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CONTENTS

FACTORS AFFECTING PERFORMANCE OF REGIONAL RURAL BANKS (RRBs) IN INDIA: A STUDY OF LITERATURE REVIEW

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ABSTRACT

The importance of the rural banking in the economic development of a country cannot be overlooked. As Gandhiji said "real India lies in villages," and village economy is the backbone of Indian economy. Without the development of the rural economy, the objectives of economic planning cannot be achieved. Hence, banks and other financial institutions are considered to be a vital role for the development of the rural economy in India. Regional Rural Banks (RRBs) were established in October 2, 1975 and are playing a pivotal role in the economic development of the rural India. The main goal of establishing Regional Rural Banks in India is to provide credit to the rural people who are not economically strong enough, especially the small and marginal farmers, artisans, agricultural laborers and even small entrepreneurs. The present study is a modest attempt to make an appraisal of the rural credit structure and the role played by RRBs in the development of rural economy. The objective of this paper is to study the factors affecting performance of RRBs in India. The study is diagnostic and exploratory in nature and makes use of earlier studies for reviewing the literature. The study finds and concludes that RRBs in India has significantly improved rural economy.

Key Words: RRBs, Rural Credit, Credit-deposit ratio, RBI, Financial Liberalization

Regional Rural Banks (RRBs) have been in existence for around 38 years as a part of Indian financial and banking sector. The origin of RRBs may be seen as a unique experiment as well as experience in improving the efficacy of rural credit delivery mechanism in India. Further, keeping in mind the local peculiarities, an effort was made to integrate commercial banking within the broad policy framework towards social banking through joint shareholding of Central Government, the concerned state governments and the Sponsoring bank.

The genesis of RRBs may be traced for the need for a stronger institutional arrangement for providing rural credit. The institution of RRBs was created to meet the excess demand for institutional credit in the rural areas, particularly among the economically and socially marginalized sections. Although the cooperative banks and the commercial banks had reasonable records in terms of geographical coverage and disbursement of credit, in terms of population groups the cooperative banks were dominated by the rural rich while the commercial banks had a clear urban bias.

The Banking Commission (1972) recommended to setup an alternative institution for rural credit and finally Government of India (GOI) formed RRBs – a separate institution basically for rural credit on the basis of the recommendations of the working group under the Chairmanship of Shri M. Narashimham. Initially, five RRBs were setup on 2nd October, 1975 under a Presidential Ordinance, followed by the promulgation of RRBs Act in April, 1976. The RRBs have been identified as scheduled commercial banks under the Reserve Bank of India Act, 1934 and are authorized to transact banking business as defined in the Banking Regulation Act, 1949. The RRBs were required, in particular, to undertake the business of providing credit facilities to the poorer sections of rural society, generally known as the target group. The first five RRBs were setup in five states: in Haryana, West Bengal, Rajasthan (one each) and two in Uttar Pradesh, which were sponsored by different commercial banks. RRBs were started in 1975 to cater to the needs of rural economy of India. They pay particular attention to the credit requirements of small farmers, artisans and agricultural workers. They operate mainly at the district level. RRBs have a special place in the multi-agency approach adopted to provide agricultural and rural credit in India. The capital of RRBs is contributed by the Central Government, concerned State Government and a sponsor bank in the ratio 50:15:35. This paper reviews the literature on factors affecting performance of a commercial bank in general and also in the context of RRBs.

REVIEW OF LITERATURE

As far as the Indian Banking sector is concerned, there is no dearth of research reports or study groups constituted by the Reserve Bank of India (RBI) or Central Government. However, the literature available in the working and performance of RRBs in India is available in limited way. RRBs though operate with a rural focus are primarily scheduled commercial banks with a commercial orientation. Beginning with the seminal contribution of (Haslem, 1968), the literature probing on the factors influencing performance of banks recognizes two broad sets of factors i.e. internal factors and factors external to the bank. The internal determinants originate from the balance sheets and profit and loss accounts of the bank concerned and are often termed as micro or bank-specific determinants of profitability. The external determinants are systematic forces that show the economic environment in which the operation and performance of financial institutions may be affected.

A number of explanatory variables have been suggested in the literature for both the internal and external determinants. The typical internal determinants employed are variables e.g. size and capital (Akhavein, Berger and Humphrey, 1997; Domirguc Kunt and Maksimovic, 1998; Short, 1979; Bikker and Hu, 2002 and Goddard, Molyneux and Wilson, 2004).

Molyneux and Thornton (1992) found a negative and significant relationship between the level of liquidity and profitability, Bourke (1989) in contrast, reported an opposite result. One possible reason for the conflicting findings may be the different elasticity of demand for loans in the samples used in the studies (Balachander, Staunton and Balashanmugam, 2004).

Credit risk is found to have a negative impact on profitability (Miller and Noulas, 1997). This result may be explained by taking into account the fact that more the financial institutions are exposed to high-risk loans; the higher is the accumulation of unpaid loans implying that these loan losses have produced lower returns to many commercial banks (Athanasoglou, Brissimis and Delis, 2005). Some of the other internal factors found in the literature are funds source management and funds use management, capital and liquidity ratios, the credit-deposit ration and loan loss expenses (Bell and Murphy, 1969; Kwast and Rose, 1982).

As far as the external factors of bank profitability are concerned the literature distinguishes between control variables that describe the macroeconomic environment, such as inflation rate, interest rates, and cyclical output and variables that show market characteristics. The latter refer to market concentration, industry size and ownership status. Among the external determinants which are empirically modeled are regulation (Edwards, 1977), bank size and economies of scale (Benston, Hanweck and Humphrey, 1982), growth in market interest rates as a proxy for capital scarcity and government ownership (Short, 1979). The most frequently used macroeconomic control variables are the inflation rate, the long-term interest rate and the growth rate of money supply.

Revell (1979) found the issue of relationship between bank profitability and inflation. The study noted that the effect of inflation on bank profitability depends on whether banks' wages and other operating expenses increase at a faster pace than inflation. Patel and Shete (1980) of the National Institute of Bank Management (NIBM) made a valuable analysis of performance and prospects of RRBs. The study gave a comparative picture of performance in deposits, branch expansion and credit deployment of the co-operative banks, commercial banks and RRBs in a specified area. This study was an eye opener for many researchers engaged in this field of rural credit.

Rajkumar (1993) found that there was an enormous increase in deposits and outstanding advances of RRBs and suggested to increase the share capital and ensuring efficient use of distribution channels of fiancé to beneficiaries. Jai Prakash (1996) conducted a study with the objective of analyzing the role of RRBs in Economic Development and revealed that RRBs have been playing a vital role in the field of rural development. Moreover, RRBs were more efficient in disbursal of loans to the rural borrowers as compared to the commercial banks. Support from the state Governments, local participation, and proper supervision of loans and opening urban branches were some steps recommended to make RRBs further efficient. Naidu (1998) conducted a study on RRBs taking a sample of 48 beneficiaries as rural artisans in Cuddapah district of Andhra Pradesh under Royal Seen Gramin Bank. The study was concluded that the beneficiaries were able to find an increase in their income because of the finance provided by the bank.

NABARD (2012) published a study of RRBs viability and revealed that viability of RRBs was essentially dependent upon the fund management strategy, margin between resources mobility and their deployment and on the control exercised on current and future costs with advance. The proportion of the establishment costs to total cost and expansion of branches were the critical factors which affected their viability. The study further concluded that RRBs incurred losses due to defects in their systems and as such there was no need to rectify these and make them viable. The study suggested improvement in infrastructure facilities and opening of branches by commercial banks in such areas where RRBs were already in operation.

Sinha, Tanmay, Orlanda and Nilotpal (2013) in a field study of five RRBs found that non-priority sector advances increased sharply in the second-half of the 1990s for all the sample banks. Of these 4 banks have a significant 25 percent of their portfolio invested in non-priority sector loans? The interviewed RRBs managers agreed that this was a deliberate strategy to

improve viability. Non-priority sector advances are mostly collateralized and therefore carry low risk; they are generally market-based and of a higher value extended to higher income clients or to low income clients through deposit and jewelry linked loans and banks have freedom to charge cost-covering interest rates on non-priority sector advances. The bank managers candidly accept that the RRBs have been able to raise their profitability by refusing to serve low-income clients.

CONCLUSION

Regional Rural Banks plays a key role as an important vehicle of credit delivery in rural areas with the objective of credit dispersal to small, marginal farmers & socio economically weaker section of population for the development of agriculture, trade and industry. But still its commercial viability has been questioned due to its limited business flexibility, smaller size of loan & high risk in loan & advances. Rural banks need to remove lack of transparency in their operation which leads to unequal relationship between banker and customer.

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