Transaction Cost and Asymmetry of Information -The Twin Odds of Indian Commercial Banks in Rural Credit Market: Theoretical Fragility

Choudhury, Saswati

OKDISCD, Guwahati, Assam ,India

2004

Transaction Cost and Asymmetry of Information -The Twin Odds of Indian Commercial Banks in Rural Credit Market: Theoretical Fragility

Saswati Choudhury

Abstract

This paper delves into the issues of transaction cost and asymmetry of information in the rural credit market. The first two sections deal with theoretical postulation of bank intermediation. The third section discusses the policy and administrative interventions in the rural credit market in India. The fourth section discusses the problem of asymmetry of information and high transaction cost the faced by the commercial banks in the rural credit market in India. The fifth section analyses the interrelation between the role of trust and transaction cost and examines the role of SHGs in bridging information asymmetry, fostering trust between bankers and the rural borrowers and thereby reduce the transaction cost.

Introduction

The role of financial intermediation in the process of economic development has long been recognised by distinguished economists like Schumpeter, Kalecki and Keynes. Evidence indicates that having a robust banking and capital market is correlated with economic development. As economic growth of service oriented sectors gains in importance it is believed that capital markets serve as more effective intermediaries vis-à-vis the banks. Nevertheless, the banks remain the best option for small and medium sized firms, which are less able to tap capital market for funding. Relationship between financial intermediation and economic growth has been further articulated in the subsequent works of Goldsmith, Gurley and Shaw and Fry. Two discernible traits emerge from the studies on the relationship between financial development and economic growth: one, economic growth depends on the functional dynamics and efficiency of financial sector and secondly, neither economic nor financial developments are exclusive entities but influence each other in a reinforcing manner leading to a higher impetus for mutual development.

Given the increasing role of financial markets in developed and emerging economies including India, the role of banks in economic development still remains an actively debated issue. In fact renowned economist and Noble Laureate W. A. Lewis (1969), defined economic development as "the process by which a community which was previously saving and investing 4 or 5 percent of its national income or less, converts itself into an economy where voluntary saving is running at about 12 to 15 percent of national income or more". It is true that with the development of the capital market Indian economy has been able to find an exigency to raise financial resources for large corporate investment. However, a major section of the economy comprising agriculture, small scale industry, trade and commerce etc. which assumes great significance in terms of employment generation and income diffusion is yet to graduate to tap investible resources from the capital market. Here comes the role of commercial banks. The task of intermediation in financial services sector provides a range of services, which hitherto would have been both time as well as cost intensive.

Bank Intermediation

Individuals have differing needs in different points of time with differing amounts of financial inputs. Intermediation helps in the process by mitigating the time difference. This is done by either saving some amount of money to be spent at a future date or by spending the amount at the current period from sources other than own to replace it back at a future point of time which is usually referred to as loan or credit. At any given point of time there are always two groups of people - those who want to put away some money to be spent at a future time and those who are in need to spend at current time either from past savings or from external sources through borrowing. Hence, there is a demand supply situation where one can get/pay a price for the differences in needs with respect to time. This creates the opportunity for economic transactions and paves the way for financial intermediation.

Unlike the neo-classical theory, which assumed economic exchanges to be frictionless and instantaneous, Coase (1937:1960) challenges the idea with the concept of transaction cost. He argues that the classical assumption is wrong and all market transactions entail some costs. However, the transaction cost approach failed to generate much debate in the initial phase and after decades of dormancy the transaction cost approach took the entire study of business economics to a new height when a surfeit of literature with academic rigour emerged in the writings of Alchian and Demsetz (1972), Williamson (1975), Klein *et al* (1978), Cheung (1983). Two types of transaction costs have captured the attention of the scholars - opportunism and asymmetric information. But opportunism can impede the Pareto-improving exchanges because one partner may find it to his interest to expropriate the other *ex-post* because of bounded rationality, asymmetry of power domain and asset/ capital specificity. Asymmetric information, on the other hand, leads to such problems as moral hazard and adverse selection. The real challenge is, therefore, to design institutions where transactions do not lead to either opportunism or adverse selection problem. Apart from the opportunity cost and asymmetric information, substantial energy is also spent in designing and framing the transaction deals which involves the twin costs of manpower and time. Hence, the real challenge of intermediation is to develop arrangements - either formal institutional or informal non-institutional - which can bridge the asymmetry of information and reduce the adverse selection problem and also mitigate the problem of opportunism.

Banks are the dominant financial intermediaries in a developing economy like India. From the economic point of view, the major tasks of banks are to act as intermediaries channeling savings to investment and consumption: through them the investment requirements of savers are reconciled with the credit needs of the investors and consumers. Banks accept deposits from the public- secured or unsecured (Demetrigades and Lunintel 1996). These deposits generate the necessary funds with the bankers to reconcile to the credit needs of the borrowers. Bank deposits are the most widely used savings option next to post office savings. However, as deposits in the banks also make the way for a payment system unlike in the case of post office savings which is only of depository nature without any facilitating provision for any payment system, therefore they also form the core of the payment system in a monetised economy.

The basic function of bank intermediation as noted by Jadhav and Ajit (1996-97) can be grouped as:

- Liability-asset transformation; i.e. accepting deposits from the public as liability and converting the same into assets such as loans.Size transformation; i.e. providing large loans on the basis of numerous small deposits.
- Maturity transformation; i.e. provision of alternate forms of deposits to the savers according to their liquidity preference while at the same time offering the borrowers with loans of desired maturities.

- Risk transformation; i.e. distribution of risks through diversification which substantially reduces risk for savers (depositors), which would prevail while lending directly in the absence of financial transformation.

In functioning as intermediaries the banks have the operational advantage that they can reduce (a) search costs, (b) transaction costs, (c) monitoring costs, (d) verification costs (Fry: 1980). In the absence of intermediation savers seek for investors and this involves search costs. In the process that banks offer standardised products and services to depositors and borrowers, they also reduce the transaction costs and by accepting deposits and extending loans, banks acquire informational advantage over other financial intermediaries, and thus reduce their monitoring and verification costs. In this way intermediation helps in bridging the asymmetry of information and the institutions so involved get a fee for managing this asymmetry and the risk involved in the process - this fee is the transaction fee which is the differential between the interest paid to the depositors and the interest charged from the borrowers.

Policy and Administrative Interventions in the Rural Credit Market

In the edifice of balanced and equitable economic growth the central leadership of an underdeveloped country like India has to ensure adequate and appropriate stimuli to the agricultural and allied agro based activities. This is so because rural economy is agrarian and typified by high incidence of poverty, landless households, small fragmented agricultural holdings, higher levels of illiteracy and small fragmented cash needs for personal and social obligations which often leave the rural households in perpetual debts as these small cash requirements are met by the indigenous local money lenders at usurious rates. Hence the needs for an institution building in the rural areas require a system which serves the twin purpose of accelerated growth and creation and redistribution of assets for the asset poor and in the process ameliorates poverty.

It is significant to note that the importance of the rural credit institutions and the process of institution building in the area were realized even in the pre-independence era when the *taccavi* loans for providing low interest rate loans were started in 1793. However, the Land Improvement Loans Act of 1883, which was based on the sound spirit of providing agricultural loans, was the first consolidated enforceable law in the realm of rural credit but its applicability was marred by the stringent procedures. Besides, the regressive land revenue system together with seasonal fluctuations of agricultural production and other vagaries of nature led to high incidence of landlessness among the rural households. These developments paved the way for theorizing the rural development in terms of mutual cooperation with emphasis on thrift, which culminated in the enactment of Cooperative Credit Societies Act, 1904. This represents the first attempt at building an institutional arrangement for meeting the small credit requirements of poor peasants and other marginalized sections of the rural population in India. It aimed to prevent the peasants from the usurious moneylenders. The subsequent attempts [The Royal Commission on Agriculture (1928) and The Central Banking Enquiry Committee (1931)] toed in the same line of argument where the emphasis was on strengthening and developing cooperative credit institutions for the rural areas owing to the small size and seasonal demand of credit and retrieving the rural poor from the clutches of the usurious money lenders. These attempts did not emphasize capital formation in agriculture. It was Sir Malcom Darling Report in 1934 which first raised the question of financial efficiency and efficacy of cooperatives in addressing the agricultural credit needs and investigating the possibility of coordinating the activities of commercial banks towards meeting the credit requirements of agricultural farmers. In 1935, the Agricultural Credit Department in the Reserve Bank of India was created for supervising the agricultural credit operations.

These attempts in the pre-independence era were followed by a series of successive attempts in the post independence era. It started with the Rural Bankers Enquiry Committee in 1949, popularly known as Sir Purushottamdas Thakurdas Committee, which found that the cooperatives had been instrumental in providing agricultural and rural credit while the commercial banks preferred to stay away from the rural agricultural lending and concentrate on more remunerative trade and business activities. The subsequent Committees and Enquiry Commissions made recommendations and suggestions, which are repetitive in restating the identified problems of rural credit delivery, and suggesting measures which lack in theoretical soundness and practical efficacy. The overenthusiastic and highly ambitious plans of poverty eradication of the government make it a mere game of numbers where the entire approach of IRDP financing in the country has a target oriented approach of numbers. The high sounding rhetoric of the programme lacks sound theoretical framework in the context of ground realities of rural poverty in the country. The approach of targeted lending under poverty alleviation programmes and priority sector credit to the rural poor is a list of numbers which in essence tries to make a dent on the rural credit market through rural poverty alleviation programme based on highly unsustainable subsidized policies. The end result has been the engineered development of a fragile rural credit delivery system plagued with low operational efficiency e.g. poor loan appraisal, poor monitoring and supervision with concomitant result of high over dues and non-performing loans leading to erosion of profitability and eventual threat to sustainability of the system.

The various enquiries/studies in the realm of rural credit in India has shown that it is timely and adequate credit, which is the necessity of rural credit market, and this has a close resemblance with the evidence from Germany, Japan and Spain. While quantitative dimensions of credit cannot be done away with, it is but also important to ensure provision of qualitative services and need based end products in the approach.

With the introduction of New Economic Policy (NEP) in 1990 reforms and liberalisation have been brought about in the real sectors of the Indian economy. Simultaneously, under the impact of NEP, there has been continuing deregulation and liberalisation of the banking system as well. The impetus to reforms in the financial sector received a major thrust with the submission of the Report of the Narasimhan Committee in 1992. The Committee recommended wide-ranging reforms that included among others the reduction in pre-emption of bank resources (in the form of reserve requirements) and the directed credit programmes. It also recommended deregulation of interest rates so as to reflect market conditions and complete abolition of branch licensing policy that regulated entry into banking. In so far as the recommendations with respect to directed credit programmes are concerned, the government policies have continued with the existing norms for the Indian commercial banks and have also made it mandatory for the Foreign banks operating in India to ensure that at least 32% of their net bank credit is directed to priority sector, inclusive of small scale industries and exports. Within the priority sector lending also agriculture has to account for at least 18% of net bank credit. However, the newly set up private sector banks have been permitted to substitute agricultural lending requirements by contributions to deposits with Small Industries Development Bank of India (SIDBI)/National Bank for Agriculture and Rural Development (NABARD) for a period of three years from the date of inception. Social banking need not conflict with canons of sound banking but when banks are required by directives to meet specific quantitative target there is the danger of erosion of the quality of the loan portfolio. The committee is of the view that the interest subsidy component should be eliminated in respect of priority sector credit and what is important is the 'timely and adequate availability of credit rather than its cost which is immaterial for the intended beneficiaries'. However, the reforms in the financial sector following the recommendations of the Narasimhan Committee Report is not aimed at reforming the rural credit market, rather it aims to reset the entire financial structure of the country. In evaluating the financial sector reforms Shetty (1997) tries to show how the present reform policies have failed to take into account the structural differences in the Indian economy. As pointed by Shetty, the present policies aim for the "most premature and operationally infeasible goal ……… of globalization" for the financial sector in India, which had not been pursued even by industrialized countries. This has resulted in the costly and "forced application of capital adequacy and other supervisory norms." Further, a monetarist approach guides the new policy which implies "primacy to the control of money supply" and monetary targeting at the cost of "size and distribution of bank credit". Besides, the "uncritical acceptance of the free-market philosophy has blinded the government to the needs of a genuine reform of the financial system".

Rural Credit Market: Transaction Cost and Asymmetry of information

The rural credit market is highly un-oraganised, imperfect and credit needs are more guided by seasonal agricultural operations. Even non farm or off farm incomes are at times dependent on the farm based agricultural activities. Although barter transactions have reduced over the years and formal institutional sources have gained access to the rural credit market, it remains a fact that the services required in the rural credit market have not yet been addressed in a pragmatic manner. There are two cases in point: one, the savings product of the commercial banks has an urban orientation which has been designed taking into consideration the regular flow of income throughout the year and facilitating cash withdrawals as and when required. This does not incorporate the element of seasonality of income which is the main feature in the rural areas; also it does not have any product which could collect tiny amount of savings on a daily basis. Second, the supply of credit products in the rural areas from the commercial banks has been target oriented, dovetailed with the government's rural development programmes. These programmes have a uniform code of rules which do not take into cognizance the differences in rural livelihood along the tribal areas and the non tribal areas. The customary laws of the tribal and the common property right over forest and other land resources are some other contentious issues in the realm of bank finance. In the process the felt needs for credit products have been ignored.

Several considerations guided the development of highly subsidized intervention in the rural credit market- one the rural poor are not bankable and hence banks need a safety net and therefore the rural credit products are dovetailed with government programmes and second, rural poor need cheap money to meet their requirements. But little does the approach reflect on the fact that the rural poor are cost indifferent, rather they are more conscious of time and simple procedures of access. The schematic and targeted credit in the rural areas is administered by commercial bank branches with low and asymmetric information on economic strength of the borrower class, their requirements and repayment capacity. There is also asymmetry of information on the part of the borrower - type of credit schemes, requirements of transaction deed and more importantly the market linkages for the type of activities he or she is approaching to take up, whether agricultural activities or non-farm activities.

This asymmetry of information at the field level offices as well as from the borrowers delays the process resulting in time and cost overrun which in the process increases the transaction cost. Loan transaction costs are associated with operations such as loan appraisal, supervision of the end use, recovery cost, technical advisory services and qualitative services and a portion of servicing deposits. The transaction costs in rural credit market are higher because of the large number of small size accounts whose processing, supervision and monitoring as well as recovery costs are high. The information gap on the economic and financial credibility and viability of the borrowers on one hand and large geographical coverage of bank branches with poor transport and communication links at the field on the other increase the transaction costs for the rural branches.

Though Service Area Approach had been adopted to map out in details the economic and other resourcefulness of the area of operation covered by the particular bank branch, it is needles to say, such approaches have failed to deliver on account of managerial problems of branch staffing and tenure ship of the personnel at the bank branch. Also, the weak liaising between the bank branches and the block development and rural development offices has been another major instance of information asymmetry on the part of bank branches and the consequent adverse selection process. The yardstick of success for programmes like IRDP, the largest ever rural poverty eradication programme of India, is scaled in terms of physical and financial targets. As noted by Karmakar (1999), 'Physical and financial targets had been exceeded and programmes had probably grown too fast for its own good resulting in several deficiencies, including over-concern with targets which were determined on a uniform basis per block; identification of 15 percent to 20 percent of beneficiaries; leakages through corruption and malpractices, absence of backward and forward linkages in project identification; inadequacies in the delivery and monitoring of credit; and, problem in the absorptive capacity of many beneficiaries. The programme has been reduced to meeting targets with constant pressure from government agencies.'

The norms of social banking and business ethics do not contradict each other, rather it is the agencies at the implementation level which create conflicts representing a case of moral hazard in the case of Indian banking in the rural areas. Asymmetric information is an important assumption in the principal-agent model. In agency relationships, uncertainty and asymmetric information are the resultant effects. While the initial theorization of the moral hazard model was built on two person relationship - principal and the agent - the economists have of late developed more realistic models where the multitask and multi principle concepts have been incorporated. The multi task agent is a common problem in daily life. Similarly, one agent faces multiple principles. The evaluation studies on the rural credit programmes in the Indian context have all along argued for simplifying the organizational involvement in the programmes. But the real problem before the government in designing the credit programmes for the rural areas is that, these rural people are mostly asset poor, credit requirements are more for consumption requirements which have led to credit leakage for production purposes to consumption needs, poor marketing and communication linkages in the rural areas and more importantly the rural lending is not so remunerative for banking business. Hence, the rural credit programmes are designed by dovetailing them with subsidized government rural development programmes. The Central Government, which is the principal here, involves multi agencies in implementing the tasks and the interest of the agents are at conflict. The grass root level bodies like the block offices and rural development agencies involved in identifying the beneficiaries with respect to the laid criteria enjoy the benefit of extra information about the potential beneficiaries due to their better information and communication access. The commercial bank branch, the other agent, which has a larger spatial and population coverage is constrained by manpower shortage and other organizational deficiencies which leads to asymmetry in its information system. The multi agency problem greatly exacerbated the control problem for the principal in charge (senior controlling authorities in the government) with low measurability. In addition, there is the problem of both the agents - the grass root level government bodies and the bank branches playing principals against each other since their interests are at conflict. The lack of functional specialization for the principal (senior controlling authorities in the government) leads to poor monitoring and control of agents (the grass root level bodies) and this in turn leads to faulty selection of beneficiaries and corruption in the process.

Apart from the multi agency task problem for the government, there arose the problem of opportunism, meaning the incomplete or faulty disclosure of information in order to hide the real facts (Williamson, 1998) for the commercial banks in the rural areas. Decision making in such circumstances is presented by the agency relationship in which two parties embark on a mutually beneficial hierarchical organizational relationship, one being better informed than the other. Each unit/ branch office in such a hierarchical structure, except at the ultimate level, is simultaneously a principal and an agent when rights are transferred down the organizational ladder (Eggerston 1990). The actions of an individual borrower are not easily observable e.g. a bank branch lends money to a borrower but can not perfectly monitor his investments and initiative. In a typical development finance approach credit officers (agents) possess more detailed and accurate information about the local environment and the clients than does central management (principal) and this entails high transaction and monitoring costs, and therefore the managers strive to align the objectives of the institution (which usually include a mix of outreach and profitability indicators) with those of the agents (credit officers) who actually decide on the loan sanctions. The subsidized credit in the rural areas and the low awareness and information gap on the part of the borrower led to rent seeking channels in the bank branches at the grass root level, taking advantage of the opportunistic information access. The heavy dependence on subsidy and cheap concessional rate of interest led to poor asset creation, often unsustainable for long run income generation.

The asymmetry of information also led to a vicious system of inefficient functioning in the rural credit delivery- there was lack of any accountability on the part of the grass root level government bodies and the commercial bank branches. This lack of accountability led to weak financial discipline and poor recovery, poor productivity, justification of financial losses with social objectives and gradually the collapse of the entire system.

Role of Trust and Transaction Cost

Trust has a significant bearing on business transactions. Lower the information asymmetry, higher the trust and lower is the transaction cost. Several attempts have been made in the past to understand the various levels and scope of trust in affecting economic transaction and its impact (Humphrey and Schmitz, 1996). In fact, lesser the trust greater is the transaction costs. Fukuyama (1995) addressed this issue in great depth. According to him "communities do not require extensive contract and legal regulation of their relations because prior moral consensus gives members of the group a basis for mutual trust". He argues that in the absence of trust between two transacting parties, legal safeguards are the substitute measures and this is referred to as the transaction cost by the economists. It is because of the information asymmetry *about* the transacting parties *among* the transacting parties themselves which makes the parties trust each other with caution and legal safeguards; this entails a kind of payment to bridge the gap through intermediation. In the context of the Indian rural credit market, the state sponsored programmes of government in the rural areas of the country represented a signal of trust on the bankable capacity of the rural poor. But this 'make believe' trust was wrought with information asymmetry and hence a substantial amount of subsidy was involved in the entire game plan. The cheap credit not only led to the poor asset creation for borrowers but also eroded the quality of performance and affected the trust in banking institutions. Further, even when there was no information asymmetry, the available information was not used in the best interest for sustainability of the system and once the subsidies were removed and the transaction costs became real the system collapsed. The erosion, both in the quality of services and of trust, in the system deepened further when came the write-offs and loan waivers for the bad debtors particularly under the Agricultural and Rural Debt Relief (ARDR) Scheme, 1990 - the few good borrowers who repaid the loans thus suffered a net loss in comparison to the bad debtors who not only failed to repay but whose loan amount was wavered too.

Unlike the commercial banks the problem of transaction costs is either absent or minimal in respect of informal agencies like the village moneylenders. The village moneylender and his borrower usually belong to the same village or nearby villages and both have close information about each other. This information helps the borrower to choose his supplier. The supplier also either has or gathers adequate information on the borrower who comes to him and this facilitates transaction. The process is usually without any legal safeguards and the mutual trust to honour the deal makes transaction possible. The transaction involves no documentation or any other management and operational costs, and therefore the transaction costs in informal lending like those of the moneylenders are absent. There are social aspects to it: the village moneylenders who are economically well-off also enjoy social trust and privilege and the fear of losing this social trust prevents them from making a breach of trust with the borrowers. Similarly, for the borrowers the money lenders are almost the modern day 'ATMs' and the fear of losing future access makes them honour the transaction without default.

The high rate of interest charged by the moneylenders is one contentious issue in the literature of rural credit and the edifice of concessional credit to poor centres round this. But the time and cost overrun due to procedural formalities in respect of the formal agencies like the commercial banks together with information gap on the part of the borrower provides a level playing ground for the moneylenders. The other point is the purpose and size requirement of loans in the rural areas. The essential purpose for loans in the rural areas is consumption requirement in small sizes. The commercial banks have no credit products designed to cater to these requirements. Secondly, collateral is yet another aspect of the commercial bank's loan. In the informal set up, the personal contact between the borrower and the lender takes care of the collateral security and the easy accessibility in terms of time and amount is the other aspect where the village money lenders have the advantageous situation. As the trust is higher with higher levels of information about each other, the transaction costs (both for the borrower and the lender) are very low due to lack of detailed documentation, immediate decision on sanction and disbursement of loan amount and lack of information costs.

As Hoff and Stiglitz (2001) pointed out, the structure and the volume of TCs depend on the institution and the institutional environment respectively e.g. recent research in Thailand has revealed that the type of lending agencies significantly influences the level of TCs incurred by borrowers (Erhardt 2000). The borrowers and the lenders include all explicit and implicit expenses that occur in the process of disbursing and obtaining a loan. The costs that are associated with in case of the borrowers are e.g. transportation, paperwork, logistics and opportunity cost of time and, in the case of the lender, the TCs include manpower costs, office rental costs and other statutory requirements. The remoter the area, the more marginalized a group of people is, the higher are the TCs.

In the post liberalization era, when information - access is the key word, the commercial banks in the rural areas need to gear themselves up to reduce their information gap. One approach in this has been the growth of self-help group (SHG) movement. The findings from the research studies conducted by NABARD showed that the most important and immediate needs of the rural poor are to keep safe their occasional surpluses in the form of thrift and consumption loans to meet emergent lifecycle needs. The credit products of commercial banks need to be free from cumbersome procedures. The priority of the rural households and the poor is for consumption credit, small savings and production credit disbursed in time. The division of consumption credit and production credit for the rural poor is non-existent. Consumption requirements are met by the non-institutional informal sources like the moneylenders at exploitative rate of interest, as the poor borrowers are unable to offer to the banks any security for the small consumption loans. For the banks, extending small consumption loans involves high transaction cost due to asymmetry of information.

Based on these findings, NABARD started the micro finance initiatives in 1992, financing 500 self help groups (SHGs) across the country and the process has been an ongoing experiment. The emphasis here is on improving the access of the poor to micro finance rather than just micro credit. Here the NGOs act as the catalysts of change and combined social and economic agenda with synergic effect. The sustainability is the core factor in the entire process. The banking system accepted the SHG-bank linkage as a cost effective means of reaching the un-served and the under-served in the rural areas and accepted peer pressure as collateral substitute for recovery of loans. The movement has gained momentum and the total cumulative loans up to March 2002, was more than ten thousand million of rupees across the country.

The SHGs and the self-help promoting institutions (SHPIs) which work in a localized way have the comparative advantage of access to higher volume of information about the clientele vis-à-vis the banks and it is here that the SHPIs or the SHGs can become the best catalysts in addressing the credit requirements of the rural population with their felt requirements and channeling the supply of micro finance from the banking institutions in a viable and sustainable manner. However, at the formal institutional level, what is required is to increase the choice of credit products that can be availed of by the borrowers and simplify the procedures of borrowing. This can substantially reduce the element of asymmetry in information and the concurrent skepticism of lending institutions on the possible default by the borrowers can be minimized. This will in turn help to relieve the rural households from the usurious money lenders.

A crucial aspect of fostering trust and reciprocity in information access between transacting parties is the degree of certainty that the business relation will be viable and sustainable over a long period of time and the pay-offs for both the parties will offset the costs involved. In case of SHGs and SHPIs it is possible initially to peg the transaction costs at a lower level owing to its smaller size and structure of operation. With the growth in size the scales of operation change and also the transaction costs rise. It is here that the formal institutional agencies have the advantage over the informal non-institutional sources. As the size and scale of operation changes, informal trust graduates over to a trust on records and documentations. The SHGs which have emerged since the nineties have been trying to address this issue on the principle of mutual reciprocity-bridging the gaps in the local demand-supply through the locally available resources and seeking external sources for incremental needs.

Evaluation studies on the SHG-bank linkage programmes by NABARD states that 'the dimension and flexibility in SHG-banking now practiced in India is unmatched in world's banking system'. The findings from the Seibel and Dave study indicate that the 'SHG bank linkage programme is the largest non-directed micro saving and micro-credit programme in the developing world and its bank lending rates fluctuating at market rates around 7% in real terms-are among the lowest'. The study also revealed that non-performing loans (NPL) to SHGs were 0%, testifying to the effectiveness of group lending to the very poor. In contrast, NPL ratios of cash credit and agricultural term loans (ATL) were up to 55% and 62% respectively. Returns on average assets of SHG banking ranged from 1.4% to 7.5% by average and 4.6% to 11.8% by marginal cost analysis, compared to –1.7% to 2.35 consolidated. The operational self-sufficiency of SHG banking ranged from 110% to 165% by average and 142% to 286% by marginal cost analysis, compared to 86% to 145% consolidated. In contrast, return on assets (ROA) of cash credit varied from –10.2% to –0.5% and of ATL from-6.3% to 0.2%; operational self sufficiency (OSS) ratios from 54% to 102%. SHG banking has been found to be a robust financial product performing well in healthy and distressed financial institutions. The impact assessment study by V. Puhazendhi and K.C. Badatya, indicates that there has been significant increase in the asset structure, mean annual savings, average loan per member, average annual income and overall repayment percentage.

However, the euphoria generated by SHG-Bank linkage has to be viewed with caution. There are reasons for this-

- Micro credit as the panacea for poverty eradication is again an ill understood concept; not all poor want to be self employed- rather, the general approach to employment in the middle class and lower strata of the Indian society is a steady income from job/wage employment either on or off -farm.

- Attempts to push micro credit for poverty eradication can lead to a situation even worse than the pre micro credit phase for the people below the poverty line. As Hume and Moseley (1996) have revealed, the increase in income of the micro credit borrowers is directly proportional to their initial level of income- lower the income level to start with, lower is the impact. But, for those below the poverty line who have been pushed with micro credit ended up with less incremental income than a controlled group who are not pushed with micro credit.

- Credit is not the only financial service required by the poor. The example of SEWA bank in India shows that women, at least value a safe place to keep their savings. Another important necessity of the poor is the safety insurance – where insurance of crops and livestock is of paramount importance, more important than life insurance. However, in respect of occupations like fishing, mining etc. which are unorganized in the informal sector, life insurance is a necessity in the absence of which the families involved have a wholly unsecured future.

- The experience with cheap credit has shown that rural enterprises do not turn out successful by pumping in credit. Credit is a necessary input but not a sufficient condition for success of a micro enterprise. A comprehensive and realistic perspective has to be incorporated into the whole scheme of things which takes into account the culture, environment, resource endowment, marketing and other forward linking activities.

- The problem of principal –agent game is another aspect which cannot be totally removed from the SHG-Bank linkage programme. The SHGs who have the dual agent role (for the bankers and the borrowers) enjoy the information advantage and the element of opportunism cannot be wiped out.

Conclusion

The existing rural credit delivery system in India has evolved over the years prior to independence as an agent of carrying forth the government's rural development programmes. The efforts lacked a clear theoretical framework without incorporation of policy changes required for the identified structural and operational impediments in the delivery system. The changes effected were in respect of thrust approach and these served the purpose of fulfilling the government's target achievement in respect of rural credit. This resulted in faulty identification of beneficiaries and opened the scope for rent seeking which led to erosion of trust and qualitative banking services in the rural areas. Credit gaps continue to exist and the target orientation of priority credit in the rural areas failed to achieve the expected results. The quantitative targets had been achieved but the target oriented approach had left its adverse impact on the rural credit system- with high transaction costs due to asymmetry of information and also opportunistic behaviour at the bottom level of the banking system leading to conflict in the cannons of social banking and business policies. The poor monitoring and recovery led to erosion of profitability of the bank branches.

The *loan melas* and the debt write offs came as a benefit to the willful defaulters while they acted as penalty for those who honoured the transaction deals with the banks. The bank branches in the rural areas suffered from high transaction costs due to:

- Interventions with targeted credit rather than felt need credit
- Poor loan appraisal and monitoring due to information asymmetry
- High default rate due to conflict of interests between multi agencies in the principal- agent model with each agent acting as principal to the other.
- Marketing problems-one, internal to the commercial banks which failed to develop and market credit products suited to the needs of the rural borrowers and

second, the external marketing problem, that of the borrowers with their end products; both arising out of information asymmetry.

The physical proximity and information advantage of the informal sources like the village money lenders with regard to the rural borrowers make them more efficient in assessing loan risks. The rural credit delivery is only an intermediating agent and cannot bring about development by itself. Also cheap and concessional credit as evidence has shown cannot deliver results. Besides, the easy money policy opens scope for nepotism and favouritism and this spells doom for any development policies. The low interest margins in the rural credit results in low or negative profits and the bank branches have been burdened with non performing assets (NPAs). Besides, a significant point that missed the attention of the policy planners was inculcating thrift in the rural poor. It was wrongly perceived that cheap credit delivery would assist the rural poor to acquire assets and help him in sustainable income generation activities. Rather, the poor need financial services which can address their small requirements of consumption credit to be met out of their own small savings product. The entire approach to the rural banking was designed on a theoretical perspective of easy money policy sans economic rationality and commercial viability. In the pursuit of social banking the ethos of business in the banking was overlooked and this led to contradiction between business of rural banks and their social obligatory roles. But the cannons of banking business do not contradict with social responsibilities if some elements of market forces are introduced. However, in a system wrought with information asymmetry or induced information asymmetry, the whole approach to rural banking was built up on a fragile theoretical framework which failed to deliver qualitative services and bail out the rural poor from indebtedness. The motto of good growth of the rural development policies ended up with pockets of what Mahbub-ul-haq calls; jobless growth resulting in a higher volume of unemployment, voiceless growth where the people for whom it had been designed did not have any say, ruthless growth where marginalization of the poor had increased which eventually had led to growth of urban poverty, rootless growth where communities had been marginalized on ethic lines and displaced from their surroundings and above all a futureless growth where questions were raised about the sustainability of the efforts.

As emphasized by renowned historian Arnold Toynbee and Daisaku Ikeda, the well known social reformist and educationist, it is not the amount of goods and services produced in the country in a year which is important, rather more important is the fact how these services have catered well to the needs and services of the citizens. The emergence of SHGs is significant in this respect where the SHG bank linkage has led to reduction in the quantum of loan and number of borrowers from the moneylenders with high rate of interest. Further, the asymmetric information between the bankers and the borrowers has been substantially reduced. The borrowers have a higher volume of information on the range of credit products and accessibility to the same through the SHGs. At the same time these SHGs, who have full information about the borrowers also reduce the risk hazard of default and non-repayment for the bankers through their monitoring and supervision. However, institutional linkage of SHG and bank cannot totally ignore the problem of opportunism which still remains implicit in the process. This cannot be questioned on any moral rhetoric as SHGs are also business entities in a space where the present trend of market forces ensures the survival of the fittest. Efforts are rather needed to make strategies where neither the SHGs nor the rural branches of the commercial banks nor the borrowers become at least worse off than their previous Pareto optimal situation.

Notes:

1. Transaction Cost: Costs of implementing an investment strategy including commissions, fees, execution costs and opportunity costs. Commissions are fees paid to brokers to trade any financial service. Other fees include custodial and transfer fees. Execution costs reflect the difference between the execution price of a security and the price that would have existed in the absence of the trade, e.g., the result of the bid-ask spread and a price concession. Opportunity cost of not transacting, such as when a trade fails to be executed. (Cited from Encyclopedia of banking & Finance-Tenth Edition; Charles J. Woelfel: S.Chand & Company Ltd., New Delhi-110055. page 1140).

2. As per the estimate of NSS 48th Round, the share of institutional agencies in the total debt of rural households is 64 percent, and share of commercial banks is 33.7 percent. The share of institutional agencies in the rural debt of cultivator households is 66.3 percent and non cultivator households are 55.3 percent. The corresponding share of commercial banks for cultivator households groups is 35.2 percent and cooperative agencies are 23.6 percent. The figures for non cultivator households are; commercial banks 27.9 percent and cooperatives 14.2 percent

3. 1954: All India Rural credit Survey, 1960: Committee on Cooperative Credit, 1963: Agriculture Refinance Corporation set up which was then changed to Agricultural Refinance Development Corporation in 1975 and subsequently to NABARD in 1982, 1968: National credit Council which indicated three sectors- agriculture, small-scale industries and exports - as deserving priority treatment in the matter of bank credit, 1969: Rural credit Review Committee and nationalization of 14 major commercial banks, 1972: Banking Commission made the recommendation for the creation of Rural Banks, 1975: Regional Rural Banks set up following the recommendation of the Working Group on Rural Banks under the chairmanship of M. Narasimhan, 1978: the Government of India set before the public sector banks the target of providing one third of their credit outstanding to all priority sectors including exports and in March 1980, this target was revised upward to 40% to be attained by 1985, 1980: Nationalisation of six more commercial banks, 1985: Chakravarty Committee advocating the necessity of moving away from quantitative controls, 1989:Service Area Approach under which 20-25 villages assigned to bank branch for meeting credit needs, in the designated area, 1992: Financial Sector Reform following Narasimhan Committee Report 1991.

References:

Hoff, K. and J.E., Stiglitz. (2001), "Modern economic theory and development", in *Frontiers of development economics - The future perspective*. Meier, G.M. and J.E.,Stiglitz (eds.): 389-459. New York and Washington DC, USA: Oxford University Press and World Bank.

Erhardt, W. (2000). *Small enterprise finance in urban and rural Northern Thailand*. Ph.D. Thesis. University of Hohenheim, Department of Development Theory and Agricultural Policy in the Tropics and Subtropics.

Karmakar, K.G. (1999), *Rural Credit and Self-Help Groups: Micro-finance Needs and Concepts in India,* Sage Publication, New Delhi.

Williamson, O.F. (1998), "The new institutional economics: Taking stock/looking Ahead", *International Society for New Institutional Economics* 2 (2): 9-20.

Shetty, S.L. (1997), "Financial Sector Reforms in India: An Evaluation", *Prajnan,* Vol.25, N0.3-4, National Institute of bank Management.

Jadhav, N. and D. Ajit, (1996-97), "The Role of Banks in Economic Development of India"; *Prajnan*, NIBM, Pune; VOL.XXV, Nos.3-4, 310.

Demetrigades, P.O. and Lunintel, K.B.(1996), "Financial Development, Economic Growth and Banking Sector Controls: Evidence from India"; *Economic Journal*, 106.

Humphrey, John and Hubert. Schmitz, (1996), "Trust and Economic Development": IDS Discussion Paper 355 Brighton: IDS.

Fukuyama, Francis (1995), *Trust-The Social Virtues and the Creation of Prosperity,* New York Press, Paper backs.

Eggertsson, T. (1990), *Economic Behavior and Institutions:* Cambridge, MA, USA: Cambridge University Press.

Cheung, Steven (1983), "The Contractual Nature of the Firm," *Journal of Law and Economics* 26 :1-21.

Fry, M. J. (1980), "Savings, Investment, Growth and the Cost of Financial Repression"; *World Development*, 8.

Klein, B. Crawford, R. and Alchian, A. (1978), "Vertical Integration, Appropriate Rents, and the Competitive Contracting Process," *Journal of Law and Economics* 21: 297-326.

Williamson, Oliver (1975), *Makers and Hierarchies,* Free Press, New York.

Alchian, Armen and Demsetz, Horold (1972), "Production, Information Costs, and Economic Organisation", *American Economic Review* 62 (December):777-95.

Lewis, W.A. (1969), *The Economics of Underdevelopment* Oxford University Press, NewYork.

Coase, Ronald (1960), "The Problem of Social Cost," *Journal of Law and Economics* 3(1):1-44.

Coase, Ronald (1937), "The Nature of the Firm," *Economica* 4 (16):386-405.

Reserve Bank of India (1991), *The Report of The Committee on Financial Sector Reforms*, *(Chairman: M. Narsimhan)*, Mumbai

Mf in India-An Overview. http://www.nabard.org/roles/mcid/section1.htm, http://www.nabard.org/roles/mcid/studiessummary.htm