A Financial Performance Analysis of RRBs: Pre and Post Transformation

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Abstract

In this paper an attempt has been made to study the performance of the RRBs since 1980 to 2009. In order to know the implications of transformation of RRBs in 2004, the study focuses financial results before and after amalgamation. RRBs were established "with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to small and marginal farmers, agricultural laborers, artisans and small entrepreneurs, and for matters connected therewith and incidental thereto"(RRBs Act, 1976). RRBs alone have organized roughly 12 lakh self-help groups, 45 per cent of the total self-help groups in the country. RRBs have also issued over 40 lakh Kisan Credit Cards to the farmers and organized over 5,000 out of 11,000 farmers' clubs under NABARD scheme. Though the growth in credit when seen in isolation gives an impression of the impressive strides made by RRBs in disbursing credit, they account for a very small proportion (around 3 per cent) of the total assets of the Indian banking sector, despite their significant branch network. While C-D ratio for 50 RRBs was more than 60 per cent that for 87 banks was less than 40 per cent in March 2004. The Government of India (Ministry of Finance) issued notifications on September 12, 2005 for amalgamation of 28 RRBs into nine new RRBs sponsored by nine banks in six States. These amalgamations have become effective from September 12, 2005. After amalgamation, RRBs transformation has resulted in a 200 per cent increase in net profits, a 100 per cent increase in business, a gradual reduction in the number of loss-making banks and addition of 1,000 outlets. All this has been because of consolidation among RRBs. The Central government initiated the process of amalgamating RRBs in September, 2005. Then there were 196 RRBs. The study reveals that, RRBs seem to have better Non-Performing Assets (NPA) management with net NPA coming down every year after the amalgamation. In 2005-06, the net NPA stood at 3.96 per cent. It declined to 1.98 per in 2008-09. RRBs are extending loans to non-agricultural sector in rural areas also. They are broad-basing their credit pattern. Malaprabha Grameen Bank went ahead to finance vehicles for rural transport system. Financing of vehicles for rural transportation helped villagers, as they sold their produce in urban areas. The reduction in number of RRBs has not resulted in any sudden reduction in staff strength since there was no termination of services of employees after amalgamation. Unlike commercial banks no voluntary retirement schemes were introduced in RRBs.

Introduction

Regional Rural Banks have been in existence for around three decades in the Indian financial scene. Inception of regional rural banks (RRBs) can be seen as a unique experiment as well as experience in improving the efficacy of rural credit delivery mechanism in India. With joint share holding by Central Government, the concerned State Government and the sponsoring bank, an effort was made to integrate commercial banking within the broad policy thrust towards social banking keeping in view the local peculiarities. The genesis of the RRBs can be traced to the need for a stronger institutional arrangement for providing rural credit. The Narsimham committee conceptualized the creation of RRBs in 1975 as a new set of regionally oriented rural banks, which would combine the local feel and familiarity of rural problems characteristic of cooperatives with the professionalism and large resource base of commercial banks. Subsequently, the RRBs were set up through the promulgation of RRB Act1 of 1976. Their equity is held by the Central Government, concerned State Government and the Sponsor Bank in the proportion of 50:15:35. RRBs were supposed to evolve as specialized rural financial institutions for developing the rural economy by providing credit to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs. Over the years, the RRBs, which are often viewed as the small man's bank, have taken deep roots

and have become a sort of inseparable part of the rural credit structure . They have played a key role in rural institutional financing in terms of geographical coverage, clientele outreach and business volume as also contribution to development of the rural economy. A remarkable feature of their performance over the past three decades has been the massive expansion of their retail network in rural areas. From a modest beginning of 6 RRBs with 17 branches covering 12 districts in December 1975, the numbers have grown into 196 RRBs with 14,446 branches working in 518 districts across the country in March 2004. RRBs have a large branch network in the rural area forming around 43 per cent of the total rural branches of commercial banks. The rural orientation of RRBs is formidable with rural and semi urban branches constituting over 97 per cent of their branch network. The growth in the branch network has enabled the RRBs to expand banking activities in the unbanked areas and mobilize rural savings. The mandate of promoting banking with a rural focus, however, would be an enduring phenomenon only when the financial health of the RRBs is sound. With built-in restrictions on their operations, it is common to expect that the financial health of the RRBs itself would be a matter of concern.

Review of Literature

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 into 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/or profit and loss accounts of the bank concerned and are often termed as micro or bank-specific determinants of profitability. The external determinants are systemic forces that reflect the economic environment which conditions the operation and performance of financial institutions. A number of explanatory variables have been suggested in the literature for both the internal and external determinants. Goddard *et al.* (2004) given the nature of banking business, the need for risk management is of crucial importance for a bank's financial health. Risk management is a reflection of the quality of the assets with a bank and availability of liquidity with it. During periods of uncertainty and economic slowdown, banks may prefer a more diversified portfolio to avoid adverse selection and may also raise their liquid holdings in order to reduce risk. Credit risk is found to have a negative impact on profitability **(**Millerand 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). The literature on RRBs recognizes a host of reasons responsible for their poor financial health. According to the Narasimham Committee, RRBs have low earning capacity. They have not been able to earn much profit in view of their policy of restricting their operations to target groups. The recovery position of RRBs is not satisfactory. There are a large number of defaulters. Their cost of operation has been high on account of the increase in the salary scales of the employees in line with the salary structure of the employees of commercial banks**.** In most cases, these banks followed the same methods of operation and procedures as followed by commercial banks. Therefore, these procedures have not found favor with the rural masses. In many cases, banks have not been located at the right place. For instance,

the sponsoring banks are also running their branches in the same areas where RRBs are operating. The issue whether location matters for the performance has been addressed in some detail by Malhotra (2002). Considering 22 different parameters that impact on the functioning of RRBs for the year 2000, Malhotra asserts that geographical location of RRBs is not the limiting factor for their performance. He further finds that 'it is the specific nourishment which each RRB receives from its sponsor bank, is cardinal to its performance'. In other words, the umbilical cord had its effect on the performance of RRBs. The limitation of the study is that the financial health of the sponsor bank was not considered directly to infer about the umbilical cord hypothesis. Nitin and Thorat (2004) on a different note provide a penetrating analysis as to how constraints in the institutional dimension5 have seriously impaired the governance of the RRBs. They have argued that perverse institutional arrangements that gave rise to incompatible incentive structures for key stakeholders such as political leaders, policy makers, bank staff and clients have acted as constraints on their performance. The lackluster performance of the RRBs during the last two decades, according to the authors can be largely attributed to their lack of commercial orientation. An appropriate restructuring strategy would require identifying the problems leading to the non satisfactory performance of the RRBs.

Restructuring Strategies

The financial viability of RRBs has engaged the attention of the policy makers from time to time. In fact, as early as 1981, the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD) addressed the issue of financial viability of the RRBs. The CRAFICARD recommended that 'the loss incurred by a RRB should be made good annually by the shareholders in the same proportion of their shareholdings'. Though this recommendation was not accepted, under a scheme of recapitalization, financial support was provided by the shareholders in the proportion of their shareholdings. Subsequently, a number of committees have come out with different suggestions to address the financial non-viability of RRBs. For instance, the Working Group on RRBs (Kelkar Committee) in 1984 recommended that small and uneconomic RRBs should be merged in the interest of economic viability. Five years down the line, in a similar vein, the Agricultural Credit Review Committee (Khusro Committee), 1989 pointed out that 'the weaknesses of RRBs are endemic to the system and non-viability is built into it, and the only option was to merge the RRBs with the sponsor banks. The objective of serving the weaker sections effectively could be achieved only by self-sustaining credit institutions'. The Committee on Restructuring of RRBs, 1994 (Bhandari Committee) identified 49 RRBs for comprehensive restructuring. It recommended greater devolution of decision-making powers to the Boards of RRBs in the matters of business development and staff matters. The option of liquidation again was mooted by the Committee on Revamping of RRBs, 1996 (Basu Committee). The Expert Group on RRBs in 1997 (Thingalaya Committee) held that very weak RRBs should be viewed separately and possibility of their liquidation be recognized. They might be merged with neighboring RRBs. The Expert Committee on Rural Credit, 2001 (Vyas Committee I) was of the view that the sponsor bank should ensure necessary autonomy for RRBs in their credit and other portfolio management system. Subsequently, another committee under the Chairmanship of Chalapathy Rao

in 2003 (Chalapathy Rao Committee) recommended that the entire system of RRBs may be consolidated while retaining the advantages of regional character of these institutions. As part of the process, some sponsor banks may be eased out. The sponsoring institutions may include other approved financial institutions as well, in addition to commercial banks. The Group of CMDs of Select Public Sector Banks, 2004 (Purwar Committee) recommended the amalgamation of RRBs on regional basis into six commercial banks - one each for the Northern, Southern, Eastern, Western, Central and North-Eastern Regions. Thus one finds that a host of options have been suggested starting with vertical merger (with sponsor banks), horizontal merger (amongst RRBs operating in a particular region) to liquidation by different committees that have gone into the issue of financial viability and restructuring strategies for the RRBs. More recently, a committee under the Chairmanship of A.V Sardesai revisited the issue of restructuring the RRBs (Sardesai Committee, 2005). The Sardesai committee held that 'to improve the operational viability of RRBs and take advantage of the economies of scale, the route of merger/amalgamation of RRBs may be considered taking into account the views of the various stakeholders'. Merger of RRBs with the sponsor bank is not provided in the RRB Act 1976. Mergers, even if allowed, would not be a desirable way of restructuring. The Committee was of the view that merging a RRB with its sponsor bank would go against the very spirit of setting up of RRBs as local entities and for providing credit primarily to weaker sections. Having discussed various options for restructuring, the Committee was of the view that '**a change in sponsor banks may, in some cases help in improving the performance of RRBs. A change in sponsorship may, *inter alia*; improve the competitiveness, work culture, management and efficiency of the concerned RRBs**'. Against this backdrop, an empirical study has been conducted to know the performance of RRBs before and after reconstruction.

Performance of RRBs before Reconstruction

The RRBs, over the years have made impressive strides on various business indicators. For instance, deposits of RRBs have grown by 18 times and advances by 13 times between 1980 and 1990. Between 1990 and 2004, deposits and advances grew by 14 times and 7 times, respectively (Table 1). Between the year 2000 and 2004, loans disbursed by RRBs more than doubled reflecting the efforts taken by the banks to improve credit flow to the rural sector. The average per branch advances also increased from Rs.25 lakh in March 1990 to Rs.154 lakh in March 2003. When one considers the deployment of credit relative to the mobilization of resources, the credit-deposit (C-D) ratio of RRBs were more than 100 per cent during the first decade of their operations up to 1987. Though the C-D ratio subsequently became lower, of late, it has shown an improvement and went up from around 39 per cent in March 2000 to 44.5 per cent in March 2004.

As regards their financial status, during the year 2003-04, 163 RRBs earned profits amounting to Rs.953 crore while 33 RRBs incurred losses to the tune of Rs.184 crore. Ninety RRBs had accumulated losses as on March 31, 2004. Aggregate accumulated loss of RRBs amounted to Rs. 2,725 crore during the year 2003-04. Of the 90 RRBs having accumulated loss, 53 RRBs had eroded their entire owned funds as also a part of their deposits. Furthermore, non-performing assets (NPAs) of the RRBs in absolute terms stood at Rs.3, 299 crore as on March 31, 2004. The percentage of gross NPAs was 12.6 during the year ending

March 31, 2004. While 103 RRBs had gross NPAs less than the national average, 93 had NPAs more than it.

Table 1: Performance of RRBs before Reconstruction: Select Indicators (Rs. Crore)

Parameters	198	1985	1990	1995	1996	1997	1998	1999	2000	200	2002	2003	2004
No of RRBs	85	188	196	196	196	196	196	196	196	196	196	196	196
Capital	21	46	91	166	358	705	1118	1380	1959	204	2143	2141	2221
Deposits	222	1315	4023	11,141	14,171	17,976	22,191	27,059	32,226	38,294	44,539	49,582	56,295
Investments	20	164	60	1348	2879	3891	5280	6680	7760	880	9471	17,138	21,286
Advances	262	1405	3384	598	705	7908	902	10,55	12,42	15,050	17,710	20,934	25,038
Total assets	426	2320	6081	14,886	18,969	24,376	29,468	35,82	42,23	49,596	56,80	62,50	70,19
Interest Earned	NA	NA	480	1158	1421	2033	2624	3281	3938	461	5191	5391	5535
Other income	NA	NA	113	72	89	103	136	151	207	240	370	430	697
Total Income	NA	NA	593	1230	1511	2136	2760	3432	4145	485	5561	5821	6231
Interest expended	NA	NA	326	851	1065	1462	1773	2131	2565	296	3329	3440	3363
Operating expenses	NA	NA	254	657	726	804	845	982	1056	116	1459	1667	1825
Provisions and contingen-cies	NA	NA	NA	120	171	673	72	99	96	128	163	132	289
Total expenses	NA	NA	581	1509	1791	2265	2617	3113	3621	413	4787	5107	5187
Operating profit	NA	NA	12	-279	-280	-129	143	319	524	729	774	714	1044

Source: RBI Bulletin

Regional Rural Banks- Consolidating after Transformation

Over the past five years, RRBs transformation has resulted in a 200 per cent increase in net profits, a 100 per cent increase in business, a gradual reduction in the number of loss-making banks and addition of 1,000 outlets. All this has been because of consolidation among RRBs. The Central government initiated the process of amalgamating RRBs in September, 2005. Then there were 196 RRBs. At the end of March 2006, the number came down to 133, and it consolidated to 82 by the end of

March 2010. Though the number of RRBs has come down by more than half, their branch network has seen modest growth of about 6 per cent. At the end of the last fiscal, the number of branches reached 15,475 as against 14,489 in 2005-06. Amalgamation and reduction of number resulted in rationalization to a great extent. This helped merge the weak RRBs with the stronger ones. For the strong RRBs, amalgamation gave the benefit of extending business operation to new areas without much cost. It helped increase customer base, reduce credit concentration risks by spreading the risk to more sectors and more agricultural crops. KVGB (Karnataka Vikas Grameen Bank) was formed by amalgamating Malapradha Grameena Bank, Bijapur Grameen Bank, Nethravathi Grameen Bank and Varada Grameen Banks. The first two were big banks and the latter two small. The management completed the merger in fifteen days and was able to bring in the strong points of Malaprabha Grameen Bank and Bijapur Grameen Bank. If weak bank adopts the policies of strong banks, the amalgamated entity becomes stronger.

Net Profits Rise

From the above table, it is clear that there were as many as 133 RRBs that posted a profit of Rs 617crore in 2005-06 with 22 making loss that year. However with consolidation in the subsequent years, the net profit jumped to Rs 1,884crore in 2009-10 with the number of RRBs being reduced to 82. Of them, only three incurred a loss. The Trend and Progress of Banking in India 2009-10, shows that all RRBs taken together reported a net profit of Rs 1,884crore showing a growth of 41.1 per cent in 2009-10. As a result, there was a marginal rise in the Return on Assets (ROA) of RRBs from 1 percent in 2008-09 to 1.1 per cent in 2009-10. The RoA of RRBs in 2009-10 thus worked out to be relatively higher than that of scheduled commercial banks. This trend mainly because of expansion of service area after amalgamation has helped increase net profits. Earlier, RRBs were confined to one or two districts. The amalgamation of different RRBs of the same sponsor bank in a State helped the combined entity increase business and profits and also RRBs were permitted to open branches at taluk headquarters.

Table-II: Performance of RRBs after consolidating

Net profit (in Rs crores)	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
	617	625	1027	1335	1884
No. of RRBs	133	96	90	86	82
(Profit / loss making RRBs)	111/22	81/15	82/8	80/6	79/3
No. of branches	14,489	14,563	14,790	15,524	15,475
Deposits (in Rs crores)	71,329	83,144	99,093	1,20,189	1,45,035
Loans & advances (in Rs crores)	38,520	47,326	57,568	65,609	79,157
NII (in Rs crores)	2852	3407	3982	4479	5570
Other income(in Rs crores)	433	540	667	810	890
Wage bill (in Rs crores)	1848	2051	2054	2291	2676
CD ratio (in %)	55.7	58.3	59.5	56.4	57.6
Share of CASA in deposits (in %)	59.14	61.21	59.63	58.35	57.90
Share of priority sector adv in total	81	82.2	82.9	83.4	82.2
Share of agri advances to total (in %)	54.2	56.6	56.3	55.1	54.8
Gross NPA (in p.c)	7.3	6.55	6.1	4.2	NA
Net NPA (in p.c)	3.96	3.46	3.4	1.8	NA

Source: RBIs reports on trend and progress of banking in India 2010

Increase incompetency of the staff, management quality, supports from sponsor banks and National Bank for Agriculture and Rural Development through refinance at reasonable rates, comparatively large share of low cost deposits (current accounts, savings accounts, or CASA), lower operational costs, expertise acquired in asset management over time, effective investment management etc., were instrumental in the growth in net profit. RRBs are now allowed to do para-banking activities such as life and non-life insurance business, helping them increases their non-interest income. Additionally, increased computerization of RRBs, including introduction of core banking solution in come RRBs has resulted in reduced operational expenses. The total business of KVGB, which was around Rs 3,000 crore during its formation in 2005, crossed Rs 8,000 crore in 2009-10. The bank recorded a net profit of Rs 72.14 crore in 2009-10.

NPA Management Gets Better

RRBs seem to have better non-performing assets (NPA) management with net NPA coming down every year after the amalgamation. In 2005-06, the net NPA stood at 3.96 per cent. It declined to 1.98 per in 2008-09. For better NPA management, RRBs are concentrating on rural credit, and the major portion of this is agricultural credit. The average size of a loan account is low and in certain RRBs, it is as low as Rs 50,000. Credit risk is thus well spread over several accounts, unlike commercial banks where the size of the loan account is much bigger and risk is more. RRBs keep good rapport and liaison with rural borrowers and the follow-up of advances is effective. Problems of the borrowers are addressed promptly and remedial steps are taken timely. Rural borrowers are more amicable, and they accept RRBs as 'friend, philosopher and guide'

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CASA Performance Better

For RRBs, the ratio of low-cost deposits to the total deposits continues to remain above their big brothers. However, the share of CASA has also witnessed gradual decline in the recent years. RRBs that managed to mobilize 61.21 per cent of CASA of total deposits in 2006-07 could not continue that further. In 2009-10, the share of CASA was at 57.9 per cent. They can take solace in the fact that their CASA share is more than that of their sponsoring public sector banks. The RRBs that managed to mobilize around Rs 38,233 crore in their savings accounts in 2005-06 took it to the level of Rs75,906 crore in 2009-10. Experts felt that being the bankers for the villagers has helped RRBs garner more CASA than the commercial banks.

Agriculture Advances Ratio

The Report on Trend and Progress of Banking in India 2009-10 is concerned the share of agricultural credit from RRBs, was on a decline in the recent years. While agriculture credit to total credit was 54.2 per cent in 2005-06 it increased to just 54.8 per cent in 2009-10. Considering the increase in the volume of business over the years, this appears to be a bit low. Although, RRBs managed to take this share to 56.6 per cent in 2006-07, that did not continue for long. RRBs are extending loans to non-agricultural sector in rural areas also. They are broad-basing their credit pattern. Malaprabha Grameen Bank went ahead to finance vehicles for rural transport system. Financing of vehicles for rural transportation helped villagers, as they sold their produce in urban areas. On the return journey, they would bring items required by the villagers and sell them at their door steps.

Wage Bill

The component of wage bill in the expenditure of RRBs continues to increase with every year. While wage bills stood at Rs 1,848 crore in 2005-06, it reached RS 2,646 crore in 2009-10. The reduction in number of RRBs has not resulted in any sudden reduction in staff strength since there was no termination of services of employees after amalgamation. Unlike commercial banks no voluntary retirement schemes were introduced in RRBs. Earlier, the wages RRB staffs were not on par with that of officers and employees of commercial bank/public sector banks. The wage revision effected in commercial/public sector banks is now extended to RRB staff also. There has been substantial increase in dearness allowance component, which has also contributed towards the increased wage bill. It is believed that passion for working in rural banks is the most important factor that drives efficient working in RRBs. Employees coming to the RRBs on deputation from the sponsor banks should have inclination for working in those banks and be partners in progress. In most cases, nearly 90 per cent staff at the RRBs is locals having better contact in their areas of operation. This is also essential for the successful running of an RRB. This builds team spirit among staff members.

Major Observation

1. RRBs were established "with a view to developing the rural economy by providing, for the purpose of development of agriculture, trade, commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to small and marginal farmers, agricultural laborers, artisans and small entrepreneurs, and for matters connected therewith and incidental thereto"(RRBs Act, 1976).
2. RRBs alone have organized roughly 12 lakh self-help groups, 45 per cent of the total self-help groups in the country. RRBs have also issued over 40 lakh Kisan Credit Cards to the farmers and organized over 5,000 out of 11,000 farmers' clubs under NABARD scheme.
3. Lack of a single owner with clear ownership and control, and no prospects for profits, diffused accountability and weakened oversight of the RRBs.
4. Though the growth in credit when seen in isolation gives an impression of the impressive strides made by RRBs in disbursing credit, they account for a very small proportion (around 3 per cent) of the total assets of the Indian banking sector, despite their significant branch network.
5. While C-D ratio for 50 RRBs was more than 60 per cent that for 87 banks was less than 40 per cent in March 2004.
6. Specifically, the sponsor bank contributes thirty-five per cent of issued capital of a RRB, appoints its chairman, advises on decisions regarding investments, monitor its progress and suggest corrective measures to be taken by the RRB.
7. The Government of India (Ministry of Finance) issued nine notifications on September 12, 2005 for amalgamation of 28 RRBs into nine new RRBs sponsored by nine banks in six States. These amalgamations have become effective from September 12, 2005.
8. After amalgamation, RRBs transformation has resulted in a 200 per cent increase in net profits, a 100 per cent increase in business, a gradual reduction in the number of

loss-making banks and addition of 1,000 outlets. All this has been because of consolidation among RRBs. The Central government initiated the process of amalgamating RRBs in September, 2005. Then there were 196 RRBs.

9. At the end of the last fiscal 2009-10, the number of branches reached 15,475 as against 14,489 in 2005-06. Amalgamation and reduction of number resulted in rationalization to a great extent. This helped merge the weak RRBs with the stronger ones.

10. The amalgamation of different RRBs of the same sponsor bank in a State helped the combined entity increase business and profits and also RRBs were permitted to open branches at taluk headquarters.

11. RRBs seem to have better Non-Performing Assets (NPA) management with net NPA coming down every year after the amalgamation. In 2005-06, the net NPA stood at 3.96 per cent. It declined to 1.98 per in 2008-09.

12. It is proved that being the bankers for the villagers has helped RRBs garner more CASA than the commercial banks.

13. RRBs are extending loans to non-agricultural sector in rural areas also. They are broad-basing their credit pattern. Malaprabha Grameen Bank went ahead to finance vehicles for rural transport system. Financing of vehicles for rural transportation helped villagers, as they sold their produce in urban areas.

14. The reduction in number of RRBs has not resulted in any sudden reduction in staff strength since there was no termination of services of employees after amalgamation. Unlike commercial banks no voluntary retirement schemes were introduced in RRBs.

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