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Beyond RRB amalgamation myths

The logic of the amalgamation of regional rural banks is based on a series of myths. It would be far more effective to deregulate interest rates on small-value loans and privatise the RRBs, argues **Sanjay Sinha.**

WITH some 14,500 branches in rural areas and market towns, it is apparent that well-functioning regional rural banks (RRBs) are one of the keys to providing low-income and remotely located families with the financial services required to enable their inclusion in the economic growth process. Given that the financial reform and economic inclusion agenda of the government is at an advanced stage, it is not surprising that RRBs have moved up the priority scales for the finance ministry and the RBI.

Thus, over the past couple of years, this once poorly performing segment of the financial landscape has been receiving considerable attention incorporating, in recent weeks, consultations of RRB chairmen directly with the finance minister. More recently, an RBI deputy governor has advised the commercial banks to tap the deposit-rich RRBs if they were short of funds. This, to accompany the process of state-wide amalgamation of RRBs in many areas that has reduced their number from 196 to just 102 by end-October 2006. The logic of this latter process is to enable the RRBs to function in a competitive environment by taking advantage of economies of scale and reducing transaction costs.

Unfortunately, this strategy is based on a series of myths. First, there is the myth that RRBs operate in a competitive environment. RRBs were created for the purpose of promoting economic development amongst small/marginal farmers, agricultural labour and other "weaker sections," otherwise excluded by the extensive branch network of the banking system. By definition, they were created to fill a market segment that was largely unserved since the commercial banks found it unremunerative and the cooperative system was constrained by the usual exclusionary tactics of the rural elites that dominate it. Not much has changed in this situation over the past three decades and we are still discussing the issue of inclusion. Apart from the limited operations of microfinance institutions and lending by banks to self help groups — covering no more than 10% of the low income population excluded by the banking system — there is little competition for RRBs in their designated market segment.

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The second myth is that there are significant economies of scale waiting to be achieved. Perhaps there are some economies of scale in integrated systems such as MIS and financial controls. But the real advantage of large banks is the ability to serve large customers, a situation that immediately lowers the average cost of operations and boosts margins. So, which large customers do we believe large rural banks will suddenly be able to attract? And why would any large customer approach the rural banks for loans when they are accustomed to dealing with increasingly efficient scheduled banks?

Third, in their present avatar as government-owned institutions, RRBs cannot achieve substantial reductions in transaction costs. For that, they would need drastically to alter their public sector ethos and heavy political interference in their operations. Perhaps the government feels larger institutions would be more difficult to interfere with but the experience is that state-level institutions only invite interference of larger proportions and the potential for disruptive action from larger labour forces would actually increase rather than reduce.

FINALLY, the effect of amalgamations: even if significantly greater efficiency was to be achieved, the RRB objective of financial inclusion would not be. It is well established that making small loans is wildly uneconomical in the present restricted interest rate regime and at the PLRs prevailing in the commercial banking sector. So the more efficient and competitive amalgamated RRBs would chase the same customer profile as the commercial banks and the financially excluded "weaker sections" would continue to weaken.

In fact, inclusion requires us to get beyond these myths. Far from being amalgamated in order to make them efficient, RRBs need action to make them functional in relation to their original objectives. This needs two simple but drastic measures. First, decontrol of interest rates on small value loans so that banks, rural or commercial, can lend to weaker sections at rates that cover their costs. Since commercial banks would be unable to compete with the lower salaries and local knowledge of rural bank staff this would provide the latter with a substantial advantage in this, their natural market segment.

Second, and equally important, the message for the weaker sections, of the loan *mela* culture of the 1980s was that an RRB loan was *sarkari paisa* (government money) and, therefore, not necessarily returnable. Times have changed but an equivocal approach to soft loans remains. The way to change this, and to improve RRB efficiency at the same time, is to render the image palpably untrue: privatise the RRBs and no one will be able to characterise RRB money as non-returnable.

Let's be clear about what is being proposed. India is practically the only country in Asia with a virtual vacuum in its financial system after the large commercial banks. Below this level, there are non-banking finance companies but these are largely urban consumer finance, leasing companies or else large savings depositories. Since RRBs became unviable very limited banking services are available to anyone outside the radar of the commercial banks. In order to get an efficient, effective banking operation at a lower level, what is required are smaller banks with permission to operate in five, 10, perhaps 20 districts at a time with appropriate minimum capital requirements. This can be done simply by selling the better performing RRBs to commercial investors.

Perhaps, where practical, those RRBs with worse performance could be bundled with those that are more attractive to buyers. Thus, a large proportion of RRBs would cease to be a headache for the finance ministry and would no longer need to be treated as mere cash cows for the commercial banking system. Best of all, accompanied by full interest rate decontrol, RRBs would become the direct means of financial inclusion they were meant to be. That is an objective the government desperately seeks to achieve.

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