Reforms in Institutional Finance for Inclusive Growth

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Abstract

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

Keywords: Development finance; Financial system, Rural financial institutions, Poverty; Governance; Reforms

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

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1. Introduction

A well-recognized in economic literature observes that efficient, broad-based and deepened financial markets can lead to increased economic growth by improving the efficiency of allocation and utilization of savings in the economy. Better functioning financial systems ease the external financing constraints that impede firm and industrial expansion and establish strong, positive link between the functioning of the financial system and long-run economic growth[1].

There can be three dimensions of effective financial systems: (i) First, there is an institutional dimension, which includes the regulatory and judicial framework and the quality of institutions, (ii) Second is the market dimension, which includes the traditional measures of size and access to finance; financial innovation; and residents' access to finance, and (iv) The third dimension is market performance, including measures of technical efficiency, liquidity, and distribution of domestic assets base. A well-developed financial sector performs the important functions like: (a) promote overall savings of the economy by providing alternative instruments; (b) allocate resources efficiently among the sectors; and (c) provide an effective channel for the transmission of policy impulses. It is well founded that a typical competitive financial sector has characteristics like: (i) there should be large number of buyers and sellers of the financial product; (ii) the price of the product is determined by the market forces of demand and supply; (iii) there should be a secondary market for the instrument; (iv) turnover of the instruments in both primary and secondary markets should be fairly large; and (iv) agencies involved in the process of intermediation between buyers and sellers should provide intermediation services at a minimum spread.

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

This article attempts to examine the need, role, and effectiveness of Institutional reforms in development finance in making services work for the poor in the context of Indian economy. In section 2, the theoretical considerations in the context of development economics in support of the institutional reforms drawn from the new institutional economics are discussed. Section 3 presents the current state of affairs of the rural financial sector in India with a focus on financing for rural and agricultural sector; particularly the structure and performance of Commercial Banks (SCBs) Regional Rural Banks (RRBs), Rural Credit Cooperatives and Microfinance Institutions (MFIs). In section 4, the discussion on the need for reforming the Indian Rural Financial Architecture is presented with some valuable suggestions and finally section 5 provides the summary and conclusion of the article.

2. Institutions and Economic Development

New Institutional Economics (NIE), which endeavors to integrate a theory of institutions into economics, argues that institutions matter, the relationship between institutional structure and economic behavior requires attention, and the determinants of institutions can be analyzed with the aid of economic theory. Led by renowned economists such as Ronald Coase, who explicitly introduced transaction costs into economic analysis (Coase, 1937), Oliver Williamson, who introduced the term 'transaction costs' in economic analysis (1975), and Richter (2005). Unlike neoclassical economics, the institutional framework is not assumed as given but is explicitly treated as an object of research, and the implications of any given institutional arrangements for economic behavior are taken into account (Richter, 2005).

2.1 Efficient Institutions and Economic Performance

[1] "Sunlight is the best disinfectant", wrote Justice Brandeis of United States Supreme Court in a landmark judgment and the phrase was later popularized by the president Franklin Roosevelt in justifying the extensive financial sector reforms in 1930s arguing that making public the activities and the state of a financial or industrial firm has a number of positive consequences. This underlines the importance of transparency, governance and the need for institutional reforms.

Only efficient institutions are growth promoting as they encourage individuals to engage in productive activities by rendering appropriate incentives and establishing a stable structure of human interactions that reduce uncertainty. It is opined that there can be two types of efficiency: (i) substantive efficiency (i.e., a rule promotes allocative efficiency), and (ii) procedural efficiency (i.e., a rule is designed to reduce the cost or increase the accuracy of using the system of rules). However, Chu (2003) argues that affluence in developed countries is a cumulative result of 'efficient institutions', while poverty in poor countries is a result of 'inefficient institutions'.

Successful institutions are believed to be those that are contract enforcing as well as coercion constraining; that is, they reward production and exchange rather than mere expropriation and redistribution. However, on the other hand in developing countries, institutional frameworks are found to overwhelmingly favor activities that promote redistributive rather than productive activity, that create monopolies rather than competitive conditions, and that restrict opportunities rather than expand them (North, 1990). Accordingly, NIE suggests that countries need two distinct and (not necessarily) complementary sets of institutions: (i) those that promote exchange by lowering transaction costs and promoting trust, and (ii) those that induce the state to protect rather than expropriate private property, to cope with the challenge of development.

2.2 Governance Reform for Institutional Development

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

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

However, the dynamics of institutional change, especially the interplay between economic and political markets is a complex aspect that needs to be understood before embarking upon institutional reforms. Since institutions are by nature deeply embedded in society, and if growth truly necessitates major institutional transformation in such areas as rule of law, property rights protection and governance, among others, then the prospects for growth would seem to be dismal in poor countries. In explaining why "good" economic policies based on "correct" economic theories have so consistently failed, orthodox economists now invoke institutions. That is, the countries that implemented their policies did not have the right institutions, which is why they did not work and not because they were wrong to begin with. As a result, the original Washington Consensus of "stabilize, privatize, and liberalize" has now been augmented by a long list of so-called "second generation" reforms that are heavily institutional in nature (Rodrik, 2006). The World Bank and the IMF have been emphasizing the role of institutions in economic development.

2.3 Financial Development and Poverty Reduction

A good strand of economic literature has established that beyond long-run growth, finance can also lessen the gap between the rich and the poor and the degree to which that gap persists across generations. Furthermore, it has potentially profound implications for poverty and income distribution by affecting the allocation of capital, as it can alter both the rate of economic growth and the demand for labor. There is an emerging body of empirical research, suggesting that in practice, improvements in financial contracts, markets, and intermediaries actually do tend to expand economic opportunities and reduce persistent income inequality. As such, it is important to care about the process of financial development as it has a well-documented nexus with economic and social development and a significant role in attaining sustainable long-term growth and poverty alleviation thereby enhancing social welfare.

Growth is good, Sustained high growth is better and Sustained high growth with inclusiveness is best of all. Inclusive growth in the economy can only be achieved when all the weaker sections of the society including agriculture and small-scale industries are nurtured and brought on par with other sections of the society in terms of economic development (Swamy, 2010).

2.4 Governance and Financial Regulatory Agencies

Governance is a concept that has evolved noticeably since it emerged in discussions of development issues during the late 1980s. World's top multinational organisational agencies such as World Bank, International Monetary Fund (IMF), European Union (EU), United Nations Development Programme (UNDP), and Asian Development Bank (ADB) have developed their own definition of governance. While, UNDP defines governance as the exercise of political, economic, and administrative authority to manage a society's affairs, ADB defines governance as the manner in which power is exercised in the management of a country's social and economic resources for development. The World Bank uses the same definition. On the other hand, for EU 'governance' means "rules, processes and behaviour that affect the way in which powers are exercised at European level, particularly as regards openness, accountability, effectiveness and coherence

2.5 The Role of the State in Financial Infrastructure

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

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

2.6 Credit Information as a Public Good

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

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

3. Overview of the Indian Financial Sector

Indian economy being a bank-dominated financial system with more than 75 percent of financial assets held by Scheduled Commercial Banks (SCBs), it is desirable to strengthen and stabilize banking system. Though India indulges in self-praise of its stable banking system, on an international comparison its position is rather not satisfactory, as other banking systems have made significant strides in their structure as well as their performance (Table-3.1). India is way behind many of its peers when compared in terms of ATMs per 100,000 adults (8.90); whereas Indonesia (16.47), Malaysia (56.43), South Africa (60.01), and Brazil (119.25). Advanced banking systems like Australia (166.92), UK (122.77) and USA (173.43) are quite ahead. In terms of outstanding loans from commercial banks as percent of GDP too India (51.75%) is a laggard when compared to China (108%), Malaysia (104%), South Africa (74%) and Russia (64%).

Table 3.1: Structure and Performance of Banking Systems around the World

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

Source: Compiled from IMF data

When compared with OECD benchmark the banking parameters of Indian Banking are way behind particularly under the indicators; (i) branches per 1000 Sq. Kms, (ii) ATMs per 0.1 million; and ATMs per 1000 Sq. Kms (refer Table 3.2).

Table – 3.2: Key Banking Parameters for India 2004-11

Indicator	2004	2005	2006	2007	2008	2009	2010	2011	Benchmark OECD
Branches per 0.1 million	8.9	8.9	8.9	9.0	9.3	9.6	10	10.6	10–69
ATMs per 0.1 million	-	-		3.3	4.2	5.2	7.1	8.9	47–167
Deposit accounts per 1000 people	607	607	618	648	711	794	864	953	976 -1671
Loan accounts per 1000 people	88	100	100	124	130	132	139	142	248–513
Branches per 1000 Sq. Kms	22	23	23	24	25	27	28	30	159
ATMs per 1000 Sq. Kms	…	…	…	9	11	14	20	25	437

Source: Financial Access Survey of IMF

Note: The benchmark indicator ranges are for select high-income OECD countries such as Australia, Canada, France, Germany, Italy, Japan, The Republic of Korea, New Zealand and the United States.

Importance of access to finance for the poor arises from the problem of financial exclusion of nearly 3 billion people from the formal financial services across the world. With only 34% of population engaged in formal banking, India has, 135 million financially excluded households, the second highest number after China. Further, the real rate of financial inclusion in India is also very low and about 40% of the bank account, holders use their accounts not even once a month. Indian Banking data reveals that credit exclusion is severe in 139 districts of the country. In these districts, only 10 per cent or less out of 100 persons have access to credit from the fact that the exclusion is large, there is also a wide variation across regions, social groups and asset holdings. The poorer the group, the greater is the exclusion (Rangarajan, 2007). The results of the All-India Debt and Investment Survey of 2002, also indicate that the share of the non-institutional sources, in the total credit of the cultivator households, had increased from 30.6 percent in 1991 to 38.9 percent in 2002 (Karmakar, 2002). According to the NSSO Survey 59th Round; 51.4% of farmer households are financially excluded from both formal/informal sources (459 lakh out of 893 lakh), Of the total farmer households, only 27% access formal sources of credit; one third of this group also borrow from non-formal sources and Overall, 73% of farmer households have no access to formal sources of credit.

Inspite of the directed credit policy of the government, India continues suffer from inadequate flow of finance to rural and agricultural sectors, with the overall credit to deposit ratio (CDR) still hovering around 70 percent. Food credit, which often is directed towards rural and agricultural sectors, is experiencing unsatisfactory and unsteady growth rates (table 3.3).

Table – 3.3: Select Macroeconomic Aggregates of SCBs in India

(Note: Amount in INR Billion)

	Aggregate Deposits	Food Credit	Growth rate of Food Credit In %	Non-Food Credit	Bank Credit	Credit as percent to Aggregate Deposits	As percent to GDP	
							Credit	**Aggregate Deposits**
2010-11	52079	642	0.33	38778	39420	75	50	66
2009-10	44928	484	0.05	31962	32447	72	49	68
2008-09	38341	462	0.04	27293	27755	72	49	68
2007-08	31969	443	-0.05	23175	23619	73	47	64
2006-07	26119	465	0.14	18846	19311	73	45	60
2005-06	21090	406	-0.01	14663	15070	71	40	57
2004-05	17001	411	0.14	10593	11004	64	33	52
2003-04	15044	359	-0.27	8048	8407	55	30	54
2002-03	12808	494	-0.08	6797	7292	56	29	52
2001-02	11033	539	0.35	5357	5897	53	25	4
2000-01	9626	399	0.56	4714	5114	53	24	45
1999-00	8133	256	0.53	4102	4359	53	22	41
1998-99	7140	168	0.35	3520	3688	51	21	40
1997-98	5984	124	0.64	3115	3240	54	21	39
1996-97	5055	75	-0.22	2708	2784	55	20	36
1995-96	4338	97	-0.20	2442	2540	58	21	36
1994-95	3868	122	0.13	1992	2115	54	20	38
1993-94	3151	109	0.62	1535	1644	52	19	36
1992-93	2685	67	0.44	1452	1519	56	20	35
1991-92	2307	46	-	1209	1255	54	19	35

Source: Compiled from RBI Database Note: 1 USD = INR 62.6981 as of 25.09.2013

3.1 Rural Finance by SCBs

Credit flow to agriculture, which is the main occupation of rural India, has been unsteady inspite of the renewed focus frequently emphasized by policy makers and experts on Indian Economy. Though the institutional lenders continue to cite their own concerns and constraints like; vagaries of rainfall; chronic defaults; inadequate collaterals; problems in marketing of agri-produce; exploitation by middlemen and others, inadequate flow of credit to agriculture (refer table-3.4) still remains a huge concern for economic development in India. There is a greater need to reform the flow of institutional finance to agriculture and ensure steady and increasing flow of credit to this vital sector to achieve inclusive growth.

Table–3.4: Flow of Credit to Agriculture from SCBs

(Note: Amount in INR Billion)

Year	Direct	Indirect	Total	Direct Growth	Indirect Growth	Total Growth
1992	173.97	14.33	188.30	0.08	0.21	0.09
1993	189.49	15.52	205.01	0.09	0.08	0.09
1994	194.65	20.99	215.64	0.03	0.35	0.05
1995	213.34	28.65	241.99	0.10	0.36	0.12
1996	238.14	36.74	274.88	0.12	0.28	0.14
1997	274.48	49.86	324.34	0.15	0.36	0.18
1998	294.43	63.35	357.78	0.07	0.27	0.10
1999	330.94	81.17	412.11	0.12	0.28	0.15
2000	364.66	129.68	494.34	0.10	0.60	0.20
2001	404.85	188.25	593.10	0.11	0.45	0.20
2002	465.81	182.38	648.19	0.15	-0.03	0.09
2003	568.57	236.90	805.47	0.22	0.30	0.24
2004	707.81	285.20	993.01	0.24	0.20	0.23
2005	955.65	360.71	1316.3	0.35	0.26	0.33
2006	1347.98	571.75	1919.7	0.41	0.59	0.46
2007	1721.28	825.64	2546.9	0.28	0.44	0.33
2008	2146.44	934.43	3080.8	0.25	0.13	0.21
2009	2648.93	1107.02	3755.9	0.23	0.18	0.22
2010	3177.67	1455.54	4633.2	0.20	0.31	0.23
2011	3602.53	1469.23	5071.7	0.13	0.01	0.09

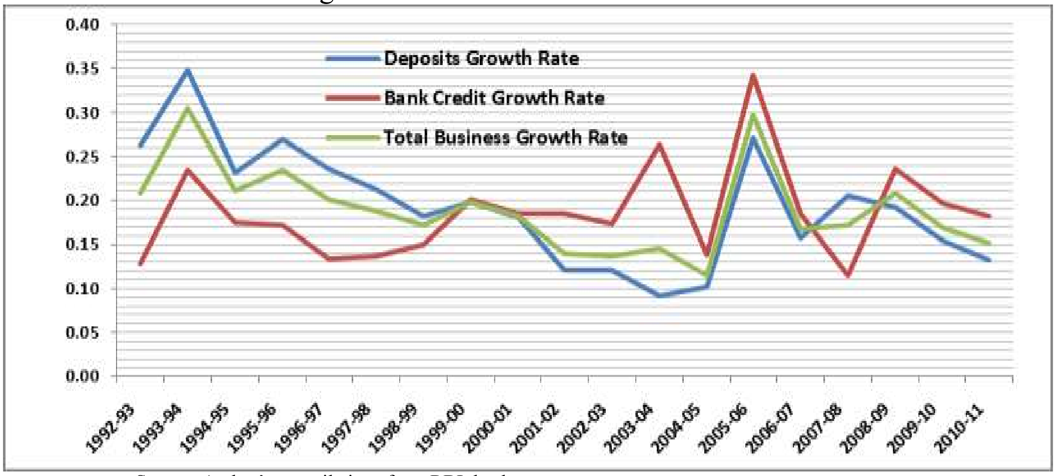
Source: Indian Economy database of RBI Note: 1 USD = INR 62.6981 as of 25.09.2013

Further, Region-wise exclusion is most acute in Central, Eastern and North-Eastern regions – having a concentration of 64% of all financially excluded farmer households (from formal sources) in the country (415.61 lakh households out of 649.54 lakh households).Overall indebtedness to formal sources of finance alone is only 19.66% in these three regions (4.09% for North-Eastern Region, 18.74% for Eastern Region and 22.41% for Central Region). The un-banked population is higher in the North Eastern and Eastern regions (Thorat, 2007). Exclusion among the Occupational Groups is observed as; Marginal farmer households constitute 66% of total farm households. Only 45% of these households are indebted to either formal or non-formal sources of finance (small farmers – 51%, medium farmers – 65.1% and large farmers – 66.4%). About 20% of indebted marginal farmer households have access to formal sources of credit (medium farmers – 57.6% and large farmers – around 65%). Among non-cultivator households, nearly 80% do not access credit from any source. The financially excluded sections largely comprise marginal farmers, landless labourers, oral lessees, self-employed and un-organized sector enterprises, urban slum dwellers, migrants, ethnic minorities and socially excluded groups, senior citizens, and more importantly women. Thus, financial exclusion is a serious concern among low-income households, mainly located in rural areas.

3.2 Rural Finance by RRBs

Regional Rural Banks, which were formed in 1975 as state owned banks with a mandate to finance rural sectors and with a clear focus on agriculture and weaker sections too have not met with any great success even after their existence since almost four decades. Inspite of couching support from the government, the business of RRBs continues to be meager in the range of 15 to 20 percent (Figure-3.1). Further, although RRB branch presence is remarkable in the rural areas, their performance in the provision of financial services is not commensurate. At present, RRBs' share in agriculture credit is 8% while that of commercial banks is about 50% and that of CCS is 42%. Such low market share coupled with poor financial performance raises serious issues about the RRB model. Studies have also pointed out that in an effort to meet financial performance expectations of shareholders, RRBs appear to be drifting from their mission to serve the underserved and unreached in a cost effective way.

Figure–3.1: Trend of Business of RRBs



Source: Author's compilations from RBI database

3.3 Rural Finance by Cooperatives

Credit Cooperatives in India claim their formal origin since 1904 from the Cooperative Societies Act and quite a long history even greater than that of their Chinese counterparts, which came into formal existence only in 1958. However, in terms of their loan outreach, Indian Credit Cooperatives have failed miserably when compared to their Chinese counterparts. While the annual growth rate of flow credit from Indian Cooperatives is in the negative range (Table-3.5), the Chinese credit cooperatives are experiencing growth in the range of 45 to 55 percent.

Table – 3.5: Flow of Credit by Cooperatives

(Note: Amounts in INR Billion)

Year	PACSs	SCARDBs	PCARDBs	TOTAL	Growth Rate
2010-11	…	101.2	56.2	157.5	0.85
2009-10	764.8	169.9	115.1	1049.1	-0.15
2008-09	640.4	162.7	112.2	915.3	0.04
2007-08	656.6	183.2	118.0	957.9	-0.07
2006-07	586.2	186.4	121.7	894.4	-0.09
2005-06	517.7	176.7	128.7	823.2	-0.04
2004-05	487.8	174.0	126.3	788.2	-0.10
2003-04	438.7	162.2	113.3	714.3	-0.04
2002-03	424.1	153.3	108.0	685.5	-0.06
2001-02	407.7	141.1	100.0	648.9	-0.17
2000-01	345.2	125.9	82.7	553.9	-0.16
1999-00	285.4	115.9	75.7	477.1	-0.48
1998-99	148.9	104.4	68.1	321.5	-0.11
1997-98	139.9	91.8	58.4	290.1	-0.10
1996-97	133.4	80.1	49.3	262.9	-0.10
1995-96	129.8	68.5	40.9	239.3	-0.57
1994-95	99.9	25.0	27.0	152.0	-0.07
1993-94	93.9	20.	27.0	141.9	0.03
1992-93	102.5	19.6	24.8	146.3	-0.41
1991-92	81.7	0.3	21.4	103.5	…

Source: Author's compilations from RBI database
Note: 1 USD = INR 62.6981 as of 25.09.2013

Indian Credit Cooperative sector is of three tier structure comprising; Primary Agricultural Credit Societies (PACSs); Primary Cooperative Agricultural and Rural Development Banks (PCARDBs); and State Cooperative Agricultural and Rural Development Banks (SCARDBs). While District Central Cooperative Banks (DCCBs) fund the PACSs, PCARDBs are funded by SCARDBs. Though, on an average, there is one PACS for every 6 villages, the growth rate of overall credit by credit cooperatives is indeed in the negative range which is a much concerning factor. Figure 3.6 presents a snapshot of the performance of the PACSs during the pre and post reform period. Even after in existence since more than a century, cooperatives have not been successful in terms of either financial sustainability or outreach.

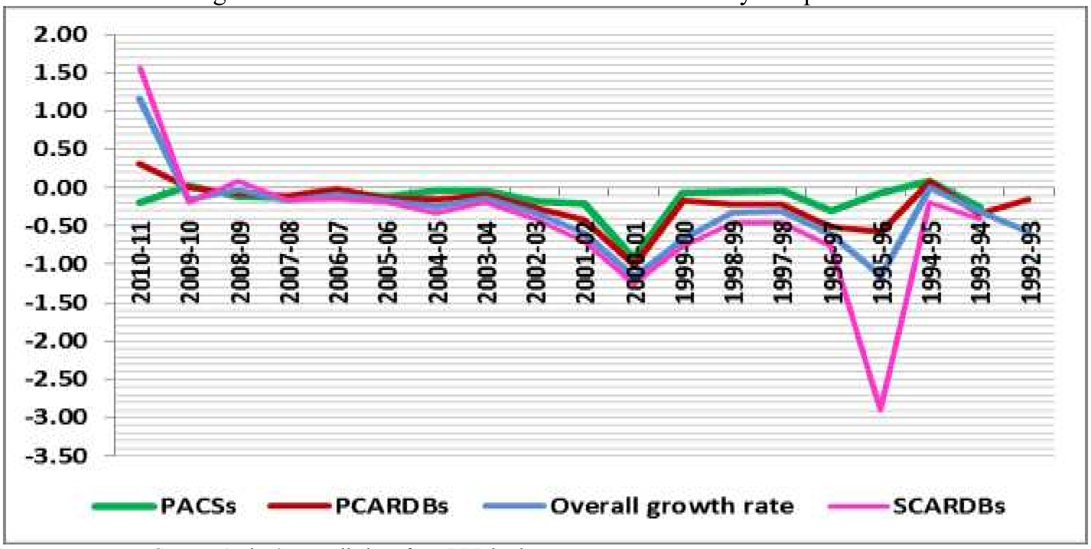
Table – 3.6: Snapshot of Performance of PACSs – Pre and Post Reform period

Performance per PACS	1993-94	2003-04	2010-11
Membership	972	1281	1298
Number of Borrowers	552	485	561
Working Capital (in INR millions)	1.7	5.86	15.43
Reserves (in INR millions)	0.08	0.30	0.73
Deposits (in INR millions)	0.22	1.71	3.98
Loans and Advances (in INR millions)	1.15	4.14	9.39
Over dues (in INR millions)	0.45	1.54	2.42

Source: NAFSCOB Note: 1 USD = INR 62.6981 as of 25.09.2013

Figure 3.2 presents the trend of institutional credit by cooperatives including PACSs, PCARDBs, SCARDBs and the overall cooperative sector during the post reform period. It is concerning to note that the annual growth rate in terms of outstanding credit is experiencing a negative growth during most part of the post reform period (almost upto 2009-10).

Figure – 3.2: Growth Rates of Institutional Credit by Cooperatives



Source: Author's compilations from RBI database

3.4 Problem of Demand – Supply Gap

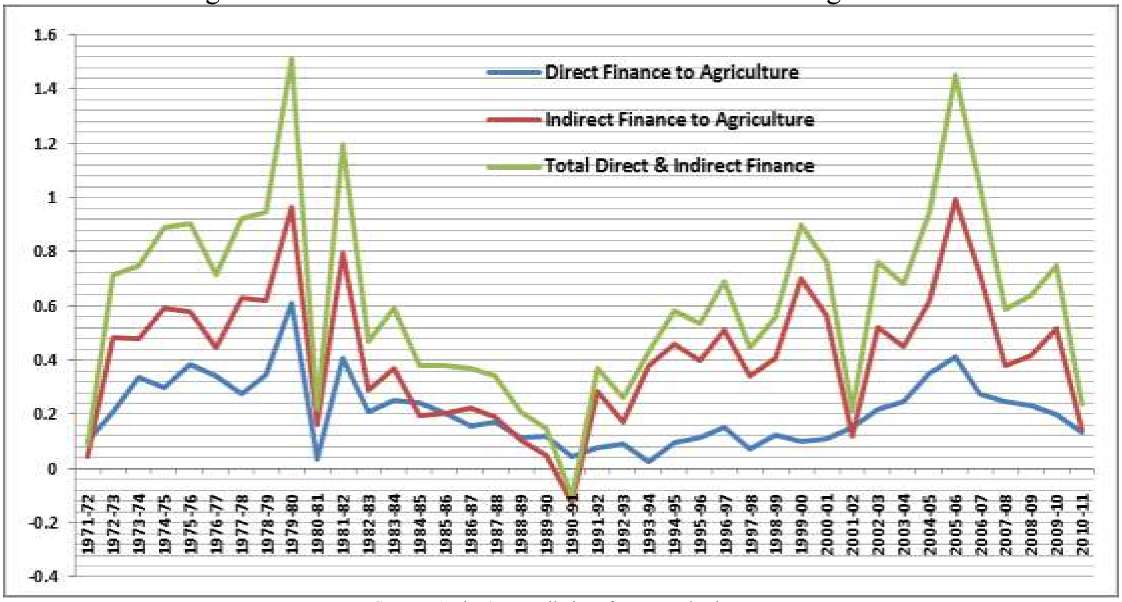
India's Rural Financial Sector (RFS) is subject to systemic policy issues and pervasive institutional weaknesses. Lack of autonomy and weak governance have affected sustainability of Rural Financial Institutions (RFIs) and constrained outreach. This, among others, impedes diversification to non-farm activities for supporting value addition and employment generation. Further, the risks in RFS due to droughts and floods are accentuated by the weak rural infrastructure and by production and marketing bottlenecks. The resulting low prices, productivity, and profitability make it difficult for the rural sector to compete for capital with urban areas. Rural credit is only 10% of total commercial bank advances. Thus, a demand and supply gap exists, despite the extensive RFS. The rural poor and women, in particular, have inadequate access to financial services and the disadvantages that the rural poor face due to limited access to finance are accentuated by the inadequacy of risk mitigating instruments to insure against the risk they face.

4. Financial Services towards Inclusive Growth

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

For achieving the objective of sustainable and inclusive economic growth, it is important to bring the under-served sectors/sections of society within the domain of institutional finance. In the Indian context, the flow of Institutional finance to agriculture (refer figure 4.1) has been skewed and uneven in terms of both period and quantum.

Figure–4.1: Growth Rates of Institutional Finance to Agriculture



Source: Author's compilations from RBI database

4.1 Reforming the Rural Financial Architecture

Keeping in view the dynamics of the changing economy, there is a strong need to reform the rural financial system. The present system that was enshrined in the late 70s greatly needs a rigorous relook. Reforms in the rural financial architecture should be focused towards evolving a new financial architecture to suit the needs of inclusive growth. Regional Rural Banks – the unfinished agenda of the Indian rural financial system need to be revitalized; (i) by liberating them from the clutches of their sponsor banks (ii) Government of India has to become proactive like the way China has been doing in the case of its policy banks towards achieving the larger goals of inclusive growth (iii) bring in new talent which is abundantly in the open market at the senior management level to bring in professionalism and focus in their operations instead of continuing them as the retiring rooms of the sponsor bank executives. Compared to the vision and focus with which RRBs were instituted by the late Prime Minister Mrs. Indira Gandhi in 1975, they have failed to reach the expectations.

Is Privatization of RRBs a good measure?

Simply a mad rush approach towards privatization, particularly in the Indian context is harmful given the experience of privatization in the Indian financial sector since 1992-93. Indian privatization saga has failed to demonstrate their commitment to provision of services to the needy and the poor. Besides the private banks have not made any inroads into rural areas for provision of financial services which establishes clearly their biased approach.

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

Table–4.1: Institutional Reform Measures for RRBs

Domain	Current measure	Suggested reform measure
Legal Framework	RRB Act, 1976	Merger with BR Act 1949
Regulation and Supervision	Multiple regulators like; Sponsor Banks, NABARD, RBI etc.,	Single regulator i.e. RBI
Governance	RRB Boards lack professionalism as dominated by the whims and fancies	Boards need to be inducted with qualified professionals and experts along with the nominated members.

	of the sponsor bank official (with conflict of interest) on the board whose bank in turn is a competitor to the same RRB for which he is the director.	Many RRBs staff complains about the high handedness of Sponsor Bank officials. As such, measures need to be taken to free the RRBs from the clutches of sponsor banks. RRB Chairmen should be recruited based on merit, suitability, expertise, experience and worthiness rather than on seniority
Benchmarking	Currently no bench marking has been possible due to the inherent diversities and heterogeneities.	Benchmarking could be done once uniform measures are introduced and relevant measures be introduced for benchmarking.
Technology induction for MIS and Customer Service	Technology has been inducted haphazardly in their own individualistic approach.	Uniform and standard computer technology needs to be inducted across all the RRBs on par with commercial banks
Human Resource Development	Most of the RRBs suffer from incapable and untrained staff that seems to be inefficient.	Rigorous training and management development programmes required to be offered to the current staff and up gradation of their skills is foremost in carrying out their responsibilities. Career path need to well laid out based on merit and performance instead of on seniority alone. Accordingly, relevant laws need to be amended.

4.2 Reforming the Cooperatives

Cooperative sector needs revitalization as had been often deliberated (refer Vaidyanathan, 2004). The revival package based on the Vaidyanathan Committee recommendations and after due deliberations was a combination of legal and institutional reforms, capital infusion and technical support for capacity building. The implementation of the action Plan [ADB 2010] of the revival package was perceived to result in the emergence of a strong, self-reliant and well-knit network of rural cooperative credit system. The implementation of the revival package involved planning and execution of a series of action plans for: (i) facilitating legal, regulatory and governance framework; (ii) institutional reforms for sustainability; (iii) financial package and; and (iv) eligibility norms. However, no perceptible change has been felt on the ground more probably due to the lack of political will in the implementation of the reforms. Given this background some plausible institutional reform measures for credit cooperatives are suggested here below (table 4.2).

Table–4.2: Institutional Reform Measures for Credit Cooperatives

Domain	Current measure	Suggested reform measure
Legal Framework	State Cooperative Laws	Enact new national cooperative laws and measures to encompass the state laws
Regulation and Supervision	Multiple regulators like; state governments, NABARD, RBI etc.,	Single regulator i.e. NABARD
Accounting Standards	Different standards, age old and archaic, not smooth and transparent for audit and supervision.	Transparent and uniform accounting standards in accordance with the international practices
Auditing	Currently state government officials perform the audit	Instead the audit responsibilities have to be vested with the regulator/supervisor i.e. NABARD
Governance	Local Boards are dominated by the whims and fancies politicians and state government officials	Boards need to be inducted with qualified professionals and experts along with the elected members.
Recruitment of Staff	Locally appointed under the influence of the local politicians and state government officials resulting in heterogeneity.	National level recruitment boards with uniformity in standards of qualification and expertise for recruitment of staff. National cooperative service could be though t of to develop specialized cadre for the sector.
Financial Packages	Under the discretion of the state governments and national governments	Need to be decided by the supervising and regulatory body such as NABARD.
Benchmarking	Currently no bench marking has been possible due to the inherent diversities and heterogeneities.	Benchmarking could be done once uniform measures are introduced and relevant measures be introduced for benchmarking.
Technology induction for MIS and Customer Service	Technology has been inducted haphazardly in their own individualistic approach.	Uniform and standard computer technology needs to be inducted across all the credit cooperatives
Human Resource Development	Most of the credit cooperatives suffer from incapable and untrained staff that seems to be inefficient.	Rigorous training and management development programmes required to be offered to the current staff and up gradation of their skills is foremost in carrying out their responsibilities.
Corruption control	Complaints of huge misuse of office for	Measures need to be twined into the system so that there

	personal gain, impairs operating efficiency, misallocates resources from the efficient to the dishonest and hurts mostly the poor	is significant reduction in the scope for corruption with adequate checks and balances built in

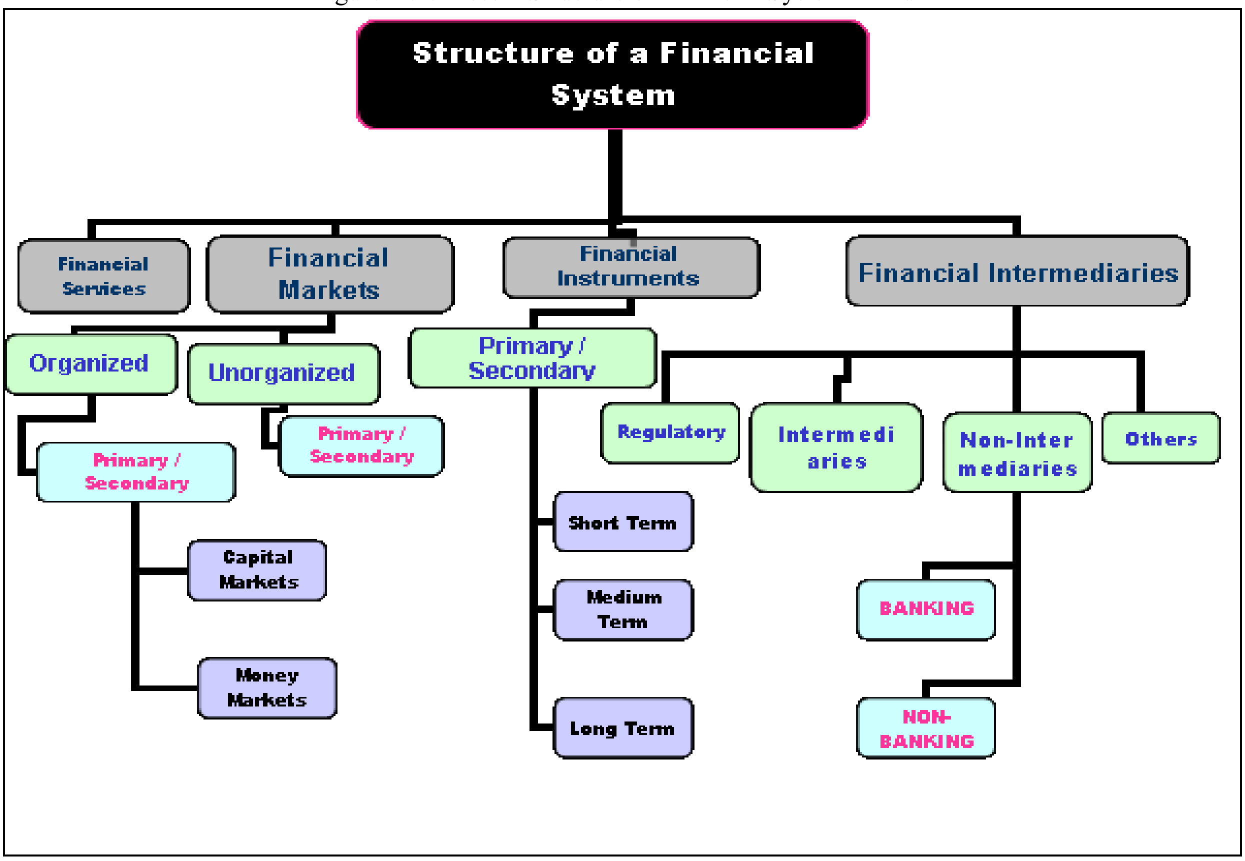
4.3 Institutional Reforms in Commercial Banks

SCBs in view of their massive outreach continue to play a significant role in provision of financial services to the poor particularly the rural poor. However, due to various factors like the apathy of the bank staff and other attitudinal issues in serving their rural clientele and lack of basic infrastructure, the provision of financial services in a more effective manner has been hindered for the commercial banks. Further there are also supervisory and regulatory issues hampering in the area of rural finance by the commercial banks. The current structure of Indian banking particularly for commercial banks to provide financial services to the rural poor need to be strengthened. SCBs need to made to comply with statutorily finance upto an extent of 40 % of their annual net credit disbursements towards rural finance. And also various sub targets like; finance to weaker sections, finance to women, finance to agriculture are required to be rigorously implemented in order to channelize the much needed credit to the rural sectors.

4.4 Reforming the Regulatory Architecture and Strengthening Interregulatory Coordination

There is a need to reform the regulatory structure as they have cropped up with lack of regulatory coordination. As shown in Figure 4.2, the current system involves half a dozen apex regulatory agencies (like; RBI, NABARD, SEBI, IRDA, PFRDA, FMC, EPFO, SIDBI, NHB, etc.) apart from several ministries in the government that retain direct regulatory powers. This structure leads to major regulatory overlaps and regulatory gaps. Sometimes this structure also can lead to regulatory arbitrage as institutions that come under different regulators and are therefore subject to different regulatory requirements may offer similar financial services. The overlapping regulatory structure also becomes a barrier to innovation as any new product might need approval from more than one regulator. In some cases, it is not even clear which regulator has primary jurisdiction over the product. In addition, multiplicity of regulators creates severe problems with interagency coordination. In India these coordination mechanisms are not formalized, and though these mechanisms can be effective in emergencies, they are not quite as effective at other times. Coordination problems are aggravated by the uneven skills and experience across regulators

Figure–4.2: Present Structure of Financial System in India



This structure needs to be relooked into with the perspective of regulatory integration as is done in many of the countries across the globe.

Table–4.4: Pros and Cons of Integrating Financial Sector Supervision

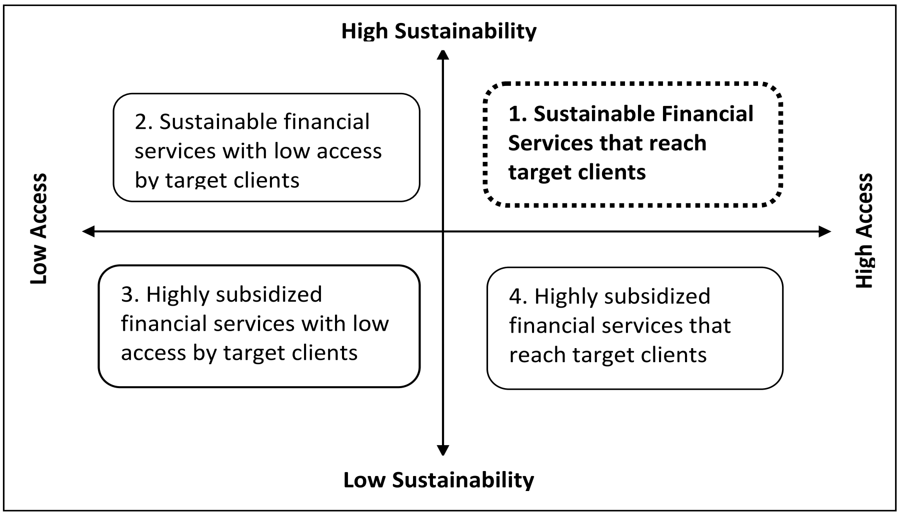
Potential Pros	Potential cons
Easier to achieve efficiency in supervision of financial conglomerates	If objectives are not clearly specified, may result ineffective than the sectoral supervisors
Could achieve possible economies of scale	Possibilities of diseconomies of scale if any organisation is too large to manage
Could improve accountability	Possibilities of moral hazard problems and across the financial sector and resultant less accountability
Helpful in elimination of duplicities and turf wars of sectoral supervisors and speeds up decision making as well as implementation	Sometimes the process of integration may get influenced by political/extraneous vested interest motivated changes in supervisory framework
Easier to ensure level playing field across market segments	Process of integration if not managed properly may lead to loss of key staff or to other problems

4.4 Provision of Financial Services to the Poor by Microfinance Institutions

Indian microfinance sector can be categorized into three main groups: (i) the SHG-Bank linkage model accounting for about 58% of the outstanding loan portfolio, (ii) non-banking finance companies accounting for about 34% of the outstanding loan portfolio (iii) others including trusts, societies, etc, accounting for the balance 8% of the outstanding loan portfolio. The borrowers in the microfinance sector are in general particularly from the vulnerable sections of society and they suffer from; lack of individual bargaining power, inadequate financial literacy, fragile economic environment and exposed to external shocks which they are ill-equipped to absorb. Hence, the financiers and MFI-NBFCs can easily exploit them.

Further, Malegam Committee (2011) on Microfinance set up by RBI has suggested that the size of an individual loan should be restricted to INR 25,000 and to prevent over-borrowing, the aggregate value of all outstanding loans of an individual borrower should also be restricted to INR 25,000. However, keeping in view the unabated rise of inflation, which usually affects the poor first, the definition limit for MFI loan, should be indeed raised to INR 50000. However, the issue of great concern is that of optimizing the performance of microfinance institutions, which is dependent on the access and sustainability of the financial services offered by these institutions (refer figure 4.3).

Figure–4.3: Optimizing Performance of Financial Institutions



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

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

Accountability of the responsible decision makers has indeed to be enhanced in order to speed up quality in service delivery. Mechanisms need to be imbibed into the systems so that there is no scope for misuse of the official position or ignorance or indifference or apathy by the employees. However, the suggested reform measures need to accompanied with concomitant research in the key areas like; (i) what is the true nature of these policies and their potential to affect the working of rural financial markets? (ii) What are the measures initiated to overcome some of the negative consequences of reforms like exclusion of poor and small borrowers, increasing cost of borrowing and growing influence of informal sources? How far these measures have helped reverse the negative consequences? (iii) What is the evolving institutional structure in rural areas to meet the emerging credit needs? What are the merits and demerits of institutional changes for ensuring affordable and hassle free access to financial services by the rural households in general and small and marginal farmers in particular? (iv) What are the innovative product and services developed by the RFIs to meet the diverse financial service needs of rural households? In what way these innovations have proved beneficial. How far some of the controversial innovations like commodity futures and derivatives have delivered for the farmers? (v) What is the impact of these reforms and innovations on the farm economy? How far these measures have contributed for either aggravating or mitigating the agrarian crisis?

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

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Annexure – 1: A Glimpse of Banking Sector in India

Indicators	2003	2004	2005	2006	2007	2008	2009	2010	2011
Number of Commercial Banks	293	291	288	222	182	173	170	167	167
(a) Scheduled Commercial Banks (SCBs)	288	286	284	218	178	169	166	163	163
of which: Regional Rural Banks	196	196	196	133	96	90	86	82	82
(b) Non – SCBs	5	5	4	4	4	4	4	4	4
Number of Bank Offices in India	68500	69170	70373	72072	74653	78787	82897	88203	93080
(a) Rural	32283	32227	30790	30251	30409	30927	31598	32529	33602
(b) Semi-Urban	15135	15288	15325	15991	16770	18027	19337	21022	23048
(c) Urban	11566	11806	12419	13232	14202	15566	16726	18288	19156
(d) Metropolitan	9516	9750	11839	12598	13272	14267	15236	16364	17274
Population per Office (in thousands)	16	16	16	16	15	15	15	14	13
Aggregate deposits of SCBs in India (INR billion)	13117	15044	17001	21090	26119	31969	38341	44928	52079
Bank credit of SCBs (INR billion)	7464	8407	11004	15070	19311	23619	27755	32447	39420
Deposits of SCBs per office (INR million)	192	226	257	304	367	434	498	547	609
Credit of SCBs per office (INR million)	114	133	170	220	275	322	361	398	457
Per capita Deposit of SCBs (in INR)	12253	14089	16281	19130	23382	28610	33919	39107	46321
Per capita Credit of SCBs (INR)	7275	8273	10752	13869	17541	21218	24617	28431	34800
Deposits of SCBs as percentage to Gross National Product at factor cost (at current prices)	58	59	60	65	70	74	78	73	71
SCBs Advances to Priority Sectors (INR billion)	2182	2766	3706	5127	6553	7814	9089	10915	13158
Share of Priority Sector Advances in Total Advances of SCBs (per cent)	29	32	32	33	33	31	30	31	30
Credit-Deposit Ratio (per cent)	56	55	62	70	73	74	73	73	76
Cash-Deposit Ratio (per cent)	6.3	7.2	6.4	6.7	7.2	9.7	7.3	7.7	8

Source: RBI Database Note: 1 USD = INR 62.6981 as of 25.09.2013