their "service" areas, most RRB managers find themselves lacking in credit-appraisal skills. Again, lending without analyzing the quality of the "credits" is risky.

Third, making new loans requires filling out redundant forms, screening and monitoring borrowers diligently, and pursuing collections intensively, if one is to be in compliance and maintain good asset quality. For long-time employees of a bureaucracy that has never linked remuneration to performance, there are no incentives for RRB managers and staff to push harder, get motivated, and turn their branches around if they do not get to participate in the fruits of their increased efforts. Although RRB reforms have led to blanket salary increases, they have done little to introduce incentives for better performance. Thus, making good loans might be *personally* costly to the managers.

Under these circumstances, it is hardly surprising that the current institutional constraint of financial viability has led many managers to conclude that "the secret [to branch profitability] is not to lend; or if [one has] to lend, . . . to lend as little as possible" (Mosley, 1996, p. 257).

What should be done to make such a perverse incentive disappear? One option is to modify the current constraint that stresses the achievement of only financial sustainability and to include the volume of credit disbursed as an *additional* indicator of performance. Indeed, international experiences in rural financial intermediation indicate that monitoring progress toward both outreach *and* sustainability is critical (Yaron, 1992). This strategy in itself, however, might be ineffective. Specifically, since the RRB staff are not adept at loan appraisal, they might once again be tempted to disburse loans without due diligence to meet quantitative targets. To avoid this scenario, the provision of appropriate technical and capacity-building training will be critical for increasing the competency of the RRB staff, if this dual-constraint is to be imposed on them as a measure of performance.

While technical and managerial skills are necessary, they need to be complemented with many other institutional changes to enhance program performance. International experiences indicate that among the many conditions that facilitate success in rural financial intermediation, the provision of incentives to staff and clients is key (Rhyne & Otero, 1994; Hulme & Mosley, 1996; Yaron, Benjamin & Charitonenko, 1998). In this regard, *rewards for officials and clients must be so designed that the pursuit of what they consider their best interests* *simultaneously contributes to the attainment of the public interest, that is, the maximization of program outreach and sustainability.*

Unfortunately, the RRB reform process has not given enough attention to designing institutional arrangements that can align the incentives of policy makers with those of banks' field staff and clients. Neglecting this aspect of reform can be detrimental to program viability.

The internal efficiency of the RRBs will not likely improve unless the field staff actively participate in the reform process. For example, vesting the RRB branch managers with the authority to make lending decisions and freeing the staff from redundant and time consuming reporting requirements can not only boost morale but can also serve as the foundation for making good loans and operating efficiently. In addition, not only should RRB branches have group incentives for meeting and exceeding the outreach and sustainability targets for their "profit centers," there also need to be upfront improvements in the operational infrastructure of the banks. Such actions—which can include purchase of vehicles for bank branches, facade improvements for branch buildings, construction of new storage spaces for files and loan records, and introduction of new MIS systems to facilitate data storage, retrieval and manipulation,[21]—can serve as signals of credible commitment on part of the owners (Williamson, 1995) and may go a long way in turning the RRBs around.

While rural clients will certainly notice the introduction of new banking "values," investments in physical improvements may not be sufficient to change their perceptions regarding the innate inefficiencies of the RRBs. It may be critical to provide them with information at village-level forums, regarding the new and improved business practices of the banks. In addition, offering them tangible incentives to do business with the RRBs is highly recommended. Perhaps the most important of these incentives will be the introduction of new loan products and financial services that take into consideration local conditions and unique needs.

Specifically, a key incentive will be the willingness of RRB staff to make loans for any purpose, as long as applicants can demonstrate repayment capacity based on current household cash flows.[22] Further, it will be critical to communicate a new culture of enhanced customer service by ensuring convenience and low transaction costs for clients. Also, incentives such as intensive collection strategies and interest rebates for prompt payment will encourage timely loan repayment.

In sum, the key to turning the RRBs around and placing them on a path of increasing outreach and sustainability is to devise and implement institutional arrangements that harmonize "public interest" objectives with the private incentives of bank staff and clients.

Policy Implications and Conclusions

The lackluster performance of the RRBs during the last two decades can be largely attributed to their lack of commercial orientation. Instead of adopting international best practices in microfinance (Bhatt, Painter, & Tang., 1999; Gonzalez-Vega, 1998; Rhyne & Otero, 1994; Robinson, 1996; Yaron et al., 1998), specially in terms of reducing transaction costs for clients (Bhatt, 1997; Bhatt & Tang, 1998b) and lending to individuals based on an appraisal of their ability and willingness to repay (Bhatt, 1998, 2001), these internally inefficient banks made loans based on political and social considerations that defied the very fundamentals of prudent underwriting. Given their poor portfolio performance over the past decade, the majority of these banks have been declared as financial disasters as development experts search for alternative ways to deliver rural financial services.

The unsustainability of the RRBs, has led some observers to advocate a greater role for nongovernmental organizations (NGOs) and self-help groups in rural financial intermediation. While many such entities seem to have reduced transaction costs and maintaining low loan losses (Puhazhendhi, 1995; World Bank, 1997),[23] their outreach is severely limited given the size of India's rural market. Rough estimates suggest that the total outreach of all the NGOs engaged in rural finance is not more than 500,000 households (Mira Chatterjee, Senior Social Development Specialist, World Bank, New Delhi Regional office, personal communication march 25, 1999). Given an estimated market potential of over 50 million households, there is little chance that NGOs can meet market demand. On the other hand, the RRB system and staff, despite their challenges, have inherent strengths such as an extensive infrastructure in place for financial services delivery, an understanding of the economics of the local markets within which they operate, a reputation among many poor households for being client-friendly, and a comparative advantage in mobilizing low-cost deposits from sources that commercial banks do not adequately reach (World Bank, 1998).

It is this context that underscores the urgent need to reform the RRBs. Although the progress in liberalizing the policy framework is indeed commendable, the RRBs have a powerful incentive to minimize lending, under the current environment of reforms, especially to disadvantaged groups. In addition to the measures we have already suggested for aligning the institutional objectives of increasing outreach and sustainability with the private incentives of bank clients and staff, a number of policy-level changes are recommended.

First, the majority equity stake, preferably 100 percent ownership, of the RRBs, needs to be transferred to the sponsor banks to ensure good governance. Having a single owner is critical for clarifying channels of control, responsibility, and accountability. However, in keeping with principal-agent theory, this ownership will be ineffective unless it also gives sponsor banks free rein to operate the RRBs as real commercial entities. Second, the process of interest rate liberalization underway needs to be completed. Since interest rates for commercial banks are still controlled for loan amounts less than Rs. 200,000, many sponsor banks do not allow RRBs to raise interest rates for fear of losing business to commercial banks.

Third, administrators need to rigorously evaluate claims regarding dramatic improvements in RRB viability. Since official assessments of loan-recovery performance are based on estimates of collections over demand, and collections are getting a strong boost from the recovery of portions of overdue portfolio, it is unclear whether recovery of post-reform loans is high enough to make the RRBs viable in the long term. In order to assess accurately the quality of new lending, computation of a Current Recovery Rate (CRR) that divides total cash receipts by total amounts falling due for a given loan contract in the post-reform period is recommended (Rosenberg, 1999). Given the challenges faced by RRB accounting systems in segregating principal from interest, this computation can also allow the RRBs to produce a reasonable estimate of annual loan losses, since it does not require segregation of principal from interest for amounts received or for amounts falling due.

Finally, directed lending to economically weak groups needs to be completely phased out. Although some observers might argue that targeted credit is needed to reduce economic inequities (Velayudham & Sankaranarayanan, 1990), there is a substantial body of evidence that it is not the poor, but the better-off households, who benefit from such schemes (Mathur, 1995; Von Pischke, 1991). Very poor households often do not have the capacity to handle and repay back debt. For example, the income generated by IRDP clients is insecure and risky; borrowing often gets them deeper into debt than they were to start with. Indeed, for many of the rural poor, microfinance is not the antipoverty weapon it is often made out to be (Robinson, 1996). In many circumstances, objectives to alleviate rural poverty will likely be more effectively furthered by other types of interventions, such as public health, education, and employment generation initiatives, and of course infrastructure development programs (Jalan, 1996). These measures have the additional advantage, as compared to the IRDP, of enhancing security and reducing risk in poor communities (Joshi & Little, 1996).

But while many of our policy prescriptions may be desirable, is their implementation politically feasible? For example, would politicians support the elimination of programs that, at least theoretically, aim to assist the poorest of the poor by placing in their hands tangible assets such as cash and livestock? Would politicians back a reform proposal that recommends charging effective interest rates as high as 25 percent in order to ensure that programs can cover their costs and become financially viable?

Our answer is a qualified no. Evidence from around the world suggests that political interests almost always take precedence over the public interest in reform processes, and that without political backing, even the most well crafted reform proposals face ultimate demise. On the other hand, where political leaders can become allies, reforms can transform failing programs into models of success, as has been the case for Indonesia's BRI Unit Desas—money-losing branches of a state-owned bank that became profitable within two years of reforms (Robinson, 1998).[24] In the case of India, however, until such time as leaders feel confident that furthering the public interest is possible without political suicide (Klitgaard, 1997), proposals that seem to adversely impact either the agricultural sector, or socially/economically weak communities, are unlikely to find support. Thus, educating political leaders and winning over their support will be critical to implementing the needed reforms, and ultimately making the RRBs viable.

Notes

The authors would like to thank Elizabeth Rhyne, Richard Rosenberg, Shui-Yan Tang, and Jacob Yaron for their useful comments on earlier drafts of this article. The usual cavaet applies.

1. Originally established by an ordinance in September 1975, these banks are governed by the RRB Act which was passed in 1976, and amended in 1987.

2. India is divided into 499 geographic districts.

3. The outreach of the entire formal rural financial system, which includes the RRBs, the nationalized commercial banks and the credit cooperatives—comprising of primary agricultural credit societies (PACS) and primary/state land development banks (P/SLDS)—is even more impressive, with one branch per 4,000 rural residents.

4. Average exchange rate (1999): Rupees 43.41 per US$.

5. Loan recovery was calculated as the ratio of collection over demand. Since loan losses were seldom written off due to inappropriate asset classification and rescheduling policies, official estimates of may have overstated loan losses.

6. Official accounts often do not adequately provision large uncollectible portions of the portfolio, and they include accrued interest which may never be received.

7. For instance, the Investment-Deposit Ratio jumped from 24.5 in 1997–98 to 41.59 in 1998–99.

8. For example, the CD ratio of loans made to deposits collected has declined, from over 100 percent in 1987 to less than 50 percent in 1997.

9. IRDP was launched nationwide in 1979 to enable households to cross an income-based poverty line by investing in income-generating activities. The targeting of eligible households was done by local government officials, and the RRB staff worked with them and the recipient in purchasing an asset bought with the loan. RRB staff was responsible for the collection of these concessional loans.

10. The RRB board consisted of two members from the Government of India, one member from the Reserve Bank of India, one member from NABARD, two members from the sponsor bank, and two members from the state government.

11. Often the RRBs and the rural branches of their "sponsor" banks were geographically proximate, and competed for clients. This further dampened the RRBs' relationship with the sponsor banks.

12. The legal upper limits on CRR and SLR stood at 15 percent and 40 percent. For comparison, the reserve requirement is 8 percent or less in most East Asian countries, and about 2–3 percent in most developed countries.

13. One Regional Rural Bank was designated as credit supplier to each rural locality, which was generally confined to 1–2 districts. RRBs having one district as their area of operation were allowed to open 100 branches, while those operating in more than one district could open up to 75 branches per district.

14. The prevailing school of thought in policy circles was that loans should generate an income stream from which repayments could be made—a view that ignored the complex cash flows of poor rural households.

15. When pursuing defaulters with legal action, banks can either proceed with a civil suit or approach the State Government administration for recovery under the Agricultural Credit Operations and Miscellaneous Provisions Act. Proceedings under State acts are quicker as compared to civil suits, which can drag on for years together.

16. It is interesting to note that "although more than six years have passed since the closure of the Agricultural & Rural Debt Relief Scheme, banks continue to cite it as one of the major impediments in the flow of credit and of poor recovery even in respect of current loans" (Gupta, 1998, p. 25). That many borrowers hope for future debt-forgiveness confirms North's (1990) assertion that "changing" an institution (in this case an informal one) that has assumed "deep roots" it is not easy.

17. Mosley assumed that 16.4 percent of the portfolio is written off, which is a very conservative estimate.

18. According to a World Bank (1998) study of 312 "weak" borrowers in the state of Tamil Nadu, there were leakages of Rs. 21 for every Rs. 100 of subsidy in the form of "incidental expenses" and "speed/quick or push money." About two-thirds of the sample also reporting "working" for the subsidy and producing "quick money" in addition to covering normal expenses.

19. The implementation of prudential accounting norms for 176 RRBs revealed that only 57.35 percent of their total assets were performing (Reserve Bank of India, 1997).

20. At the 1997 Microcredit Summit held in Washington, DC, the government announced that India could have a share of 25 million in the overall target of 100 million poor families to be reached by microfinance worldwide in 2005.

21. This may also facilitate timely identification of defaulting borrowers. Currently, a branch manager receives a report on "defaulter status" between three to six months after the loan has become overdue (Gupta, 1998).

22. Mosley's (1996) field studies of RRB borrowers revealed that loans used for consumption purposes resulted in higher income gains than those used strictly for investment. This was because when borrowers took care of their consumption needs, it helped build their capacity to profitably commit resources to productive investments in the future.

23. Indian microfinance NGOs have consistently recorded a loan repayment performance of over 95 percent.

24. According to Hulme and Mosley (1996, p. 154) "BRI's unit desas evolved out of a failed programme under the auspices of Indonesia's repressive military regime which has manipulated state institutions to maintain its position. They have used an element of this authoritarian political framework—the village head—to help make the programme viable." Christen (1997) too suggests that BRI "is dependent on political support for the continuation of its microfinance program" (p. 20). Of course, in addition to the political backing, the introduction of performance-based incentives for bank staff and clients played a critical role in turning the unprofitable bank branches around (Charitonenko, Patten, & Yaron, 1998; Klitgaard, 1994).

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