# Restructuring State-owned Financial Institutions: Bidar District Central Cooperative Bank, India

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**Financial year**

1 April – 31 March
If not otherwise stated, financial data of a particular year, eg, 2008, pertain to FY 2007/08.

## Abbreviations and acronyms

| | |
|---|---|
| ADB | Asian Development Bank |
| CAR | Capital adequacy ratio |
| CCS | Credit cooperative system |
| DCCB | District Central Cooperative Bank |
| DGRV | Deutscher Genossenschafts- und Raiffeisenverband,<br>German Cooperative and Raiffeisen Confederation |
| FY | Financial year |
| GCG | Good corporate governance |
| GM | General manager |
| GTZ | Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH,<br>German Technical Assistance Agency |
| HO | Head office |
| IT | Information technology |
| KCC | Kishan Credit Card |
| MACS | Mutually Aided Cooperative Society |
| MCC | Micro Credit Cell (of DCCB Bidar) |
| MCID | Micro Credit Innovation Department (of Nabard) |
| MCD | Micro Credit Division (of DCCB Bidar) |
| MD | Managing director |
| MIS | Management information system |
| Nabard | National Bank for Agriculture and Rural Development |
| NIM | Net interest margin |
| NGO | Non-governmental organization |
| NPL | Non-performing loan |
| PACS | Primary Agricultural Cooperative Credit Societies |
| PCARDB | Primary Co-operative Agriculture and Rural Development Bank |
| RBI | Reserve Bank of India |
| ROA, ROAA | Return on assets, return on average assets |
| ROE, ROAE | Return on equity, return on average equity |
| RRB | Regional Rural Bank |
| Rs | Rupees |
| Saharda | Sahakara Rural Development Academy |
| SCARDB | State Co-operative Agriculture and Rural Development Bank |
| SCB | State Cooperative Bank |
| Sharseti | Sharada Rural Development and Self Employment Training Institute |
| SHG | Self-help group |
| SHPI | Self-help promoting institution |
| Sidbi | Small Industries Development Bank of India |

*"If we think that commercial banks will be able to...(practice) financial inclusion in a cost effective manner in rural areas, we are 100% mistaken. It is left to the rural and urban cooperative banks and many other arms of the financial system to achieve the obligations of financial inclusion," (RBI Deputy Governor V. Leeladhar, 30 May 2008, Bangalore)*

## 1. Introduction

The study of DCCB Bidar cannot be separated from the history of the credit cooperative system in India which in an earlier phase provided the framework for its establishment and in a more recent phase for a multitude of challenges resulting from government intervention. It must also cover the credit cooperatives of Bidar District as the bank's owners and users, which have been equally affected by the changes in the policy environment. Finally, it must include a study of its most outstanding achievement: SHG banking as an instrument of inclusive outreach to the poor, which DCCB Bidar has pioneered among the cooperative banks of India. This case study is thus based on historical material on the credit cooperative system in India, the bank's annual reports, information generously provided during field research in May 2008 supported by ADB, as well as previous studies of DCCB Bidar (in 2002) and of various aspects of rural finance including SHG banking (since 1994) in India by Seibel (supported by IFAD, GTZ and InWEnt).

For centuries, since taxes had to be paid in cash instead of kind, farmers in India depended on moneylenders, dispossessing large number of farmers and throwing many of the rural population into abject poverty. As Sir Daniel Hamilton put it in1884: "The power that stands in the way of India's economic development is the power of evil finance…. The land lies blighted by the shadow of the mahajan (usurer)." Government intervention accomplished little: "The dole system was resorted to by rendering active help in times of famine and loans were given from Government funds. This… proved to be only a palliative but no cure." (Huss 1924: 83)

As news spread of the emergence of a new system of rural finance in Europe, Sir Frederick Nicholson was sent to study the question of mutualist credit and the mysteries of a system based on self-help by the farmers themselves. He summed up the results of his inquiry in two words: "Find Raiffeisen." 1894 thus marked the dawn of the restructuring and reform of rural finance in India, just five years after the passing of the credit cooperative act in Germany. Ten years later, in 1904, the Co-operative Credit Societies Act was passed, laying the legal foundation for a new system of rural finance in India. Within twenty years some 50,000 credit cooperatives came into existence. "People's Banks are the greatest benefit that India has yet received," stated an Indian registrar. (Huss 1924: 82-83)

The District Central Cooperative Bank (DCCB) of Bidar in Karnataka, which is the object of this study, was founded in 1922, during the golden age of credit cooperatives. Its establishment, together with numerous other DCCBs at district level throughout India, marked the consolidation of a fast-growing self-help movement, at a time when the credit cooperatives had reached a level of expansion where they needed a bank of their own in their vicinity as an instrument of liquidity exchange and refinance.

The credit cooperative system continued to grow in quantity and complexity, with almost 15,000 banking outlets, more than 100,000 primary credit cooperatives and a total number of 135m shareholders today. Along similar lines, DCCB Bidar continued to grow, attaining virtually total outreach to all land-owning farmers in the district and their 171 credit cooperatives (PACS).

However, while cooperative finance essentially is part of a self-help movement, its establishment and expansion in India involved the government as an active participant and promoter from inception. This stood in sharp contrast to countries like Germany, the Netherlands and many others where the state was kept at bay, entering only in due course upon the request of the movement to provide a legal framework. Not so in India, where a law marked the starting point, and the establishment of a central bank, the Reserve Bank of India, in 1935 opened the flood gates of a generous government supply of financial and human resources. This led to a long drawn-out process of restructuring and reform in reverse, which eventually turned a self-help movement into a vast network of public institutions.

The final result has been disastrous. Large numbers of cooperative banks, and more than half the primary credit cooperatives, are loss-making. Many are technically bankrupt, but are kept open, thanks to lenient supervision and political pressure. DCCB Bidar is one of those cooperative banks which have survived the negative restructuring and reform during the independence era; but it has not flourished. It has been able to gradually increase the share of internally mobilized funds, and has remained moderately profitable throughout its history. This is attributed to a committed board of directors and management, though it is difficult to pinpoint the secret of this commitment over its long history.

In contrast to DCCB Bidar, most of its shareholding members, the 171 credit cooperatives, are in bad shape, just like the majority of credit cooperatives in India. There is a long list of factors which have undermined their health: loan channeling, mandatory crop lending, interest rate subsidies and controlled interest rates, loan and interest waivers and all kinds of political interference, backed by the complacency of their multiple regulators and supervisors. Reform of the cooperative sector is under way, but had not yet reached Karnataka at the time of study. The government will clean the portfolio of non-performing cooperative banks and primary societies. Whether restructuring across the board at the expense of the government will turn the cooperatives back on their feet in a lasting manner remains to be seen; some in the sector fear that restructuring might act as a perverse incentive, rewarding the defaulters.

Yet, despite the poor overall performance of the credit cooperative sector, during the last decade DCCB Bidar together with its primary credit cooperatives has achieved a revolution in inclusive outreach. In the framework of a national program they have expanded their services to the vast majority of the rural poor in Bidar, who do not own land, by assisting them to organize in self-help groups (SHGs). The SHGs, with more than 200,000 members in Bidar District, are grassroots financial intermediaries owned by their members. They mobilize their own resources from savings and profits and, as nominal members of the PACS, have access to bank refinance channeled through the PACS. In contrast to landed male members of the cooperatives, the landless female members of the SHGs save regularly und repay their loans on time.

In Bidar the vigor of the SHGs and their members might eventually lead to a type of reform of the primary credit cooperatives quite different from the one envisaged by the government. If the women in the SHGs would become shareholding members of the PACS, this might revolutionize their membership, resource mobilization and credit culture, turning the cooperatives back into self-help organizations. But this would require the state to pull out of its patronage, once and for all. There is no sign that it might happen.

## 2. Restructuring and reform in reverse: The rise and fall of the credit cooperative system in India

### A great start

Credit cooperatives in India had a great start, taking off with a legal framework in 1904, the Co-operative Credit Societies Act. In no other country, not even in Germany where the movement had originated around 1850, did credit cooperatives expand faster. Regulation and supervision provided a conducive framework: "Registrars refuse to register societies unless the applicants have been properly instructed in co-operative principles and unless there is sufficient and efficient supervision…. Nonfunctioning societies are dissolved by the Registrar." (Huss 1924: 84-85; Strickland 1922: 45)

Self-financing and self-governance kept the movement growing, as Strickland (1922: 51) stated in *Co-operation in India*: "The credit movement of British India is not working with official money: about 50% of its capital consists of small shares contributed by the members and the surplus accumulated from the interest on their borrowings; another 10% consists of deposits by the members themselves, the remainder is commercial credit. The societies are not managed by Government or by officials, they are in the hands of their members, subject to an audit prescribed by law and carried out by non-officials under a decreasing official supervision."

### Continual growth…

By 1912 credit cooperatives numbered 8,000; they reached around 50,000 by the mid-1920s. Lending rates of interest were in the range of 9%-12% p.a., far below those of the informal sector. As in the early Raiffeisen credit associations, unlimited liability initially served as a substitute for collateral. Citing Prof. Jadunath Sarkar, that "the movement of co-operative credit is tending to create a revolution… in rural India. The people have developed an extraordinary capacity for united action", Huss (1924: 83) simultaneously issued a prescient warning: "The fact that the British Government planted the idea of co-operative credit in the minds of the Indian people and guided the movement through the last twenty years is now considered by the Indians as a >pre-natal defect<." A decade later, in 1934, the Reserve Bank of India Act included provisions for refinancing the cooperative credit system. After a good start, this marked the wrong turn. From there onwards overdues increased rapidly.

The credit cooperative system (CCS) has continued to grow and forms an essential part of what today is one of the largest rural finance systems[1] in the world. The CCS comprises 51 state cooperative banks, 1,133 district cooperative banks with 13,743 branches, and about

[1] India's formal rural financial sector is mostly state-controlled. In addition to over 120,000 cooperative units, there are 98 commercial banks with more than 47,000 rural and semi-urban branches; and 196 regional rural banks (RRB) with 14,372 branches. The semi-formal sector includes about 800 MFIs. At the aggregate level, there are roughly 94m rural borrowers and 300m rural savers, including those who save at post offices. The outstanding rural credit as of March 2005 from formal sources was estimated at $100bn, with the commercial banks accounting for 53.0%, the CCS for 38.5%, and RRBs for 8.5%. There are 60m rural loan accounts with the CCS, compared to nearly 20m in the commercial banks and 6m in the RRBs. Yet there is a significant supply and demand gap, the poorest households having little access to formal finance.

107,000 primary credit cooperatives. Total outreach is around 135m shareholding members, plus an unreported number of so-called nominal members.

**… but ruinous government intervention**

The impressive growth has not been matched by performance. Rather, the >pre-natal defect< has turned into a contagious disease, resulting in frozen assets and heavy overdues as noted by the 1945 Cooperative Planning Committee. "State partnership" in terms of equity, governance and management, introduced in the mid-1950s in state cooperative laws,[2] worsened the disease. Encumbered by an ideology of central planning, the state assumed control over all institutions including cooperatives. Governance was alienated from the local communities and the members. Instead, state governments were given full authority in matters such as appointment of chief executives, suspension of elected boards of directors, fusion or fission of co-operative banks, amendment of bylaws, vetoing of bank decisions, issuing of directives, and supervision. State cooperative administrations are in charge of registration, licensing, statutory inspections and audit of the cooperative banks. The states participate also in the ownership of cooperative institutions at all levels. Bureaucracy, government intervention and loan channelling have replaced the original system of self-management and self-reliance. As stated by the Committee on Financial Inclusion, in the 1990s "an increasing realization of the disruptive effects of intrusive state patronage and politicisation of the cooperatives, especially financial cooperatives… resulted in poor governance and management and the consequent impairment of their financial health." The system became borrower-driven, and the concept of mutuality and self-reliance was lost. (Rangarajan 2008: 69)

**Diagnosing the disease**

The results have been disastrous: large numbers of cooperative banks, and more than 50% of primary credit cooperatives (PACS), are loss-making – probably many more if international accounting standards were applied. According to Nabard's annual report (2007: 87), cooperative credit institutions suffer from low resource base, high dependence on financing agencies, imbalances, poor business diversification and recoveries, huge accumulated losses, lack of professionalism and skilled staff, weak MIS, poor internal check and control systems, etc. As on 31 March 2006, large numbers of cooperative institutions incurred losses: 4 out of 31 reporting state cooperative banks (SCBs), 88 out of 366 district central cooperative banks (DCCBs), 53,626 out of 105,735 primary agricultural credit cooperative societies (PACS), 8 out of 19 reporting State Co-operative Agriculture and Rural Development Bank (SCARDBs) and 194 out of 696 reporting Primary Co-operative Agriculture and Rural Development Banks (PCARDBs). The total accumulated losses of the CCS, excluding PACS, amounted to Rs9,139 crore (US$2.05bn).

Three-fourths of CCS credit is for crop loans. After a century of cooperative development the farmers have not learned to finance their recurring seasonal financial needs from their savings. This portion of scarce financial resources is not available for investment loans, further widening the demand and supply gap.

The problem is most serious at the bottom tier, the PACS, with some 120m shareholders[3] and a large number of so-called nominal members. With reportedly half the PACS loss-making and most of the other half poorly performing, client deposits amounting to $4.3 billion are at risk. PACS are channeling agents, the largest part of their funds provided by Nabard, guaranteed by state governments and rolled over perpetually.[4] If Nabard refinance were recalled, the CCS would collapse. The CCS is supposed to be the binding element for the

[2] In line with the cooperative act of 1919, which had made "cooperation" a provincial subject.
[3] 42% are small or marginal farmers, 37% marginalized social groups. 51m members are borrowers.
[4] As of 31 March 2005, Nabard (2007:81) reports the following consolidated balance sheet data for the PACS: owned funds Rs92.0bn ($2.1bn); deposits Rs189.8bn ($4.3bn); borrowings Rs 402.5bn ($9.2bn). No data are given on loans outstanding and non-performing loans.

broader cooperative movement in India, which includes crop production, processing, marketing, input distribution, dairying, weaving, and textiles; its reach directly or indirectly extends to nearly half of the population. The sad state of the CCS is all the more tragic as it adversely affects the backward (inputs) and forward (marketing) linkages and their integration with the multipurpose service concept of the cooperative system, a major impediment to rural development.

Numerous problems in the cooperative credit system have been noted, including inadequate provisioning resulting in inflated reported profits or deflated losses, erosion in the value of assets, inadequate financial margins, ineffective fund management, poor risk management, lack of appropriate corporate governance, and weak internal checks and controls (ADB 2006: 94). All this can be brought down to one core problem: the lack of effective supervision, which in turn is due to fuzzy delineation of authority and to political control over the cooperative sector.

Nabard, carved out of RBI in 1982, supervises the banks, providing at the same time refinance and capacity-building. The DCCBs supervise the PACS. But no one possesses the authority of enforcing compliance. Nabard reports serious deficiencies to the cooperative department of state governments, which act as concurrent supervisors, auditors, dominant shareholders, managers and regulators – an agenda of conflicting interests. SCBs and DCCBs are classified as banks under the Banking Regulation Act of 1949; but prudential norms cannot be enforced since the registrar of cooperatives is empowered to override or delay implementation of RBI recommendations. State governments are not inclined to close non-performing institutions or to insist on good corporate governance. To the contrary, credit cooperatives are loan channels for economic and political purposes; and the overall credit culture is undermined by interest subsidies and loan or interest waivers. Its long history has been a liability rather than an asset of the CCS, with no living memory, or institutional recollection, of a splendid past.

**Towards cooperative reform**

Some states have recently provided a different legal framework, starting with Andhra Pradesh which in 1995 passed a Mutually Aided Cooperative Societies (MACS) Act. These societies are autonomous and not subject to the authority of Nabard or a cooperative registrar. Some remarkable developments have ensued, as among SHG federations; but the problem of effective supervision has remained unresolved, as MACS and similar institutions have not, or not yet, established a financial authority of their own. They are also beyond the purview of the ongoing reform efforts.

Since the 1990s India has taken steps to liberalize its financial sector. These reforms have first been mainstreamed in the government-owned commercial banks and subsequently among the regional rural banks (RRBs), but not in the rural CCS. A comprehensive reform program to transform India's CCS is now under preparation (Vaidyanathan 2004).[5] Announced in January 2006, the reform package is "designed to transform the potentially viable CCBs into democratically governed, efficiently managed, financially sustainable, self-reliant entities that can provide a wider range of financial services to the rural poor" (World Bank 2007: 1-3). Legal reforms are to be geared at full independence and autonomy of cooperative institutions; regulatory reforms at effective enforcement of RBI's prudential regulations and corporate governance standards; operational reforms at uniform financial reporting and internal control systems, improved credit appraisal and risk management, and new staffing policies; and restructuring at cleaning the balance sheet.

Total cost of the short-term CCS at the all-India level has been estimated at Rs136bn (US$3bn): 92% for cleaning up accumulated losses and 8% for audit, human resource development, and technological support. The costs are to be shared by the central

[5] Some inspiration has reportedly come from isolated reforms in southern India including Bidar District.

government (68%), state governments (28%) and the CCS (4%). The Central Government (GOI) will provide its share as grants, while the states will meet their share from their budget or through open market borrowing. In support of the revival package, ADB[6] has sanctioned a loan of US$1bn, the World Bank US$600m and KfW €140m to GOI. GTZ, in cooperation with DGRV, the German Cooperative and Raiffeisen Association, is among the agencies providing technical assistance.

Some critical observers from within the CCS question the likely outcome. They see restructuring at government's expense as a perverse incentive, just like interest and debt waivers, rewarding the defaulters and confirming expectations of continual government leniency.

## 3. DCCB Bidar: a steady performer in a difficult environment

**Bidar, an underdeveloped district**

Bidar, with a population of 1.5m in 599 villages and a population density of 276/km², is a remote and poorly developed district in Karnataka State, with irregular rainfall, averaging 890 mm. The main source of employment is agriculture, with a heavy reliance on sugar cane; other main crops are rice, cotton and pulses. 65% of holdings are up to 2 ha. 25% of cultivated land is irrigated. 56% of the 300,000 families in Bidar are below poverty; 30% belong to scheduled castes and tribes. There is a total of 18 banks in the district, with 136 branches, 68% rural. Total deposits as of 31/3/2007 were Rs11.6bn ($266.1m) and total loans outstanding Rs10.5bn ($240.9m), 14% overdue as of June 2007. The total number of bank loan accounts was 219,000, with an average outstanding of Rs47,800 ($1,078). In addition there are 207,400 accounts of the poorer section of the population in 14,000 SHGs (*March 2008*), which in turn hold credit and savings accounts with banks. All villages, and 94% of poor families, are covered by SHG bank linkages, mostly through DCCB. (Nabard 2007: 7, 10, 88) In Karnataka State the three-tier cooperative banking sector comprises 4630 Primary Agricultural Cooperative Credit Societies (PACS), 21 District Central Cooperative banks (DCCBs) and a State Cooperative Apex Bank, established in 1915. In FY 2002/03 and 2003/04 the DCCBs as a whole incurred losses, as did the apex bank; in 2006/07 average profits per DCCB amounted to Rs32.3m (US$0.74m).

**The policy environment and how it afflicts performance**

In a mixture of social concern and political motivation, policy has undermined the performance of the cooperative banking sector. By withdrawing resources from both the PACS and the DCCB, government-imposed loan and interest waivers have affected state and national policies, resulting in a kind of negative restructuring. In addition there are substantial liquidity requirements of 25% for DCCBs to be held in other banks and 3% within the bank itself. It is also feared that interest subsidies to SHGs will undermine their dynamics and sustainability.[7]

Loan and interest waivers for cooperatives are a popular instrument in India, both at national and state levels. There is a long list of loan and interest waivers of the government of Karnataka for cooperatives (Nabard 2007: 98). Eg, in 2002 Karnataka State announced a 100% waiver of interest payments. This was followed in 2004 by a 7% interest rate subsidy which continues to be in force. In 2006 the state announced forgiveness of loan amounts up to Rs25,000, including the same portion of larger loans up to Rs50,000, provided the amount

[6] In line with ADB's strategic priority in India of inclusive social development. ADB's assistance is limited to five states, where total cost is estimated at $1.43bn.

[7] The Committee on Financial Inclusion (Rangarajan 2008: 84) noted "that certain States are providing a subsidy on interest rates being charged by banks to the SHGs... (which) cuts at the very root of the self help character of SHGs… the subsidy could be re-directed towards capacity building efforts or in providing input supplies and marketing support to the SHGs," the latter being precisely what DCCB intends to do.

above Rs25,000 was repaid. Some waivers were conditional upon repayment of loans or portions thereof and led to improved agricultural loan recovery in 2007.

In his Union Budget Speech on 1 March 2008, the Minister of Finance announced a Rs600bn (US$ 15bn) loan waiver; banks would be reimbursed over a period of 2-3 years. The announcement allegedly came in sight of federal government elections in 2009. An immediate fall-out was the promise of total loan waivers, and a reduction of the interest rate on agricultural loans from an already abysmally low 4% to 3%, by all political parties in Karnataka State during the May 2008 elections.

The results of these pronouncements, seen from the perspective of DCCB, are two-fold. First, they undermine the credit culture. The deleterious impact of the announcement in the Budget Speech on PACS and DCCB in Bidar were immediate: from March 1, the day of the announcement, to May 13, the time of our field visit, not a single payment has been recovered. Second, they cut down on the loanable funds of the cooperative sector. PACS and DCCB are reimbursed by the government, but this takes up to two years and longer. The PACS suffer from a shortage of funds repaid and from a decrease in refinance from DCCB, which in turn hurts DCCB. When the government announced interest rate subsidies in 2004, farmers expected loan waivers and delayed repayment of loans as well as new loan applications. As a result, DCCB was only able to sanction Rs600mn ($13.8m) instead of an expected Rs1.8bn ($41.5m). The impact of delayed reimbursements for waivers is cyclical. At the time of delayed payments, as in 2006/07, net profits dropped from Rs23.7m ($0.53m) im FY 2005/06 to Rs17.3m ($o.40m) in FY 2006/07; when the government settled its dues, as in 2007/08, profits rebounded to Rs29.4m ($0.74m). It is hard to avoid the conclusion that while with one hand the government is trying to salvage the cooperative sector, with the other it is tearing it down.

**History, mandate and reorientation of Bidar DCCB**
*The District Cooperative Central Bank Ltd. Bidar* was established in 1922, at a time of rapid expansion of the credit cooperative sector, with the mandate of serving the primary credit cooperatives in Bidar district.[8] Its functions included deposit mobilization from individuals and cooperatives, refinancing of cooperatives, liquidity exchange and investment of surplus funds on the commercial market (Strickland 1922: 50). Its legal framework had been provided by the Co-operative Societies Act of 1912, which made allowance for “secondary bodies, i.e., central banks and unions intended to finance, supervise, or co-ordinate the primary societies.” (Strickland 1922: 36) Furthermore the cooperative act of 1919 had made “cooperation” a provincial subject, thus providing a framework for provincial and, after independence, state government intervention.

Little is known about the first thirty years. In 1954 the neighboring Ugdir Cooperative Bank was annexed, and the DCCB was reregistered. Territorial changes in state borders in 1956 led to redefinitions of the bank’s area of operation. This coincided with the decision to switch from short-term loans based on land revenue[9] to the present crop loan system, which at the time turned out to be a great boost. In 1971 the office of a deputy cooperative registrar was opened in Bidar.

Several events positively affected the bank. In 1984 a new management was appointed, and a new president was elected, who is still in office. New deposit and loan schemes were introduced, resulting in steady growth. At the same time the bank responded to Nabard’s directive to increase its non-agricultural (ie, non-crop loan) portfolio to above 50%, which

[8] “The central banks have in nearly all cases been founded by groups of public-spirited and comparatively wealthy men…, who contributed share capital and business ability in order to raise funds for the benefit of primary societies.” (Strickland 1922: 48)

[9] At a ratio of 1:12 of taxes paid on land to loan amount.

resulted in faster growth of deposits and loans. Since 1992, again under a new management, the bank has been gradually diversifying its portfolio, with such new products as gold (as collateral) and salary loans and business loans, including loans to agribusiness and chemical industries. In 1996 the bank joined the SHG Banking program promoted by Nabard, which opened up a rapidly expanding new market.

**Towards inclusive finance**

Over the past twenty years there has thus been an overall change from exclusive to inclusive finance, in two phases: the first, as of 1987, from agricultural credit for farmers to a diversified portfolio; the second, as of 1996, from exclusive services for cooperatives of landed farmers to inclusive finance for the unbanked, organized in self-help groups (SHGs) predominantly of women; this was followed in 2000 by microloans to unemployed youth trained in the bank's training facilities. This has led to a change from a narrowly defined market predominantly of male farmers to a rapid increase in inclusive outreach to the poor and to women, affecting both the bank and the PACS.

DCCB Bidar is considered one of the best among 367 district cooperative central banks in India, consistently showing profits. It functions as a central cooperative bank in the region, delivering its services through 43 branches, 171 primary agricultural credit cooperative societies (PACS) and, starting in 1996, 11,000 self-help groups (SHGs), which are nominal members of the PACS. The primary function of the bank from the beginning has been providing financial services to the PACS in the district, with an emphasis on crop agriculture. Since 1967 DCCB has financed a cooperative sugar factory in Bidar, the only one at the time, and since 1987 a broader agriculture-related sector, including several cooperative and private sugar factories. Since 1992 DCCB has further diversified its portfolio, with consumer loans and finance for non-agricultural cooperatives. In 1996, when Nabard began implementing its SHG Banking program for the rural poor on a national scale, DCCB expanded it mission to include SHGs predominantly of poor landless women. It further deepened its inclusive outreach in 2000, establishing a non-formal training center for unemployed youth and providing start-up and repeat loans for new microbusinesses of the trainees.

**Ownership and governance**

DCCB is a statutory institution registered by the Registrar of Cooperatives and licensed by the Federal Reserve Bank of India (RBI).[10] The regulators are Nabard and RBI; supervisors are the Registrar of Cooperatives and the apex cooperative bank. DCCB is owned by 385 cooperative societies as shareholders, among them 171 PACS. 11,000 SHGs are non-shareholding *nominal* members of the PACS without voting rights.

DCCB is governed by a board of eleven members, all from within the cooperative sector. As throughout the CCS, there is no private sector or non-cooperative banking expertise on the board. Five board members are elected by the PACS. Three are chosen through elections organized by the government: one each from the Urban Cooperative Bank of Bidar, the Taluka Agricultural Produce Marketing Cooperative Society and other cooperative societies. One board member is nominated by the apex cooperative bank. There are two ex-officio members, the managing director and the deputy registrar of cooperatives. The managing director is appointed directly by the registrar of cooperatives of Karnataka; he is an officer with the rank of joint registrar of the department of cooperatives of the state government. General elections are held every five years. The president and vice-president are elected by the board of directors every 2.5 years. Incumbency tends to be indefinite; eg, the president has been with the bank since 1968 and has presided over the board since 1985. The same holds for senior staff which is promoted to management positions, not hired from outside; eg, the general manager has been with the bank for 35 years.

[10] Only 3 out of 23 DC banks in the district are so licensed.

The board meets every two months. It decides over corporate loans and loans to PACS up to Rs3.5m ($87,500) and over appointments and promotions. While agricultural lending rates are set by the state government, the board reviews deposit rates and non-agricultural lending rates every quarter.

Good corporate governance (GCG) has not been impeded by the interference of trade unions, which have played a disruptive role in the reform of the regional rural banks (RRBs). As DCCB has adjusted its salary scales and terms of employment to those of the government, there have been no disputes with the union in twenty years.

Effective risk management, a crucial part of a bank's governance system, is impeded by the bank's mandatory function of channeling crop loans to farmers through PACS, regardless of their performance. This imposes restrictions on the bank's selection of wholesale and retail clients and on lending decisions. The bank cannot exclude loss-making PACS; and has little control over crop loans to the 150,000 PACS members, 90% of whom are borrowers.

Risk management is in the hands of the MD and GM. There are monthly reviews by the MD and department heads of the performance of all loans. Only two risks are reportedly monitored: credit risk as the main perceived risk and interest rate risk as a minor additional risk. Risk management by the MD and GM is supported by a task force chaired by the president. The majority of the task force is external, comprising officials of the apex cooperative bank, Nabard, RBI and the cooperative registrar's office, plus the MD and the GM. Meetings are quarterly and last for about 2-3 hours. The task force mainly reviews the financial statements of the bank. It is difficult to see how the task force with its limited time involvement could effectively contribute to risk management.

The accounting system at the branches and the HO is computerized. But this is not matched by a computerized management information system (MIS). Each of the branches prepares some 20 monthly reports. The branch reports are transmitted by hardcopy. The incoming data are processed and consolidated at the bank's IT department; full computerization is now under preparation. Since 2007 the bank reports electronically to the three regulators, RBI, Nabard and the department of cooperatives, with slightly different formats. The bank uses these reports for monitoring; but they do not seem to be used systematically for informing its decision making (EDA & M-CRIL, 2003: 16). Also, the lack of harmonization of reporting formats among the regulators imposes a burden upon the bank.

Branches are inspected every half year by a division in the accounts department. The bank is audited by the department of cooperatives. Good governance is inspected by Nabard; shortcomings are pointed out to the department of cooperatives of Karnataka, which may or may not take action. The two essential norms are a statutory liquidity ratio fixed at 25% and a cash reserve ratio of 3%; the bank is complying with both. The main moot issue is the bank's over-exposure to the sugar sector, which according to Nabard should not exceed 40% of internal funds but, due to pressure from sugar farmers and their PACS as well as state government, has actually reached 70%. Ironically, the bank had initially moved into lending to sugar farmers and sugar factories following guidance from RBI and Nabard at a time when the price of sugar was high. As the price of sugar dropped, non-performing loans have surged, revealing imprudent risk management by the bank and inadequate oversight by its supervisors.

**Structure, delivery system and personnel**
DCCB is divided into six departments: Planning and Development, Establishment, Loan Supervision, Accounts, Information Technology, and Microcredit which is in charge of SHG banking. The bank is managed by a managing director, a general manager and six deputy general managers, each in charge of a department.

The bank has 43 branches, comprising 12 full branches and 31 pay offices with a limited range of operations. The branches are profit centers; but there are no special incentives related to branch performance. All branches collect deposits, and they finance agricultural loans through 171 PACS as part of the bank's delivery system. Only full branches are authorized to provide nonagricultural loans directly to borrowers. A branch is supposed to have a minimum of 4-7 employees, but eight branches have two employees only.

*Lending authority* is vested in the board, the MD and the branch managers. Branch managers decide on loans to individuals and SHGs up to Rs100,000 ($2,500), the MD up to Rs300,000 ($7,500). There is a special business loan program for the unemployed, trained at a training center of the bank. Lending authority of branch managers for such start-up loans is limited to Rs5,000 ($125); larger loans up to Rs25,000 ($625) are decided by the head office. All corporate loans and loans to PACS are decided by the board, which meets every two months, with a limit of Rs3.5m ($87,500) set by Nabard as the maximum single loan exposure. The bank complains that many good clients demand bigger loans and migrate to commercial banks. Agricultural and non-agricultural loan applications to be submitted to the board are screened by a committee, which usually meet on the same day as the board. EDA & M-CRIL (2003: 18) found that the lack of adequate delegation of power to branch managers regarding non-farm loans leads to considerable delays in decision-making.

*Total employment* of the bank as sanctioned by the government is 273. Of the 273 regular employees 26% are female; there are no women in senior positions. In addition there are 10 employees for SHG banking by special permission of the state registrar of cooperatives, and 171 assistant SHG supervisors, one in each PACS, which originally were paid by the bank on a declining sharing arrangement and are now fully taken over by the PACS.

Until February 2008 employment size and pay scales were set by state government. All employees in clerical and manual positions are appointed by the board. All management positions are filled by promotion, except that of the managing director, who is appointed by state government. The board decides on promotions, proposed by a screening committee which takes into account vacancies and annual staff evaluations. In 2007 there were 38 promotions from clerical to management. Employees are not civil servants, but are paid according to the civil service pay scale. The salary comprises a base pay, a medical allowance and other allowances. If the bank makes a profit, 20% of the salary is added for the financial year, regardless of the size of the profit. There are no individual performance incentives. Retainment rates are very high; employment tends to be life-long, generating a strong sense of commitment. Retirement age is 58.

By notification of 13/2/2008 the Cooperative Act of Karnataka State has been amended. The board of a DCCBs that has been profitable for at least three years is now authorized to decide on personnel and their pay within the framework of a revised government pay scale: a new experience and challenge for the bank. The bank expects to employ an additional 80 staff members; hiring on the market on such a scale will be a new experience for the bank. The bank will now also be free to introduced performance incentives if so desired.

All employees are trained in external training centers. Main areas of training are induction, profitability, modern banking, loan appraisal, effective recovery, fund management, general banking, inspection and audit, and financial management; there is no training abroad. With a training budget of $25,000, 58 persons were trained in 2007-08. With support from Nabard and Sidbi, the bank maintains two specialized training centers, one for SHG banking and one for the unemployed.

**Source of funds**

Sources of funds are deposits amounting to $79.44m (61%) and borrowings of $51.50m (39%) as of 31 March 2008. In the cooperative banking sector as a whole, this ratio is reversed, which indicates that the bank is on the way to self-reliance. The bank is required to place deposits which are not intermediated in the cooperative apex bank. Nabard and the state apex cooperative bank are the main lenders, accounting for respectively 65% and 35% of borrowings. Nabard reduces its refinancing of agricultural credit if non-performing loans exceed 10%. Nabard charges 3.15% on short-term loans (the bulk of its lending) and 9.5% on medium-term loans; the apex bank charges 6.5%, which in 2007 corresponded to the inflation rate. Total equity is $19.0m, comprising $5.3m in paid-up capital and $13.7m in statutory and other reserves.

**Financial products**
While diversifying its sources of funds and loan portfolio, the bank's operations are still shaped by traditions of supply-led finance, with target groups, loan purposes and interest rates to a considerable measure externally determined or influenced. Based on preparations by the various banks, Nabard presents a Potential Linked Credit Plan, which provides a basis for a district credit plan prepared by the State Bank of India as the lead bank for Bidar. Crop loan decisions are not based on expected profitability and repayment capacity; instead, DCCB, through PACS, lends fixed amounts per ha, eg, Rs20,000/ha for sugar cane, Rs6,000/ha for pulses and Rs6,000/ha for oil seeds.

DCCB offers a highly differentiated range of products, comprising 30 deposit and 139 loan products, the latter characteristic of a tradition of targeted credit. Many of the credit products are similar, differing only by category of recipient or purpose; rationalization would enhance the bank's efficiency in many respects.

*Deposits:* Depositor outreach is 280,325 accounts, close to the number of families in the district, with a total deposit balance of $79.44m and an average deposit size of $283. Savings deposits have the largest number of accounts and the largest balance, but the smallest average size. Regular deposits and micro cash certificates are particularly attractive products, with much larger average sizes. Interest rates vary from 0% (on current accounts) to 9.5%; the interest rate on 3-month fixed deposits is 6%. The weighted average interest rate as given by the bank is 3.21%; at an inflation rate of 6.4% in 2007, this is a negative real rate of -3.2. Low-cost deposits account for 40% of total deposits. The deposits-to-loans ratio is 69%, and the loans-to deposits ratio 144%. Despite the large number of accounts, in terms of amounts there seems to be a considerable potential of additional deposits. Many clients reportedly borrow from DCCB, but take their deposits to a commercial bank, which as a result are overliquid. Depositing in commercial banks and borrowing from DCCB/PACS is an unhealthy pattern that should present a major challenge to the bank.

**Table 1: DCCB, deposit products, 31 March 2008**

| Product | Interest rate | No of accounts | Amount (US$ million) | Average (US$) |
|---|---|---|---|---|
| Current deposits | 0 | 3,025 | 1.79 | 592 |
| Savings deposits | 4 | 214,458 | 30.22 | 141 |
| Regular deposits | 5.0-9.5 | 25,567 | 20.06 | 785 |
| Fixed deposits | 5.0-9.5 | 24,142 | 5.43 | 225 |
| Micro cash certif. | 9.5 | 13,133 | 21.93 | 1,670 |
| Total | | 280,325 | 79.44 | 283 |

*Loans:* Borrower outreach is 164,022 accounts, including 145,000 crop loan accounts via 171 PACS and 10,966 SHG accounts, but excluding the SHG membership of 170,000. Most of the bank's portfolio is agriculture-related, which includes loans officially designated as non-agricultural, such as loans to sugar factories. Analytically, one may distinguish between wholesale and retail lending. The bank's wholesale lending comprises 171 PACS accounts and 10,966 SHG accounts. The bank's own direct retail lending to individuals and firms comprises 8,222 accounts; 55% are loans against fixed deposits and most of the rest cash credit loans, largely handled by the branches. The total number of accounts held by the bank thus amounts to 19,359; 57% of these are SHG accounts, which are handled by the PACS. End-user outreach would amount to 323,000 accounts – more than the number of families in the district – if SHG members are included, but not all are borrowers at any given time.

The total amount outstanding as reported on the bank's balance sheet is $114.7m; the average loan outstanding is $700. Total disbursements during 2007-08 amounted to $152.7m. Short-term crop loans via PACS, with about 145,000 accounts and an average of $322 outstanding, account for 41% of the total portfolio.

*Kishan credit cards (KCC)*: The crop loans are handled by KCCs, one for each PACS member. The KCC accounts are held by the PACS; liquidity management is in the hands of the bank, each PACS holding one account with the bank. KCCs operate like overdraft accounts, allowing the farmers to withdraw small amounts as needed within their credit limits, or to repay early, paying interest only on the actual loans outstanding. The KCC credit limit is established for each farmer every three years, taking into account land holdings, types of crop and past credit performance. The individual credit limits of the PACS members are totaled up to become the limit of a PACS.

Short-term non-agricultural loans, with 344 accounts and an average loan size outstanding of almost $110,000, account for another 33% of the portfolio. 1100 cash credit loans comprise 8% of the portfolio; the maximum loan size is $125,000; the average outstanding balance is $8,557. They include some 500 petty business loans for start-ups trained by the bank at its training center for the unemployed, with a maximum initial loan size of $625. Like the KCCs, they are handled like an overdraft, permitting for flexible withdrawals and repayments within a one-year period, and may be subsequently renewed up to a limit around $2,500. Along the same line PACS are encouraged to lend to small businesses from their own funds. The bank's largest loan is to a sugar factory, amounting to $25m, which exceeds the bank's total equity.

**Table 2: Loan products, interest rates, loans outstanding and NPLRs, 31/3/ 2008**

| Product | Interest rate: To PACS, SHGs | Interest rate: End-user rates | No of accounts | Amount (US$ million) | Average (in US$) | NPL ratio |
|---|---|---|---|---|---|---|
| Short-term crop loans | 6 (+7.5% subsidy) | 4 | 144663 | 46.6 | 322 | 0.31 |
| Short-term non-agric. | | 13 | 344 | 37.5 | 108,897 | 13.05 |
| Medium-term agric. | 9.50 | 11.50 | Incl'd above | 3.8 | | |
| Medium-term non-agric.* | | 13 | 2276 | 6.3 | 2,783 | 42.75 |
| Loans to SHGs | 4% (+7% subsidy) | ~24 | 10966 | 7.3 | 662 | 0.41 |
| Cash credit | | | | | | |
| To PACS | 13 | 14-15 | 171 | 0.3 | 1,695 | 0 |
| To individuals | | 13 | 1100 | 9.4 | 8,557 | 24.78 |
| Other | | 13 | 2 | 0.3 | 129,960 | 100 |
| Loans against fixed deposits | | FD+9% | 4500 | 3.3 | 727 | 0 |
| Total | | | 164022 | 114.7 | 699 | 8.86 |

* Without SHG loans via PACS.

*Interest rates* were liberalized in 1998. But as agricultural lending rates continued to be fixed by the state government, financial repression has persisted. Until 2004 the lending rate was 6% to PACS and 4% to farmers, which left the PACS with a margin of 2%, plus a subsidy of 5.5% to DCCB by the state government – adding up to 11.5%. At that rate DCCB incurred a loss. In 2006 the subsidy to DCCB was increased to 7.5%. The margin of 2% for the PACS and the end-user lending rate of 4% to farmers remained unchanged, bringing the total interest rate to 13.5%.

Since 2007 Karnataka State has instructed DCCB to lend to SHGs at 4%, paying the bank a subsidy of 7%.[11] SHG are free to charge any rate of interest, using the margin to build up their internal fund. Most SHGs lend to their members at 24 % p.a. (or 2 % p.m.), ie, at a comfortable margin of 20%. In 2008, as the inflation rate exceeds 8%, the end-user lending rates of 4% to farmers for crop loans and to SHGs is equivalent to a real rate of about -4%.

About 58% of the bank's portfolio is handled by the PACS, including SHG loans. The PACS operate on an extremely narrow margin, 2% in the case of crop loans, on which they take the risk, and a commission of 1% in the case of SHGs, which is not sufficient to cover their transaction costs.

The bank charges 13% p.a. on its own direct end-user loans, except on loans against fixed deposits, on which the bank charges 9% above the respective fixed deposit rate. The weighted average interest rate of the bank is given as 7.16%, barely above the inflation rate during 2007. The bank's net interest margin in 2007-08 was 3.3%; since 1994 it has fluctuated between 2.8% and 4.9%. Despite deregulation, banks in India are under strong moral suasion to charge low interest rates, with negative effects on service quality, profitability and innovation. At such interest rates customers are not compelled to invest scarce financial resources in activities with the highest returns; instead they waste a major portion year after year on crop loans, instead of financing their recurrent expenses from the proceeds of their harvest. In the absence of individual performance incentives, there is little opposition among bankers against such an interest rate regime.

*Repayment schedules:* Crop loans by PACS are repaid upon maturity; early repayment is permitted. Non-agricultural short-term loans, including SHG loans, are repaid monthly, medium-term loans annually.

*Security:* Crop loans and other agricultural loans by PACS and DCCB are mortgaged. Salary, gold and deposit loans are secured respectively by salary deductions, gold and pledged deposits. Business loans are secured by movable and immovable property. SHG loans are collateral-free. Start-up microbusiness loans of Rs10,000 and above for unemployed who were trained at the bank's training center are collateral-free. Repeat loans to microentrepreneurs may go up to Rs100,000, with the business serving as collateral. Medium-term loans are secured by land. Sugar factories are financed against a pledge of sugar.

*Loan recovery:* Recovery of crop loans is in the hands of PACS. Non-agricultural loans are in the hands of a field officer in each branch. Recovery of loans by the head office is in the hands of a recovery team of three who visit branches in case of need. In case of overdue payments a letter is sent the day after the due date. The bank tries to find a solution; rescheduling might be considered. As a last resort the bank files a case. It takes 1-2 months to get a decree. Seizing the collateral takes one month, after which the assets are auctioned.

There is a sharp difference in repayment performance between the bank's wholesale and retail lending. The NPL ratios of three loan products via PACS and SHGs are below 0.5%, with the PACS and SHGs absorbing any slack in repayment. In contrast, the NPL ratios of the bank's own retail products vary from 13% to 100%. This is a serious, and unmet, challenge to the bank's credit risk management, aggravated by the lack of a computerized MIS.

[11] In Bidar District NGOs lend to SHGs at 24%, which is much closer to a market rate.

## Outreach and client satisfaction

Outreach in terms of number of accounts is summarized in Table 3. Like any bank, DCCB Bidar reports accounts, not individuals. It also does not report the number of male and female depositors and borrowers. The vast majority of PACS members are male farmers, while 97.2% of the SHG members are women. Total depositor outreach (in terms of accounts) is around 280,000; this excludes 170,000 SHG members with their compulsory savings accounts. Total borrower outreach is around 11,000 wholesale and 153,000 retail accounts, 95% of the latter handled by the PACS, plus 170,000 SHG members. The total number of accounts, both direct and indirect, is thus around 614,000. Around 600,000 accounts are held by individuals, probably less than half of them women.

**Table 3: Wholesale and retail outreach of DCCB, 31/3/2008**

| Outreach category | No of accounts | |
|---|---|---|
| Deposit accounts | | 280,325 |
| Wholesale loan accounts | | 11,137 |
| *PACS* | *171* | |
| *SHGs* | *10,966* | |
| Retail loan accounts | | 152,885 |
| *DCCB accounts* | *8,222* | |
| *Agricultural loans via PACS* | *144,663* | |
| SHG members | | 170,000 |

Client satisfaction is discussed at annual customer meetings in the branches. Main issues are loan ceilings, which are reviewed every three years by a district committee, and politically motivated loan and interest waivers, applicable only to the cooperative sector and regarded as disruptive.

### Financial highlights since 1971

There is no information available on financial performance of the bank during the first fifty years since 1922. However, the bank claims that it has always been in profit. Balance sheet data on the bank's working fund, which is almost identical with total assets[12], and selected items are reported for the period starting 1971. In Rupees (unadjusted for inflation), the working fund grew from Rs46.5m in 1971 to Rs307.3m in 1990, Rs 719.5m in 1995 and Rs 6,258m in 2008 (Table 4).

Returns for the period since 1971 have been marginal at best. Expressed in percent of working fund, return on assets (ROA) at end-of-financial-year (31 March)[13] was 0.3% in 1971; between 1975 and 1985 ROA at five-year intervals varied from 1.1% to 1.6%; in 1990 it fell to 0.0%; in the following five-year intervals it stayed at figures below 1%. Adjusting for inflation, subsidies and adequate provisioning, the bank would have been at or below the brake-even point for most of the years during that period.

Taking a look at the structure of the balance sheet, capital adequacy has weakened. Total equity in percent of working fund as a proxy rose from 16% in 1971 to 25% in 1980, fell gradually to 8% in 2000 and now stands at 12%. Gross loans fell from a high of 90% of working fund in 1975 to a low of 64% in 1990 and now stand at 73%. The composition of

[12] Working fund is defined by the bank as total assets less contra items less intangible assets less fixed assets less branch adjustment account. For 1995 and 2000 the figures for working fund and total assets are 100% identical; for 2005 and 2008 the working fund equals respectively 97.6% and 98.7% of total assets.

[13] Nowadays ROA is normally expressed as return on average assets over the preceding 12-month period, yielding a somewhat higher value. This is not possible for the period before 1995, because data are only reported for every fifth year.

sources of loanable funds has fluctuated considerably; but there has been an overall trend of declining borrowings, from 63% in 1971 to 33% in 2008, paralleled by increasing deposits, from 18% in 1971 to 51% in 2008. Overall this has been a healthy trend, but not fully satisfactory, for several reasons: since 1990 there has been no consistent increase in the share of deposits; the bank continues to rely to a considerable extent on borrowings, with strings attached; and cheap borrowings undermine savings mobilization and self-reliance. In addition, interest and loan waivers discourage both, the growth of the loan portfolio and the vigorous mobilization of savings.

**Table 4: Quintennial key balance sheet data in percent of working fund, 1971-2008**

| | Working fund * | | Balance sheet items in percent of working fund | | | | |
|---|---|---|---|---|---|---|---|
| Year | Rs. million | US$ million | Equity | Borrowings | Deposits | Loans gross | Net profit |
| 1971 | 46.5 | | 15.7 | 62.8 | 17.8 | 86.7 | 0.3 |
| 1975 | 82.8 | | 20.7 | 56.0 | 19.1 | 90.1 | 1.1 |
| 1980 | 100.6 | | 25.2 | 32.5 | 35.8 | 78.2 | 1.6 |
| 1985 | 182.3 | | 19.1 | 34.3 | 37.4 | 76.0 | 1.4 |
| 1990 | 307.3 | | 15.8 | 25.4 | 52.5 | 63.9 | 0.0 |
| 1995 | 719.5 | 22.8 | 10.1 | 36.1 | 46.3 | 70.9 | 0.6 |
| 2000 | 2736.8 | 62.7 | 8.2 | 27.7 | 60.4 | 75.2 | 0.8 |
| 2005 | 5293.7 | 121.0 | 9.7 | 45.4 | 42.4 | 80.4 | 0.4 |
| 2008 | 6257.9 | 156.6 | 12.1 | 32.9 | 50.7 | 73.3 | 0.5 |

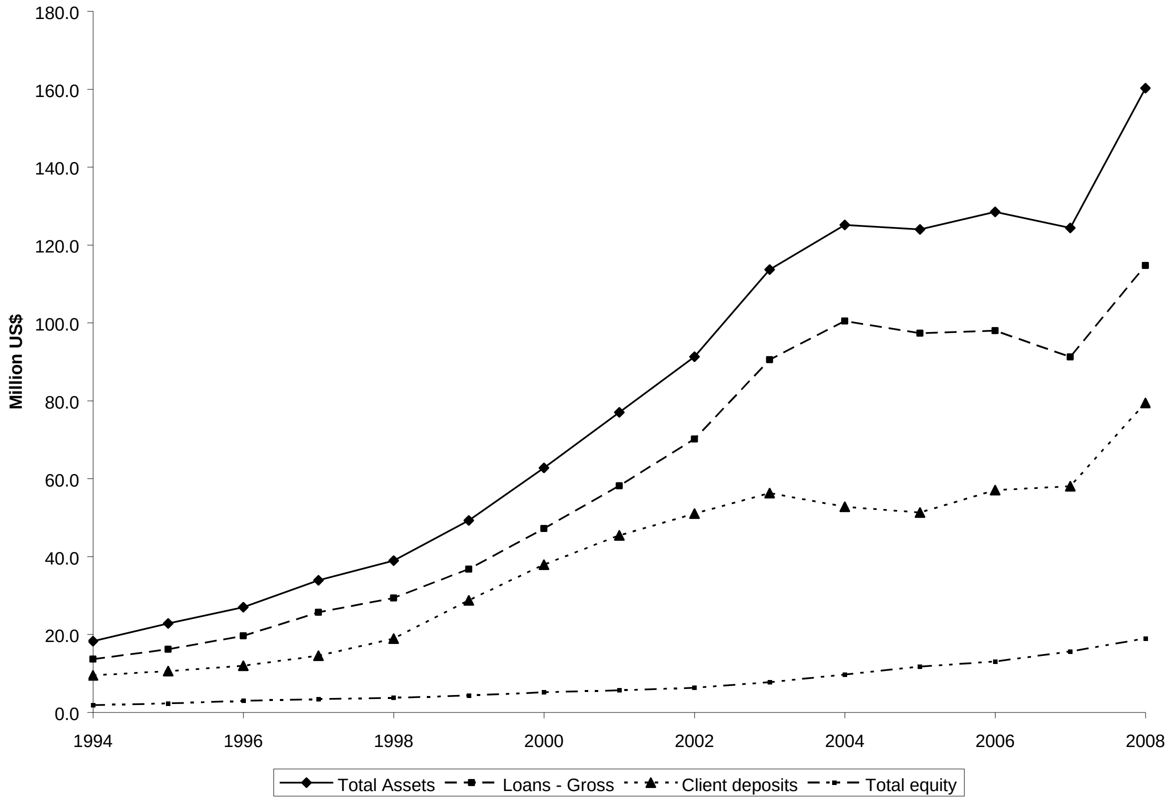
*Source:* Recalculated from DCCB Bidar 2007: 45; 2008
* Exchange rates not available for 1971-1990

**Performance, 1994-2008**

Detailed performance data are available for the 15-year period 1994-2008 during which DCCB Bidar struggled against the vicissitudes of an ailing cooperative sector and well-meaning but ill-guided government interventions. In US$ terms most major balance sheet items grew between eight- and nine-fold during that period: total assets from $18.3m to $160.2m (8.7 times), gross loans from $13.7m to $114.7m (8.4-fold), client deposits from $9.5m to 79.4m (8.4-fold), borrowings from $5.5m to $51.5m (9.4-fold) and total equity from $1.9m to 19.0m (10-fold); due to taxation newly imposed during the last two financial years, net profit grew only six-fold, from $.12m to $0.73m.

Due to loan and interest waivers, growth of loans, total assets and borrowings was stalled for three years after March 2004, with a fall below the level of 2004 in 2007. When the state government settled its due payments for waivers and subsidies with the bank in 2008, there was a surge in all these items. Only profit after tax, which stood at $0.77m in 2004, fell in 2008 by 5% to $0.73m, due to taxation newly imposed in 2007 and 2008. Expectations of loan and interest waivers, delayed compensatory payments to the bank by state government, and newly imposed taxes had an erratic impact on profitability. Net profits fell by 48% from $0.77m in 2004 to $0.40m in 2007 and grew by 82.5% between 2007 and 2008, at $0.73m still below the level of 2003 and 2004. Overall, the data show, and bank management realizes, that the impact of the state’s waiver and subsidization practices is repressive rather than conducive.

**Graph 1: DCCB Bidar: total assets, loans outstanding, deposits and equity, 1994-2008 (in million US$)**




Capital adequacy fluctuated between 7.9% and 12.1%; as of March 2008 it stood at 9.0% (risk-weighted). This is on the low side, given the uncontrollable policy risks deriving from government interventions and the poor performance of the PACS as the bank's owners and wholesale mediators. Between 1997 and 2000 the gross non-performing loan (NPL) ratio stood at amazingly low values just above 1%; until 2003 it gradually increased to 3.2%. This trend changed abruptly in 2004, first with the expectation, and then the announcement, of interest and loan waivers. In 2004 the gross NPL ratio rose to 8.4%. In response to new expectations of loan waivers, it peaked in 2007 at 19.7%. At the same time, it depressed the demand for loans, with loans outstanding falling from an already depressed $98.0m in 2006 to $91.2m in 2007. As of March 2008 the NPL ratio fell to 8.9%, still far too high. Similarly, the net NPL ratio, after provisioning, surged from 1.9% in 2003 to 7.0% in 2004 and fluctuated in the following years, with a high of 12.9% in 2007 and a low of 3.6% in 2008.

During all but one year throughout this period, return on average total assets stood below 1%, without adjustment for subsidies and the erosion of capital due to inflation. From a peak of 1.04% in 1999, ROAA fell to 0.75% in 2003 and declined to a low of 0.31% in 2007. Even after the government paid its dues for interest subsidies, it climbed back to merely 0.50%.

Cost of funds since 1994 fluctuated between 5.5% in 1996 and 9.7% in 2003; since then it gradually fell to 5.0% by March 2008. Only 69% of the loan portfolio is financed from deposits; and only 40% of deposits are low cost. Political pressure to keep interest rates low, which has characterized agricultural and other priority sector lending in India for decades, has resulted in low net interest margins (NIM) below five percent throughout the period, with a high of 4.8% in 1999 and a low of 2.8% in 2006. In the last two FYs, the NIM was 3.5% and 3.3%, respectively. This is paralleled by a high ratio of operational expenditure over operational income, fluctuating between 91% and 97%, without a clear trend.

In sum, there are three major negative results of low lending rates and associated net interest margins that policymakers have ignored: on profitability, savings and credit portfolios, and service quality. Only unrestricted profitability enables banks, and their management and staff, to pay for the growth of their portfolios and for service quality – taking the bank to the people instead of expecting the people to come to the bank. All this applies to DCCB Bidar: profits are low, growth of savings and loans has been restricted, and service quality is not outstanding. Amazingly however, the bank has managed to always stay in the black; and it has come up with a remarkable innovation in outreach to the poor.

## Rating assessment

In December 2002 EDA & M-Cril, two rating companies based in the UK and in Delhi, respectively, evaluated the operations and performance of DCCB Bidar. They arrive at a rating of Alpha minus, the fifth grade on a scale of ten ranging from alpha triple plus to gamma. Five years later, we generally share their assessment, with the exception of their evaluation of the bank's financial performance:

"DCCB Bidar's performance on management and financial indicators is good and its performance on governance aspects is excellent. With its huge coverage of the rural population in Bidar district, the DCC Bank has done very well in terms of attaining profitable operations. However, the factors that bring down overall performance are the lack of an effective MIS, the unsustainable pricing of the SHG loan product and concerns about the operational experience of the Board in the context of the bank's growth plans."

"The following strengths are reported. With regard to governance: experience and strategy: non-partisan and visionary leadership, well established presence in the area of operation, focused and geographically concentrated operations; with regard to management and operations: strong internal audit and control, streamlined operations and efficient accounting system, and good infrastructure base; with regard to its financial situation: good portfolio quality, satisfactory performance on profitability, and very good saving and liquidity performance."

"Three key risk factors were identified:
(1) Lack of information on an optimal product-mix: The DCC Bank does not have a system to find out the contribution from its different products. This leads to a portfolio composition which provides a sub-optimal return. Lack of such an analysis results in the sub-optimal product mix and inappropriate pricing of its products. An analysis carried out at sample branches of the bank shows that one of the reasons for the low return on assets is that the bank is effectively not receiving any contribution on the 49% of its total portfolio deployed in agriculture – short and medium term loans – even though this is its primary business.
(2) Cursory appraisals of non-farm loans: The bank presently does not have a rigorous appraisal system for non-farm lending. Though it is complying with all procedural requirements (such as mortgage of assets and hypothecation of stocks), this is not adequate in a situation where recourse to a slow moving legal system is required for encashment of collateral. With around 11% of the portfolio in medium-term non-farm loans this is a significant risk for the bank.
(3) Gap in policy and implementation: All the policy decisions of the bank are taken by the board. However, there is no one on the board who has operational experience of bank management. This coupled with the political nature of the board adds to the risk profile of the bank and certainly limits its ability to cope with competition and expansion issues."
(EDA & M-Cril 2003: 4-5)

**Table 5: DCCB Bidar, Financial data 1994-2008, at 31 March (in US$ million)**

| **Balance sheet** | **1994** | **1995** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** | **2004** | **2005** | **2006** | **2007** | **2008** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Total Assets | 18.3 | 22.8 | 27.0 | 33.9 | 39.0 | 49.3 | 62.8 | 77.0 | 91.3 | 113.7 | 125.2 | 124.0 | 128.5 | 124.4 | 160.2 |
| Average total assets[1] | | 20.5 | 24.0 | 29.8 | 34.9 | 42.8 | 55.3 | 67.9 | 82.5 | 103.7 | 124.8 | 124.0 | 124.9 | 128.1 | 147.9 |
| Loans - Gross | 13.7 | 16.2 | 19.7 | 25.7 | 29.4 | 36.8 | 47.2 | 58.1 | 70.2 | 90.5 | 100.5 | 97.3 | 98.0 | 91.2 | 114.7 |
| Client deposits | 9.5 | 10.6 | 12.0 | 14.5 | 18.9 | 28.7 | 37.9 | 45.4 | 51.0 | 56.3 | 52.8 | 51.3 | 57.1 | 58.1 | 79.4 |
| Borrowings | 5.5 | 8.2 | 10.7 | 14.8 | 14.7 | 14.5 | 17.4 | 23.6 | 30.7 | 43.6 | 53.7 | 55.0 | 51.9 | 41.9 | 51.5 |
| Total equity[2] | 1.9 | 2.3 | 3.0 | 3.4 | 3.7 | 4.3 | 5.1 | 5.6 | 6.3 | 7.8 | 9.7 | 11.8 | 13.1 | 15.7 | 19.0 |
| **Profit after tax**[3] | 0.12 | 0.13 | 0.15 | 0.17 | 0.28 | 0.45 | 0.51 | 0.65 | 0.67 | 0.77 | 0.77 | 0.50 | 0.53 | 0.40 | 0.73 |
| **Financial ratios** | | | | | | | | | | | | | | | |
| Capital adequacy | n.a. | n.a. | n.a | 10.1 | 9.6 | 9.3 | 9.3 | 9.4 | 10.3 | 7.9 | 9.0 | 10.0 | 10.5 | 12.1 | 9.0 |
| NPL - gross | n.a. | n.a. | n.a | 1.3 | 1.3 | 1.0 | 1.3 | 2.3 | 2.7 | 3.2 | 8.4 | 13.9 | 9.8 | 19.7 | 8.9 |
| NPL - net | n.a. | n.a. | n.a | n.a. | n.a. | n.a | n.a | 1.0 | 1.6 | 1.9 | 7.0 | 11.4 | 4.7 | 12.9 | 3.6 |
| ROAA[4] | | 0.66 | 0.63 | 0.58 | 0.81 | 1.04 | 0.93 | 0.96 | 0.82 | 0.75 | 0.62 | 0.40 | 0.42 | 0.31 | 0.50 |
| Cost of funds | 5.6 | 5.6 | 5.5 | 8.8 | 8.6 | 8.5 | 8.9 | 9.4 | 9.7 | 9.1 | 8.1 | 6.8 | 6.4 | 5.9 | 5.0 |
| Net interest margin | 3.3 | 3.2 | 3.5 | 4.6 | 4.9 | 4.8 | 4.3 | 3.7 | 3.3 | 3.8 | 3.8 | 3.5 | 2.8 | 3.5 | 3.3 |
| Op. exp./op. income | 93 | 93 | 94 | 95 | 93 | 91 | 93 | 92 | 93 | 94 | 94 | 96 | 95 | 97 | 94 |
| Loans-to-deposits | 144 | 153 | 164 | 177 | 155 | 128 | 125 | 128 | 138 | 161 | 190 | 190 | 172 | 157 | 144 |
| **US$ exch. rate** | 31.37 | 31.5 | 34.33 | 35.91 | 39.5 | 42.43 | 43.62 | 46.64 | 48.8 | 47.5 | 43.39 | 43.75 | 44.69 | 43.59 | 39.97 |

[1] (Total assets at beginning of financial year + Total assets at end of financial year)/2

[2] Paid-up capital + Statutory reserves + Free reserves

[3] The bank was taxed only during the financial years 2006-07 and 2007-08; it was tax-free until 31 March 2006. Whether taxes will be charged during 2008-09 has not yet been announced.

[4] I have calculated ROAA as Profit after tax/Average total assets x 100. The bank's formula, Interest income on loans and investments/ average working fund x 100, which disregards expenditure and taxes, arrives at very different ratios incompatible with international definitions.

## 4. Banking with agricultural credit cooperatives: a continual challenge[14]

PACS are the bottom tier of the cooperative financial system. There are 171 PACS in Bidar, owned by land-holding farmers as shareholders. The PACS are owners of DCCB Bidar as *their* bank. On principle the PACS are autonomous local financial institutions, yet functioning to a large extent as channeling agents for DCCB, which sources most of the channeling funds from Nabard and the state cooperative bank, at fixed interest rates and predetermined loan purposes. They offer deposit and credit services to their shareholder-members and provide inputs, mostly as credit-in-kind. To a limited extent their services also extend to people without land including SHGs, who may pay a fee and register as nominal members, without voting rights. Given a rather rudimentary financial reporting system, information on their operations is limited.

**Governance**
Each PACS is governed by a board of ten: a government nominee and nine elected members including the chairman of the board. Elections are every five years. The composition of the board follows the directive of the state cooperative registrar. The field assistant of the nearest DCCB branch is usually appointed as a government nominee. One board position is reserved for women, one for scheduled castes, four are reserved for small and marginal farmers, and the remaining three can be freely allocated. The board meets monthly on policy issues and operational matters including decisions on agricultural loans. Decisions on non-agricultural loans are taken by a loan committee comprising the secretary, the chairman and the DCCB field assistant. Eda & M-Cril (2003: 43) noted a well-established system of accounting and record keeping, but "a complete lack of MIS and poor use of records for decision-making."

**Delivery system**
PACS operate out of a single office, covering three to five villages. On average they have a staff of five: a secretary who acts as manager, an accountant, a clerk, an SHG supervisor and a messenger. The secretary is drawn from the staff of the state cooperative department or the DCCB; the others are local people. The physical infrastructure is generally adequate. All PACS have telephone connections; but only few are computerized.

**Outreach**
Most of the PACS have between 300 and 2000 members; the average is 875. Total shareholding membership during the last three years was about 150,000, up 2% from 1997. The number of borrowers as of 31 March 2007 was 134,522. There are no consolidated data on deposit accounts and on nominal members, except on SHGs affiliated with PACS; their number grew from 4 in 1997 to 5,367 in 2007. Total direct outreach of the PACS thus covers about 50% of the families in Bidar, not counting indirect outreach to SHGs and individual nominal members.

**Sources of funds** are mainly borrowings from DCCB, which are in turn refinanced by Nabard and the state cooperative bank. Deposit-taking has only slowly evolved over the last ten years, accounting for a mere 2% of loans outstanding in 1997 and 13% in 2007. Members mostly prefer to deposit their savings in DCCB, and larger deposits

[14] Based on data provided by DCCB, a sample study of 6 PACS by Eda & M-Cril in 2002, and a field visit.

in commercial banks. With the restrictions on lending rates, there is little motivation for PACS to mobilize savings. In 2002 EDA & M-Cril (2003: 46) calculated the cost of deposit products in six sample PACS. The total weighted average was 10.1%, consisting of 5.1% direct operating costs and 5.0% average interest charges. The costs of ordinary savings, accounting for 56% of the deposit portfolio, were 7.1%, comprising 4.1% operating costs and 3.0% interest charges. The costs of term deposits, accounting for 37% of the deposit portfolio, were 12.8%, comprising 4.8% in operating costs and 8.0% in interest charges. Daily savings, a mere 7% of the deposit portfolio, were interest free; but operating costs were calculated at 14.3%.[15]

### Financial products

There are four savings products: ordinary savings at 5%-6% interest, which are also used by SHGs to deposit their excess liquidity; interest-free daily deposits, which mainly serve as collateral for so-called pigmy loans to microentrepreneurs; fixed regular monthly deposits at term deposit rates; and term deposits for periods from 90 days to ten years. Interest rates are generally slightly higher than those offered by DCCB.

The PACS function as retailers of DCCB credit, mainly for the delivery of agricultural loans to farmer members and of loans to SHGs, which in turn on-lend to their members. Margins are mostly between 1% and 2%, which are inadequate. The PACS also offer some loan products of their own at a higher interest rate, such as consumer loans secured by gold, deposits or other secured papers, and microenterprise loans linked to daily deposit schemes and guaranteed by a shareholding member. In 2002 EDA & M-Cril (2003) calculated the cumulative repayment rate in six sample PACS at 96.8%. They also calculated the cost of loan products. They arrived at a weighted total average of 3.5%, comprising 2.2% operating costs, 0.1% provisions for loan losses, and 1.2% cost of funds. The cost of agricultural loans, which accounted for 86% of the portfolio, amounted to 1.9%, comprising 1.8% operating cost, 0.1% provision for loan losses and 0.0% cost of funds. They found the PACS barely breaking even on their agricultural loans and incurring operating losses on their SHG loans, both channeled on behalf of DCCB and its refinancing institutions. They only made a profit on their own loan portfolio; but this accounted for only 12% of their total loans outstanding.

Almost all loans are fully or partially secured. Loan tracking as well as internal controls were found adequate. DCCB monitors the operations of the PACS on a monthly basis. The PACS are audited annually by the state cooperative department and prepare reports of compliance with the audit reports.

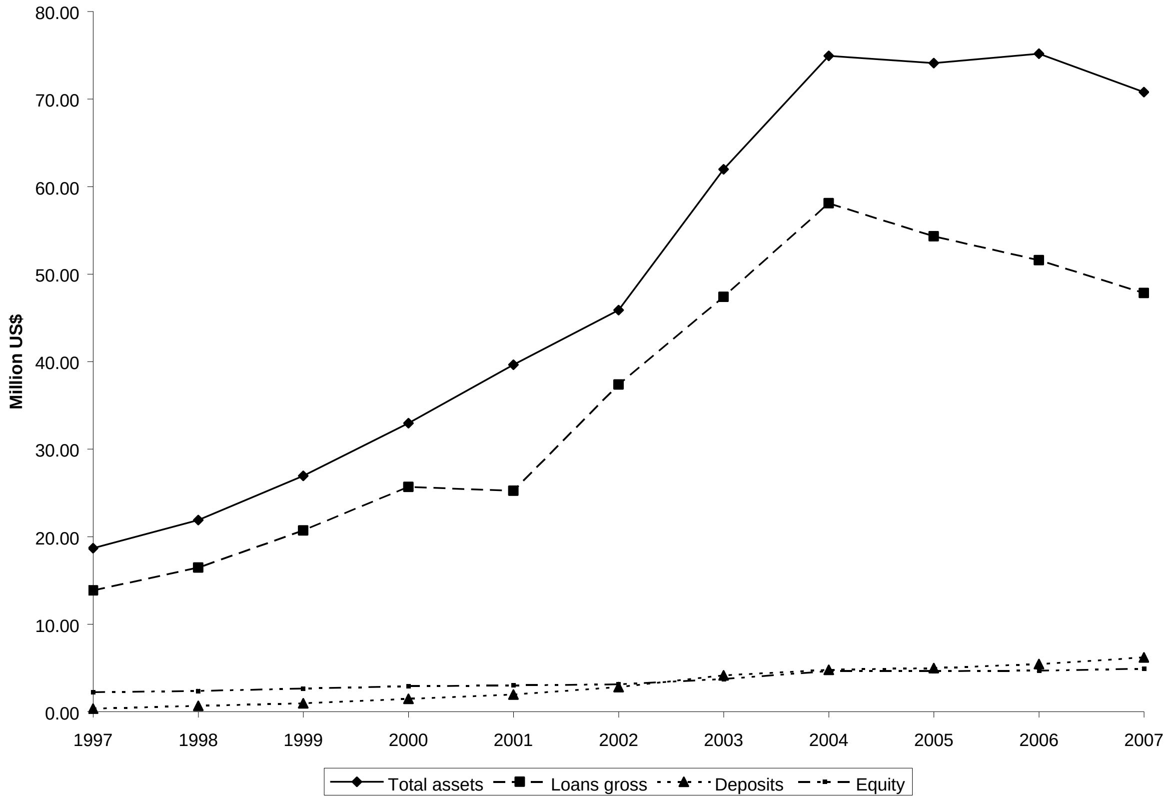
### Performance

From (31 March) 1997 to 2004 total assets of the 171 PACS grew from $18.7m to $74.9m. As in DCCB, interest and loan waivers subsequently disrupted the hitherto smooth growth. Total assets stagnated in 2005 and 2006 and fell to $70.8m in 2007. This is paralleled by the growth of loans outstanding from $13.8m in 1997 to $58.1m and a decline to $47.8m in 2007. Only deposits of clients continued to grow, from $0.3m in1997 to $5.2m in 2007; but they are but a fraction of loans outstanding: 2% in 1997 and 13% in 2007. Paid-up capital steadily increased from $1.9m in1997 to $4.2m in 2007. But reserves were affected by the slump after 2004. They grew from $0.3m in 1997 to $0.76m in 2004 and went down to $0.68m in

[15] Calculations were done on an average cost basis. Marginal analysis, which is based on a calculation of actual additional costs, would bring the costs closer to the interest charges, assuming that staff time is not fully occupied.

2007. Total equity was similarly affected: from $2.2m in1997 to $4.6m in 2004 and $4.9m in 2007. (Graph 2, Table 6)

**Graph 2: PACS in Bidar District: Total assets, loans outstanding, deposits and equity, 1997-2007 (in million US$)**




The consolidated figures hide the complexities of profit- and loss-making PACS and of the rollercoaster impact of loan and interest waivers. Between 1997 and 2007 there was extreme variation in the number of PACS with a positive net income, ranging from almost none to all 171 PACS. There are also data discrepancies according to source that could not be clarified. Eg, according to one source, there were 81 profit-making PACS in 1997, according to another only 37. From 2000 onwards the sources largely agree. The number of profit-making PACS reached 150 in 2003, but due to interest and loan waivers slumped to 33 in 2004 and 2 in 2005. With compensation paid by the state government to DCCB and passed on to the PACS in 2005/06 all 171 PACS arrived at a positive income. The new announcement of loan waivers in 2006 left only 20 PACS in profit in 2007. As the government paid its dues in 2008, the number of profitable PACS went up again.

There are also discrepancies between the two sources of information on the amount of profits and losses of the PACS, but not as pronounced as those above for the first three years of the reporting period. Using the data from the first source, consolidated losses are reported in seven out of eleven years, with the largest amount of losses in 2005 (-$4.3m) and the largest gains in 2006 ($7.7m); consolidated losses in 2007 amounted to -$2.6m. These figures are paralleled by those on returns on average total assets (ROA) and on average total equity (ROE)[16]. ROA reached a low of -5.8% in 2005 and a spectacular 10.7% in 2006, but fell to -3.5% in 2007; the respective figures for ROE are -94%, 172% and -53%. (Table 6)

[16] Net profit/Average total assets; Net profit/Average total equity. DCCB uses a different formula in its reporting, arriving at very different results.

**Expected cooperative reform**

Reforms of the cooperative sector, which have started in some states, aim at cleaning the balance sheet of the loss-making PACS and getting all PACS into profit. Karnataka State decided in March 2008 to go ahead with the reforms; details about the respective shares of federal and state grant funds have yet to be announced. The process will start with special audits of PACS and cooperative banks. All cooperatives will be compensated for their losses as a one-time measure. Just as interest and loan waivers reward the defaulters and indirectly punish the good borrowers, cleaning the balance sheet of cooperative institutions across the board is seen by many in the sector as a perverse incentive. It will be difficult for the government to impress on the cooperatives that this is their last and only chance of straightening out. Much will depend on how the cooperatives will be weaned of government protection and interference to become genuine self-help organizations relying on their own resources and dynamism; and whether or not they will be subjected to stringent rules of regulation and their enforcement.

**Table 6: PACS under DCCB Bidar, Financial highlights 1997-2007 (in million US$)**

| **Outreach:** | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| No.of PACS | 171 | 171 | 171 | 171 | 171 | 171 | 171 | 171 | 171 | 171 | 171 |
| PACS w. pos. income I (*Reporting sheet*) | 81 | 89 | 67 | 71 | 108 | 131 | 150 | 33 | 2 | 171 | 20 |
| PACS w. pos. income II (*Work sheets*) | *37* | *29* | *86* | *71* | *108* | *130* | 150 | 33 | 2 | 171 | 20 |
| No. of members | 121745 | 121824 | 121875 | 132386 | 133990 | 136384 | 143578 | 147580 | 149631 | 149631 | 149637 |
| No.of borrowers | 113220 | 113258 | 113286 | 117867 | 119471 | 121362 | 121362 | 121565 | 122610 | 123411 | 134522 |
| Percent of borrowing members | 93.0 | 93.0 | 93.0 | 89.0 | 89.2 | 89.0 | 84.5 | 82.4 | 81.9 | 82.5 | 89.9 |
| No.of depositors | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| No.of affiliated SHGs | 4 | 112 | 136 | 451 | 1140 | 1866 | 2224 | 3503 | 3679 | 4530 | 5367 |
| **Balance sheet:** | | | | | | | | | | | |
| Total assets | 18.67 | 21.89 | 26.94 | 32.96 | 39.64 | 45.87 | 61.97 | 74.94 | 74.11 | 75.17 | 70.78 |
| Average assets | | 19.43 | 23.66 | 29.58 | 35.23 | 41.88 | 54.55 | 71.39 | 74.21 | 73.86 | 73.92 |
| Loans outstanding (gross)* | 13.84 | 16.46 | 20.70 | 25.68 | 25.23 | 37.37 | 47.40 | 58.10 | 54.30 | 51.58 | 47.82 |
| Deposits of clients | 0.33 | 0.66 | 0.94 | 1.45 | 1.94 | 2.80 | 4.13 | 4.77 | 4.97 | 5.44 | 6.19 |
| Paid-up capital | 1.94 | 2.05 | 2.25 | 2.48 | 2.53 | 2.68 | 3.21 | 3.87 | 3.93 | 4.01 | 4.21 |
| Reserves | 0.28 | 0.30 | 0.37 | 0.41 | 0.46 | 0.43 | 0.52 | 0.76 | 0.71 | 0.67 | 0.68 |
| Total equity | 2.22 | 2.36 | 2.62 | 2.90 | 2.99 | 3.11 | 3.73 | 4.63 | 4.64 | 4.68 | 4.89 |
| Average equity | | 2.19 | 2.41 | 2.72 | 2.85 | 2.98 | 3.46 | 4.36 | 4.61 | 4.61 | 4.84 |
| Profit I (*Reporting sheet*) | -0.49 | -0.63 | -0.22 | -0.22 | 0.31 | 0.55 | 1.05 | -1.59 | -4.33 | 7.93 | -2.56 |
| Profit II:(*Work sheets*) | | | | | | | | | | | |
| Profits of profit-making PACS | 0.03 | 0.04 | 0.21 | 0.21 | 0.64 | 0.77 | 1.13 | 0.15 | 0.01 | 7.73 | 0.26 |
| Losses of loss-making PACS | -0.37 | -0.59 | -0.36 | -0.45 | -0.29 | -0.14 | -0.06 | -1.69 | -4.30 | 0.00 | -2.82 |
| Profit II (*Work sheets*) | -0.34 | -0.55 | -0.14 | -0.24 | 0.35 | 0.63 | 1.07 | -1.55 | -4.29 | 7.73 | -2.56 |
| **Financial ratios (in percent):** | | | | | | | | | | | |
| Return on average total assets | | -3.24 | -0.93 | -0.73 | 0.87 | 1.31 | 1.92 | -2.23 | -5.84 | 10.74 | -3.46 |
| Return on average total equity | | -28.82 | -9.10 | -7.96 | 10.73 | 18.33 | 30.27 | -36.51 | -93.91 | 172.15 | -52.83 |
| Average cost of funds | 2.21 | 1.99 | 1.78 | 1.90 | 1.56 | 1.58 | 1.41 | 1.28 | 1.44 | 2.24 | 2.04 |
| Net interest margin | 11.51 | 9.83 | 12.41 | 11.83 | 12.62 | 12.80 | 13.03 | 7.46 | 3.48 | 24.51 | 3.48 |
| Loans to deposits | 4202 | 2476 | 2195 | 1765 | 1302 | 1333 | 1147 | 1217 | 1092 | 947 | 772 |
| Deposits to loans | 2 | 4 | 5 | 6 | 8 | 8 | 9 | 8 | 9 | 11 | 13 |
| **SHG banking:** No of affiliated SHGs | 4 | 112 | 136 | 451 | 1140 | 1866 | 2224 | 3503 | 3679 | 4530 | 5367 |
| SHG deposits in % of PACS deposits | 0.1 | 2 | 2 | 5.6 | 7.2 | 6.3 | 4.8 | 4.9 | 5.1 | 5.3 | 8.7 |
| **US$ exchange rate** | 35.91 | 39.5 | 42.43 | 43.62 | 46.64 | 48.8 | 47.5 | 43.39 | 43.75 | 44.69 | 43.59 |

## 5. SHG Banking: a revolution in inclusive outreach

### SHG banking in India

After centuries of highly exploitative rural credit, India developed during the post-independence period a diversified rural financial infrastructure. Yet, despite a massive network of commercial, regional and cooperative banks, the All-India Debt and Investment Survey of 1981 found that some 250 million rural poor had no access to financial services. Searching for innovative solutions, Nabard, carved out of RBI in 1982, encountered new moves simultaneously by NGOs like Myrada at national and Apraca with GTZ at regional level. This inspired Nabard to start a pilot project in 1992, promoting SHGs as savings-based financial intermediaries to be linked to an existing bank infrastructure for refinancing. Encouraged by the results and backed by the joint political will of the Union Government and RBI, Nabard began mainstreaming SHG banking in 1996, setting up a Credit and Financial Services Fund for program dissemination and capacity-building and, in 1998, a Micro Credit Innovations Department (MCID), with cells in every state. (Seibel 2005) This prepared the ground for an extraordinary surge in the number of SHGs credit-linked to banks, from 33,000 in (31 March) 1999 to 2.9 million as of 2007, with more than 40 million members, covering a population of some 200 million (*cumulative data*).[17] Bank loans outstanding to SHGs amounted to Rs123.7bn (US$2.8bn).

The SHG approach promoted by Nabard is based on internal capital formation of SHGs as the basis of institutional self-reliance, and on access to bank refinance as a source of unrestricted growth. The main sources of internal funds are regular savings and profits from sizeable interest rate margin. Most of the savings are recycled as loans to members; but a portion is kept in banks or PACS. By 2007 a total of 4.2m SHGs, covering 58m poor households, were maintaining savings accounts with banks, with a total savings balance of Rs35.1bn (US$0.8bn), equivalent to 28% of bank loans to SHGs outstanding. (Nabard 2007c: 3, 5; 2008: 77) There are no consolidated data on the internal savings of SHGs; but they probably exceed savings deposited in banks (Karduck & Seibel 2008).

### How to get started

DCCB Bidar entered the SHG banking program in 1996 when Nabard invited cooperative banks to participate. While cooperative banks overall account for a rather small share of SHG-bank linkages in India[18], Karnataka is first among the states in SHG linkages of cooperative banks – due to a considerable extent to the breakthrough role played by DCCB Bidar. Exposure visits to Myrada, an NGO leading in SHG promotion, convinced the directors "that this could be an ideal approach for reaching the poor for providing not only the credit required without the hassles and paperwork associated with the conventional loan sanction but also to provide other support services to bring about improvement in the socio-economic status of the poor." (Mohanty 2008: 361) The bank submitted amendments to its bye-laws to the state cooperative department, which in turn amended the cooperative act permitting informal SHGs to become nominal PACS members and open SHG accounts. Building on promotional initiatives by Prawarda, an NGO in Bidar District, the first 13 SHGs obtained bank loans in 1996/07.

### How to expand

With guidance and a grant of Rs554,000 ($15,000) from Nabard, DCCB opened an SHG cell in February 1998 and contracted three officers from Myrada as managers who trained bank staff and NGOs in SHG formation and the management of linkages. Thereby DCCB became the first cooperative bank recognized as a self-help promoting institution (SHPI) in Karnataka. In 2000 the SHG cell was converted into a microcredit division (MCD) with a staff

[17] The majority of members (90%) are women: by choice, not by program design.

[18] As of 31 March 2007, public commercial banks accounted for 66.5% of bank loans outstanding to SHGs, private commercial banks for 4.3% and Regional Rural Banks for 22.7%. Cooperative banks account for 6.5% of outstanding loans and 9.4% of groups.

of 15, headed by a deputy general manager. Microcredit cells (MCCs) under the supervision of a branch manager were established in each of the five subdistricts. The tasks of the division include all aspects of promoting SHGs, including establishment, training, maintenance, bookkeeping assistance, monitoring, supervision and rating. During the same year DCCB, with assistance from Nabard, established the Sahakara Rural Development Academy (Saharda), a generously equipped training center specialized on SHG banking, with an outreach beyond the district. As a subsidiary of the bank, Saharda is fully self-supporting. In addition DCCB has established SHG training facilities at its five main branches within each subdistrict. Realizing that sustainable poverty alleviation may require more than access to finance, DCCB also established the Sharada Rural Development and Self Employment Training Institute (Sharseti), which provides skill upgrading to SHG members as well as training for the unskilled and unemployed. DCCB reports a total number of almost 20,000 people trained: 95% SHG members in group management, 2% animators in book keeping and 3% microentrepreneurs and unemployed in skills for income-generating activities (Table 7).

In the following years all PACS turned into SHPIs. Each PACS hired an assistant supervisor, with a share of the salary paid by DCCB on a declining scale from 75% to 25% over a three-year period. Initially starting with three NGOs, DCCB over the years motivated and trained 50 NGOs as SHPIs, who received promotional grants from Nabard channeled through DCCB. Also included in the program, and trained and financed by DCCB, are *Streeshakti* groups. These are SHGs promoted by the Women and Child Development Department of Karnataka. Other initiatives geared to SHG formation include farmers clubs and a school for the blind, which has established an SHG and brought out a handbook on SHG banking in Braille.

**Financing SHG banking**

Nabard provides credit lines to banks for refinancing SHG banking.[19] The PACS act as channeling agents of loans on behalf of DCCB, considering SHG banking as part of their social mission. They receive a commission of 1%, which is not sufficient to cover their costs; but the savings deposited by the SHGs are low cost funds which they use as liquidity for their own loan products. In a deregulated environment, the determination of interest rates should be left to the DCCB and the PACS, and they should be given the opportunity of earning a decent profit. This is a contentious issue only among cooperative banks, particularly in Karnataka; elsewhere, commercial and regional rural banks have found SHG banking highly profitable, as shown by Seibel & Dave (2002); and this has been the motor of the extraordinary rate of expansion nationwide.

**A revolution in outreach to women and the poor**

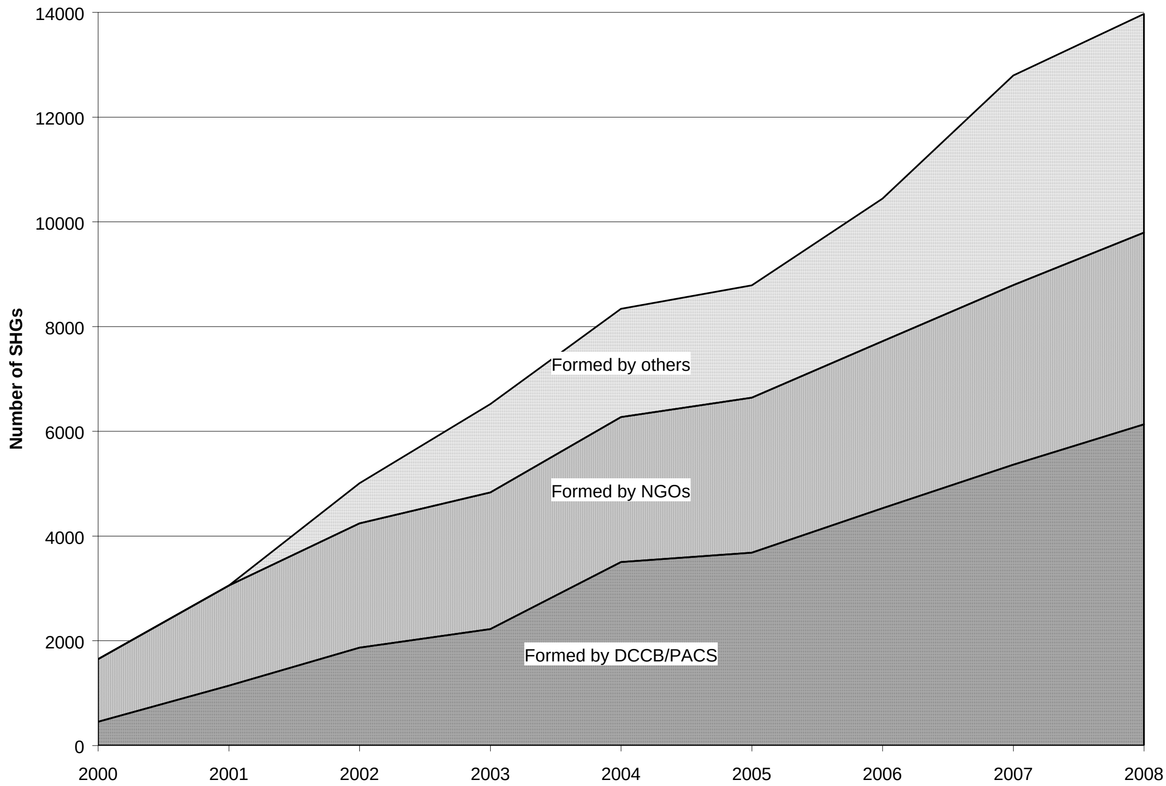
During the first 70 years of its existence DCCB Bidar attained exclusive outreach to virtually all farmers who own land, most of them male heads of households. During the 90s the bank began to open up, introducing consumer lending through its branches to farmers and non-farmers, women and men. But inclusive outreach to the poor has been an achievement DCCB has attained only through SHG banking, starting in 1996. Now it is reaching almost all poor families in the district who don't own land, in the vast majority of cases women as the borrowing and saving, or investing, household member. As astonishing as the coverage achieved has been, equally astonishing is the motivating force behind it: the commitment of the bank's board of directors, not profits. Here are the outreach figures (*31 March data*), also summarized in Table 7.

By March 1998 the first 13 SHGs had been established and received bank loans. From there

[19] Nationwide the percentage of bank loans to SHGs refinanced by banks has steadily declined from 91% in 1999 to 33% in 2007: a powerful indicator of the perceived profitability of SHG banking. A study of bank transaction costs of SHG banking was commissioned by Nabard in 2002, which included DCCB Bidar (Seibel & Dave 2002). Transaction costs of SHGs in Karnataka were studied by Karduck & Seibel (2007).

onwards group formation proceeded rapidly, reaching 1,647 in 2000 and 13,967 in 2008. In 2000 73% of the groups had been established by NGOs and 27% by DCCB and PACS. By 2008 the share of NGOs had declined to 26% and that of DCCB and PACS had gone up to 44%; Stree Shakthi, a government program, accounted for 20%, other banks for 7% and other agencies for 3%.

**Graph 3: Share of 13,967 SHGs formed by DCCB/PACs, NGOs and others in Bidar District, 2000-2008**




In 2000 less than half the SHGs established had received a bank loan; by 2008 all but 5% (13,327 SHGs) had been credit-linked to banks. In 2000 DCCB/PACS was the only financier; in 2008 18% of the SHGs were financed by other financial institutions. Credit linkages to banks are a recurring pattern, with 10,844 SHGs repeat-financed, and the total amount of repeat finance, $14.39m, accounting for 58% of total loans disbursed.

The number of SHG members skyrocketed between 2000 and 2008: from around 26,000 to around 207,000. The share of women members fluctuated between 95% and 100%: a particularity of microfinance in many parts of South Asia where men are unreliable borrowers. In most years more than half the members came from scheduled castes and tribes, the lower echelons of society.

**Performance**

Cumulative disbursements grew from $0.41m in 2000 to $23.05m in 2008, 89% of that amount from DCCB/PACS. Loans outstanding in 2008 amounted to $7.26m. Recovery rates consistently stood at a remarkable 98%-99%.

One of the most impressive aspects of SHG banking is the accumulation of internal funds from savings and profits.[20] These grew from $0.36m in 2000 to $11.46m in 2008, exceeding

[20] For most of the program period Nabard only monitored disbursements of bank loans to SHGs. Loans outstanding to SHGs and SHG deposits in banks have only been captured recently. In contrast, DCCB kept records on loans outstanding since 2003 and on internal savings of SHGs since 2000.

bank loans outstanding by 58%. Until 2003 all SHG savings were held internally. Since 2004 SHGs were given access to opening savings accounts. All SHGs now hold savings accounts: 54% in PACS, 25% in DCCB and 21% in other banks. Since 2004 the percentage of savings kept in PACS and banks doubled from 11% to 22%.

**How to achieve sustainable poverty alleviation**

Inclusive outreach of DCCB has been the achievement of the past decade. The challenge DCCB has decided to face in the next decade is sustainable poverty alleviation. A first step DCCB has taken is skill training for group members and the unemployed. Once trained the unemployed are given access to credit and are assisted in forming SHGs. But it is not enough to acquire skills, to obtain credit and to start producing; the up-start microentrepreneurs also have to sell. Profitable marketing is the challenge, particularly of agro-related value-added products and services. Therefore, the next step envisaged by DCCB is marketing assistance, including assistance with product design, standardization, packaging, pricing and value chain financing as essential components of marketing. How to go about this is under discussion. This is a concern to the board; but it realizes that this is not the business of a bank. Hence, the bank may establish a subsidiary to pursue the promotion of marketing directly. Alternatively the new subsidiary might help establishing associations or federations of SHGs for the promotion and marketing of high-yielding products and services, profiting from experience in neighboring Andhra Pradesh. DCCB Bidar is committed to be the bank of the small farmers, microentrepreneurs and poor women and men in the district, helping them to grow, and growing with them in the process.

**Table 7: SHG banking in Bidar District, 31 March 2000-2008, (in million US$)**

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|---|
| Number of SHGs | 1,647 | 3,055 | 5,005 | 6,520 | 8,339 | 8,784 | 10,441 | 12,795 | 13,967 |
| *% formed by DCCB/PACS* | 27.4 | 37.3 | 37.3 | 34.1 | 42 | 41.9 | 43.4 | 41.9 | 43.9 |
| % formed by NGOs | 72.6 | 62.7 | 47.4 | 40 | 33.2 | 33.7 | 30.5 | 26.8 | 26.2 |
| % formed by others | 0 | 0 | 15.3 | 25.9 | 24.8 | 24.4 | 26.1 | 31.3 | 29.9 |
| Number of members | 26,174 | 49,535 | 80,567 | 102,829 | 126,299 | 150,942 | 167,613 | 191,925 | 207,401 |
| Percent women | 100 | 95.9 | 95.1 | 96.2 | 96.9 | 97.4 | 97.5 | 97.4 | 97.2 |
| Percent SC/ST | 60.9 | 57.9 | 54.6 | 51.1 | 50.1 | 50.1 | 48.6 | 48.1 | 51.9 |
| Number of SHGs financed | 764 | 1,488 | 3,117 | 5,174 | 6,771 | 7,878 | 9,417 | 12,022 | 13,327 |
| % financed by DCCB/PACS | 100 | 100 | 100 | 93.2 | 88.6 | 90.2 | 87 | 81 | 82.3 |
| Cum. disbursements | 0.41 | 0.88 | 1.61 | 2.73 | 4.30 | 6.03 | 9.39 | 15.60 | 23.05 |
| % disb'd by DCCB/PACS | 100 | 100 | 100 | 100 | 100 | 100 | 90.9 | 85.7 | 89.2 |
| Loans outstanding (US$m) | n.a. | n.a | n.a | 1.14 | 1.64 | 2.18 | 3.19 | 3.91 | 7.26 |
| Recovery | 98% | 99% | 98% | 98% | 98% | 98% | 98% | 99% | 99% |
| No. of repeat-financed SHGs | n.a | n.a | n.a. | n.a. | 839 | 920 | 4,070 | 6,414 | 10,844 |
| Amount of repeat finance | n.a | n.a | n.a. | n.a. | 0.76 | 0.84 | 3.89 | 8.47 | 14.39 |
| Amount of SHG savings | 0.36 | 0.68 | 1.80 | 2.65 | 4.17 | 5.09 | 6.54 | 8.94 | 11.46 |
| % internal savings | 100 | 100 | 100 | 100 | 88.6 | 89.3 | 85.8 | 77.3 | 77.6 |
| % in PACS and banks | | | | | 11.4 | 10.7 | 14.2 | 22.7 | 22.4 |
| SHG savings accounts | | | | | 8,339 | 9,235 | 10,441 | 12,795 | 13,967 |
| % in PACS | | | | | 50.4 | 51.9 | 53.1 | 53.4 | 54.2 |
| % in DCCB Bidar | | | | | 31.4 | 28.6 | 26.6 | 23.6 | 24.6 |
| % in other banks | | | | | 18.2 | 19.6 | 20.3 | 23 | 21.1 |
| Number of people trained: | 718 | 1,983 | 4,475 | 5,612 | 8,251 | 11,450 | 13,979 | 16,777 | 19,750 |
| Group training | 709 | 1,877 | 4,336 | 5,471 | 7,994 | 11,044 | 13,289 | 15,981 | 18,691 |
| Animator book keeping | 9 | 75 | 108 | 110 | 226 | 250 | 301 | 350 | 401 |
| Microentrepreneurship | | 31 | 31 | 31 | 31 | 156 | 389 | 446 | 658 |
| **US$ exchange rate** | 43.62 | 46.64 | 48.8 | 47.5 | 43.39 | 43.75 | 44.69 | 43.59 | 39.97 |

## 6. Conclusions and lessons learned

DCCB of Bidar is part of a complex, century-old credit cooperative system. After a golden age during the first part of the 20th century, the sector has undergone a kind of restructuring in reverse. Its decline in performance over the past fifty years has been the result of government dominance and interference. This has affected the bank, though it has managed to remain profitable, albeit at a low level. Its owner-users, the credit cooperatives, have been more severely affected, many of them loss-making. Yet, the bank has accomplished a feat which is rare in the cooperative sector in India: that of near-total inclusive outreach. It not only serves virtually all farmers through their cooperatives. As a pioneer of SHG banking in India among cooperative banks it has also reached the vast majority of rural poor women and their families in the district. It is now making efforts to go beyond banking services, providing entrepreneurship training to SHG members and the unemployed through a subsidiary, and credit for start-ups. This is to be followed by assistance in marketing their products and services.

DCCB Bidar has two messages to tell. First, even under challenging circumstances, cooperative banks together with their primary societies have a great potential in achieving inclusive outreach. Second, their full potential of providing adequate financial services will only be realized in the context of an overall reform of the cooperative sector, which is under preparation. However, there is a double caveat to policymakers. This reform will only be successful if cooperatives turn back into genuine self-help organizations relying on their own resources, as they did during the first decades of their development; and if state and national government agencies stop undermining rural finance with cheap credit, interest rate subsidies and loan waivers.

There are a number of lessons to be learned from our analysis, with powerful messages to policymakers on what it takes to restructure a credit cooperative system. There may be more to be learned from errors than success stories.

Legal framework

An appropriate legal framework is a crucial prerequisite for the establishment, or restructuring, of a multi-tiered credit cooperative system, replacing usurious moneylending. In India the credit cooperative law of 1904 and the cooperative law of 1912 provided a framework for rapid self-sustained growth of the cooperative movement, including the establishment of cooperative banks like DCCB Bidar. However, in contrast to cooperative origins in Europe, self-help has been intermingled in India with government control. This was initially beneficial, but eventually turned into an explosive mixture. As state governments, in the 1950s, were given authority over cooperatives and acquired ownership in cooperative banks, cooperative credit became an instrument in the hands of state governments. Legal reforms should be geared at autonomy of cooperative institutions and their independence from government.

Policy environment

To finance their services and growth credit cooperatives must be free to set their own terms and conditions. Interest rates were liberalized in 1998; yet, for crop loans, which make up the bulk of the DCCB's and the cooperatives' lending, they continue to be fixed by state government. Low lending rates and inadequate net interest margins have a negative impact on profitability, the growth of savings and credit portfolios, and service quality. The supply of cheap credit, interest subsidies and loan waivers, together with delays in government payments for imposed subsidies and waivers, have undermined the health of the CCS in Karnataka State and Bidar District. A bank must be able to pay for the growth and quality of its outreach; taking the bank to the people is more efficient than having the people come to the bank. Reforms should be geared to complete interest deregulation and to the strengthening of cooperative self-reliance at all tiers. Subsidies should be used smartly: building efficient institutions rather than undermining rural finance with cheap credit.

Governance

Good corporate governance (GCG) of cooperative institutions must be built on self-management and local control by their members. During the first part of the 20th century credit cooperatives were self-governed and self-reliant. Under central planning, starting in the 1950s, the government took control over all institutions including cooperatives. Governance was thus alienated from local communities and their members. Bureaucracy, government intervention and loan channeling have replaced the original system of self-management and local control. Without a return to full self-governance, the restructuring of the cooperative credit system which is under preparation will not succeed.

Regulation and supervision

Prudential regulation and effective supervision by financial authorities capable and willing to enforce regulation are essential for the maintenance of a well-functioning credit cooperative system: performance must be monitored; deficiencies must be acted upon; regulation must be enforced. This seems to have been the case during the golden age of credit cooperatives in India. In the postwar era, political control over the system and multiple responsibilities have made supervision ineffective. Several agencies have been in charge of supervision, the Reserve Bank of India (RBI) being one of them. However, prudential norms cannot be enforced because the state registrar of cooperatives is empowered to override recommendations by RBI, and frequently does so for political reasons. This has resulted in inadequate provisioning, erosion in the value of assets, insufficient financial margins, ineffective fund management, poor risk management, weak internal checks and ineffective controls by higher-tier institutions. Regulatory reforms are to be geared at clear lines of authority and the enforcement of RBI's prudential regulation and corporate governance standards.

Institutional change and restructuring

It appears that India has lost its institutional memory of a splendid cooperative past, perhaps the most outstanding early experience of any country in the developing world. Closing non-performing institutions has been part of that early experience, a rare event nowadays. DCCB Bidar, at low levels of profitability, has survived the downturn of the system without any traceable restructuring. There are significant weaknesses in its risk management of retail lending; appraisal of non-farm loans is cursory, pricing is inadequate, government interference stifling. In wholesale lending it has unloaded most risks to primary cooperatives, which bear the brunt of an overall policy failure. The government has now set a process into motion of restructuring the credit cooperative system, starting with the primary societies. Operational reforms are to be geared at uniform financial reporting and internal control systems, improved credit appraisal and risk management, and new staffing policies. Restructuring is being geared at cleaning the balance sheet, with union and state governments bearing almost all the burden. There seems to be no evidence of lessons learned from the experience of the past one hundred years: the change from self-reliance and self-governance to government dependence, and the impact of that change on financial and social performance. Without major inputs by the members themselves, such capital injections are unlikely to bring about the desired transformation. There is a serious policy risk that government dependence, not self-reliance, will be deepened. Government recapitalization bonds, to be redeemed in due course, in addition to new member share capital, might be an alternative.

Despite the turmoil in the cooperative sector, DCCB Bidar has performed a miracle, earning a reputation throughout India – the reason for including the bank in our study. Behind that miracle stands the personal commitment of the bank's leadership, backed by guidance received from Nabard and Myrada. As self-help promoting institutions, the DCCB with its member cooperatives has brought about a revolution in inclusive outreach, namely to the vast majority of poor women and their families in the district. The women's self-help groups (SHGs) are nominal members of the cooperatives, with steady excellent repayment performance, resilient against the ups and downs of the cooperatives. Here is a possibility of reorienting the whole restructuring process: by giving the SHGs of landless women full membership in the cooperatives and an active role in governance. There is thus a chance that the DCCB might turn into a model of restructuring the cooperative sector of India, which in turn might serve as an innovative model for the restructuring of rural finance in Asia.

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