Financing Small & Marginal Farmers
Some Policy Issues
Dr Amrit Patel

Agriculture has been the most important sector contributing to the overall economic growth as well as providing livelihood to a very significant proportion of rural population in India, besides having been an instrument of food security to children and women in particular. Agriculture contributes 22 per cent to the Gross Domestic Product [over Rs.6000 billion] of the Indian economy. It employs around 57 per cent of the labor force on a total of 163 million hectares of land. It has a significantly decisive role in achieving the expected GDP growth rate of 8 to 10 per cent during the Tenth five year plan.

It is, therefore, legitimate for the Government of India & States to support agricultural development through formulation & implementation of national policies and programs that can make country self-reliant in its food requirements & create large scale employment in rural areas. This should lay emphasis on integrating agricultural research, extension and education system on one hand and establishing efficient, sustainable and cost effective functioning of rural financial markets on the other. After country’s Independence, Government of India & Reserve Bank of India both are committed to expand & deepen the rural financial intermediaries in the country side so as to facilitate the rural households’ easy access to credit for farm sector development.

Entire banking system comprising cooperative, private/public sector/nationalized/foreign/regional rural banks is geared up & its performance is reviewed/monitored periodically such that each one plays its role in this most significantly important area of development through provision of credit.

Performance

The Government of India, in its budget for the year 2004-05, had asked banks to double the flow of credit [from Rs. 869,820 million to Rs.1,739,640 million] to farm sector & increase its outreach to cover small & marginal farmers; tenant farmers, share croppers, oral leases, in three years i.e by the end of the 10th Five Year Plan[2006-07]. As on 31st March 2005, the credit flow was of the order of Rs 1,152,428.10 million as against the target of Rs. 1,045,000 million for the year 2004-05 & actual flow of Rs. 869,820 million during the year 2003-04, indicating increase by 9.76 per cent & 32 per cent respectively. Agency-wise details of the performance during the year 2004-05 & as on 31st March’05 are given in following tables.

**Table No.1**

<table>
<thead>
<tr>
<th>Agency</th>
<th>Target –2004-05</th>
<th>Disbursements</th>
<th>% Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>670,000</td>
<td>728,862.6</td>
<td>+27.87</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>390,000</td>
<td>306,388</td>
<td>-21.44</td>
</tr>
<tr>
<td>RRBs</td>
<td>85,000</td>
<td>117,181.7</td>
<td>+37.86</td>
</tr>
<tr>
<td>Total</td>
<td>1,045,000</td>
<td>1,152,428.1</td>
<td>+9.76</td>
</tr>
</tbody>
</table>

While disbursements made by RRBs were higher by 37.86 per cent over the targets, followed by commercial banks at 27.87 per cent, cooperative banks’ achievements were 78.56 per cent of the targets. Overall achievements were higher by 9.76 per cent during the year 2004-05 over the targets.

**Table No.2**

<table>
<thead>
<tr>
<th>Agency</th>
<th>Disbursements 2003-04</th>
<th>Disbursements 2004-05</th>
<th>% Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>52,4410</td>
<td>728,862.6</td>
<td>+39</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>26,9500</td>
<td>306,388</td>
<td>+14</td>
</tr>
<tr>
<td>RRBs</td>
<td>7,5810</td>
<td>117,181.7</td>
<td>+55</td>
</tr>
<tr>
<td>Total</td>
<td>86,9810</td>
<td>1,152,428.1</td>
<td>+32</td>
</tr>
</tbody>
</table>
Disbursements made by RRBs were 55 per cent higher during 2004-05 over that of the year 2003-04 followed by commercial banks at 39 per cent, whereas cooperative banks’ disbursements were only marginally higher by 14 per cent. Overall disbursements during the year 2004-05 were higher by 32 per cent over that of the year 2003-04.

Table No.3
Agency-wise targets & achievements of financing of new farmers during 2004-05

<table>
<thead>
<tr>
<th>Agency</th>
<th>Target [2004-05]</th>
<th>Achievements</th>
<th>% Achievements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>3,500,000</td>
<td>4,774,000</td>
<td>136.4</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>-----</td>
<td>1,252,000</td>
<td></td>
</tr>
<tr>
<td>RRBs</td>
<td>1,500,000</td>
<td>1,858,000</td>
<td>123.87</td>
</tr>
<tr>
<td>Total</td>
<td>5,000,000</td>
<td>7,884,000</td>
<td></td>
</tr>
</tbody>
</table>

Commercial banks & RRBs had together financed 6.632 million new farmers during the year 2004-05 against the targets of five million new farmers, while cooperative banks had financed 1.252 million new farmers. Total number of new farmers financed were as high as 7.884 million. Loans granted to tenant farmers, oral lessees & share croppers was of the order of Rs. 3600 million accounting for 1.65 per cent of total loans to new farmers.

Table No.4
Agency-wise number of farmers in distress & arrears as on 31st March'05 [Rs in million]

<table>
<thead>
<tr>
<th>Agency</th>
<th>Farmers in Distress</th>
<th>Farmers in Distress</th>
<th>Farmers in Arrears</th>
<th>Farmers in Arrears</th>
<th>One Time Settlement</th>
<th>One Time Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. A/C</td>
<td>Amount</td>
<td>No. A/C</td>
<td>Amount</td>
<td>No. A/C</td>
<td>Amount</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>1,226,072</td>
<td>39,875</td>
<td>299,000</td>
<td>9,395.3</td>
<td>117,009</td>
<td>2,716</td>
</tr>
<tr>
<td>Cooperative</td>
<td>34,470.4</td>
<td>10,077.8</td>
<td>2,208.8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>RRBs</td>
<td>13,729.4</td>
<td>1,988.2</td>
<td>2,643.5</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>88,074.8</td>
<td>21,461.3</td>
<td>7,566.3</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Amount of Rs. 117,104.4 million was provided as debt relief by all agencies as on 31st March’05. While farmers in distress received the highest assistance at 75 per cent, it was 18 per cent incase of farmers in arrears & seven per cent as one time settlement. Commercial banks extended loan facility amounting to Rs. 570 million to 16,758 farmers indebted to informal sources [money lenders] to redeem their debts.

Table No.5
Financing of Self-Help-Groups as on 31st March’04 & ’05 [Rs in Million]

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Cumulative progress As on 31st Mar’04</th>
<th>Progress during 2004-05</th>
<th>Cumulative progress As on 31st Mar’05</th>
</tr>
</thead>
<tbody>
<tr>
<td>No.of SHGs financed</td>
<td>1,079,091</td>
<td>518,713</td>
<td>1,597,804 [48.07%]</td>
</tr>
<tr>
<td>No.of SHGs refinanced</td>
<td>611,043 [56.63%]</td>
<td>213,845 [41.23%]</td>
<td>824,888 [51.63%]</td>
</tr>
<tr>
<td>Bank loan disbursed</td>
<td>Rs, 39,042.1</td>
<td>Rs 29,623.8</td>
<td>Rs 68,665.9 [75.87%]</td>
</tr>
<tr>
<td>Refinance disbursed</td>
<td>Rs 21,242.4 [54.4%]</td>
<td>Rs 9,681.1 [32.68%]</td>
<td>30,924.3 [45.03%]</td>
</tr>
</tbody>
</table>

During the year 2004-05, 518,713 SHGs were financed by banks taking the total number of financed SHGs at 1,597,807 as on 31st March’05. Bank loan disbursed during the year was Rs. 29,623.8 million with cumulative disbursement of Rs. 68,665.9 million as on 31st March ’05. While percentage of refinanced SHGs were 51.63 as on 31st March’05 cumulative amount of refinance disbursed accounted for 45.03 per cent. Number of SHGs financed as on 31st March’05 increased by 48.07 per cent over the year ended 31st March’04, loan amount disbursed was higher by 75.87 per cent.
**Dismal Picture**
While the quantum-wise performance of banks has been indeed very impressive, following data as reported by the National Sample Survey Organization for the year 2003 exhibits a dismal picture in so far as coverage of small & marginal farmers is concerned.

1. Out of the 147.90 million rural households in the country around 89.35 million households [60.41%] are cultivator households. Of this, around 49 per cent are indebted to formal or informal or both, revealing that nearly 51 per cent cultivator households are not indebted at all. In the category of non-indebted households, 88 per cent households belong to small & marginal farmers with farm holding of less than two hectares.

2. As a proportion of total cultivator households, while around 55 per cent are indebted households, only 27 per cent or 24.31 million households are indebted to formal sources.

3. The outreach of the banking system covering 24.31 million cultivator households shows a distinct bias towards farmers with larger holdings. NSSO data show that outreach to small land holders of 25 cents land holding is hardly 23 per cent as against 65 per cent outreach to farm holdings between five & 10 acres.

4. Of the 24.31 million indebted households, if five States of Andhra Pradesh, Kerala, Karnataka, Tamil Nadu & Punjab showing high level of indebtedness to formal & informal sources are excluded, the overall level of indebtedness falls by six percentage points [48.6% to 42.7%]. What is more shocking is that the level of indebtedness to only formal sources by cultivator households in the remaining states drops to barley 20 per cent.

The findings of the World Bank & NCAER under the “Rural Financial Access Survey” conducted in States of Andhra Pradesh & Uttar Pradesh in 2003 also paints a very disheartening picture. The data reveal that
1. Only 21 per cent rural households had access to formal credit.
2. Small & Marginal farmers were at a relatively disadvantaged position as only 11.8 per cent of marginal farmers in Andhra Pradesh & 13.5 per cent in Uttar Pradesh secured loans from banks.
3. The time taken for loan clearance ranged from 24 to 33 weeks & loans were generally collateralized.

While Southern region accounts for lion share in forming & financing SHGs, banks have yet to commit themselves & involve in this activity from the angle of increasing SHGs’ income appreciably rather than facilitating them to survive. Besides, Northern & North-Eastern region calls for concerted attention of bankers in expanding this activity on a substantial scale. Banks depend heavily on availing refinance from National Bank at reduced interest rate rather than deploying their own resources, leave alone playing developmental & promotional role.

It is indeed a sorry state of affairs that even after half a century of our Independence no serious attention has been paid to evolve a policy of making rural financial intermediaries operationally sustainable & significantly reducing transaction costs taking into consideration [i] the special characteristic features of Indian agriculture & risk factors associated with agricultural lending & [ii] the overwhelming need for shifting approach from directed credit & provision of subsidies. An attempt is, therefore, made in this paper to appreciate all these aspects, learn lessons from the past experiences & suggest policy prescriptions that can make rural financial intermediaries sustainable & reduce their transaction cost.

**Characteristic Features of Agricultural Finance**
Agricultural finance in India presents following special features in the context of agriculture being dominated by large number of small & marginal farms and huge number of landless laborers.

- Agriculture as is practiced in India is a very vast & complex subject covering a wide variety of economic activities viz, crop & live- stock farming; horticulture, vegetable cultivation & plantation crops; forestry & fisheries/acquaculture; agro-processing and agri-business, etc. that calls for specialized know-how for financing.
The high financial transaction costs for serving small households in dispersed geographical locations more particularly in hilly, tribal, drought prone & desert areas. High financial transaction costs for lenders and borrowers are due to:

[i] Inadequate or grossly underdeveloped transportation and communication infrastructure
[ii] Long distances to serve a dispersed rural clientele
[iii] Expensive management and supervision of rural bank branch networks
[iv] Bankers’ lack of knowledge about heterogeneous farm households
[v] Heterogeneity of farming traditions & practices
[vi] The diversity in farm and non-farm income generating activities of rural households requires better knowledge of the farm household financial situation. Loan officers should have more information than may be needed in the case of urban lending. This can extend the bank staff time [and expenses] needed for loan appraisal. It may also require the setting of individual loan repayment terms. It increases the costs of training agricultural loan officers &
[vii] High additional costs for borrowers:, opportunity costs [loss of working time] transport costs, payment of fees for several purposes.

Effective demand for credit has following dimensions which necessitate continuous focused attention for review & introducing sufficient flexibility, rather than rigid policy framework.

1. The seasonality and the importance of opportune timing of on-farm finance for cultivation practices, input application, harvesting and related output marketing
2. The heterogeneity in farmers’ lending needs [seasonal, medium and long term lending] and the relative long duration of agricultural lending contracts.
3. Agricultural development calls for provision of long-term/investment credit that often leads to mismatch between assets [loans] and liabilities [funding sources]
4. Seasonality in agricultural credit demand
5. Farm households are integrated units of production and consumption.
6. Demand for loans depends on the self-financing potential, access to savings deposit facilities and risk management ability of borrowers
7. Due to the fungibility of money borrowed, funds can be used by farm households for consumption, education, social insurance, production and investment purposes. The reality is that these farm households are confronted with emergency needs and that their loan repayment capacity is highly dependent on consumption and social security contingencies.
8. The dependence on sustainable natural resources management and the relative low profitability of on-farm investments.
9. The limited availability of conventional bank collateral that small & marginal farm households can offer, Small farmers have few physical assets [land] that necessitates the significant importance to develop appropriate collateral substitutes; heavy reliance on character & capacity rather than collateral & credit worthiness based on risk bearing capacity .
10. Farmers and especially poor rural women have difficulties in clearly demonstrating their legal ownership of assets. Legal contract enforcement problems arise even when collateral is available.
11. The need for adequate on-going/ continuous training of both bank staff and farmer-clients to keep pace with changing environment of agricultural technology & financing techniques which is very costly & cannot be avoided.
12. Lending activities are often undertaken in a politically sensitive environment. Over the period, agriculture in most of the developing countries including India has been identified as a politically sensitive sector. This has, therefore, necessitated State interventions in the functioning of rural financial markets. Often unwarranted interventions such as waivers of interest on loans and/or write off of over due loans
have resulted in low repayment discipline among borrowers; it encourages defaulters not to repay loans & demotivates regular repayers.

Existing prudential norms having bearing on stipulated time for loan repayment & provision for loan losses need adequate flexibility based on case studies in each of agro-ecological regions.

**Risks Associated with Agricultural Lending**

**Profitability and Risks of On-farm Lending**

The major factors that affect banker and farmer behaviour in on-farm lending operations are the expected profitability of and the risks related to on-farm investments. Risks can be of different natures and include those associated with the impact of unfavorable weather on production [drought, hail, floods etc] diseases and pests damage, economic risks due to uncertain markets and prices, productivity and management risks related to the adoption of new technologies, and credit risks as they depend on the utilization of financial resources and the repayment behavior of farmer clients. The relative importance of these different risks will vary by region and by type of farmer. For example, marketing risks are greater for mono-crop cultures and under dry farming conditions. These risks will decrease as the level of education of farmers and availability of information on markets, prices and loan repayment behavior increase. In some cases, especially for relatively high technology farming that involves significant investments, agricultural insurance may be useful as a risk management tool. This can be used only for specific crop/livestock enterprises and for clearly defined risks.

Risks are also related to duration of loans, since the uncertainty of farm incomes and the probability of losses increases over longer time horizons. Thus, given the average short maturity of loanable resources in deposit-taking financial institutions, and considering the time horizon of agricultural seasonal and investment loans, commercial banks are normally reluctant to engage themselves in agricultural lending. To protect themselves, banks should carefully match the maturity of their loans with that of their loanable resources and apply measures to protect their loan portfolio from potential risk losses.

Additional risk protection measures that present added costs to borrowers include insurance coverage against insurable risks such as specified adverse weather events leading to crop damage or insurance against fire [buildings and crops] and theft [moveable assets] Government or donor financed loan guarantee schemes, in general, have not led to significantly increased lending [additionally] and they should be carefully designed in order to secure appropriate risk management and sharing as well as cost effective administration. On the other hand, mutual guarantee associations have proven their usefulness. Banks also control their financial exposure by limiting their loans to only a portion of the total investment costs and by requiring that the borrower engages sufficient equity as well as careful diversification of their loan portfolio in terms of lending purposes, market segments and loan maturities. Portfolio diversification is a key to sustainability and successful risk management.

**Institutional Risks**

Financial institutions face four major risks

1. Credit or loan default risk refers to borrowers who are unable or unwilling to repay the loan principal and to service the interest rate charges.
2. Liquidity risk - occurs when a bank is not able to meet its cash requirements. Mismatching the term of loan assets and liabilities [sources of loanable funds] exposes banks to high liquidity risks.
3. Interest rate risk - risk that a loan will decline in value as interest rate change
4. Foreign exchange risk - defines exposure to changes in exchange rates which affect international borrowings denominated in foreign currency.

Risks impact borrowing farmers and the financial institutions that lend to them. Active management can reduce these risks. Risks and uncertainty are pervasive in agricultural production and are perceived to be more serious than in most non-farm activities. Production losses are also extremely difficult to predict. They can have serious consequences for income
generation and for the loan repayment capacity of the borrowing farmers. The type and the severity of risks which farmers face vary with the type of farming system, the physical and economic conditions, the prevailing policies, etc.

Agricultural lending implies high liquidity risks due to seasonality of farm household income. Surpluses supply increased savings capacity and reduced demand for loans after harvest and deficits reduce savings capacity and increase demand for loans before planting a crop. Also, agricultural lenders face particular challenges when many or all of their borrowers are affected by external factors at the same time. This condition is referred to as covariant risk which can seriously undermine the quality of agricultural loan portfolio. As a result, the provision of viable, sustainable financial services and the development of a strong rural financial system is contingent on the ability of financial institutions to assess, quantify and appropriately manage various types of risks.

**Production and yield risks**

Yield uncertainty due to natural hazards refers to the unpredictable impact of weather, pests and diseases, and calamities of farm production. Risks severely impact younger, less well established, but more ambitious farmers. Especially affected are those who embark on farming activities that may generate a high potential income at the price of concentrated risks. For example, in case of high input monoculture of maize. Subsequent loan defaults may adversely affect the credit worthiness of farmer borrowers and their ability to secure future loans.

**Market and price risks**

Price uncertainty due to market fluctuations is particularly severe where information is lacking and where markets are imperfect, features that are prevalent in the agricultural sector in many developing countries. The relatively long time period between the decision to plant a crop or to start a livestock enterprise and the realization of farm output means that market prices are unknown at the moment when a loan is granted. This problem is even more acute in tree crops because of the gap of the several years between planting and the first harvest. These economic risks have been particularly noticeable in those countries where the former single crop buyer was a parastatal body. These organizations announced a buying price before planting time. Many disappeared following structural adjustments reforms and privatization of agricultural support services. Private buyers rarely fix a blanket-buying price prior to the harvest, even though various interlinked transactions for specific crops have become more common today. These arrangements almost always involve the setting of a price or a range of prices, prior to crop planting.

**Risk of loan collateral limitations**

Problems associated with inadequate loan collateral pose specific problems to rural lenders. Land is the most widely accepted asset for use as collateral, because it is fixed and not easily destroyed. It is often prized by owners above its market value and it has a high scarcity value in densely populated area. Smallholder farmers with land that has limited value, or those who have only usufruct rights, are less likely to have access to bank loans. Moveable assets, such as livestock and equipment are regarded by lenders as higher risk forms of security. The owner must provide proof of purchase and have insurance coverage on these items. This is rarely the case for low-income farm households.

Moreover, there are a number of loan contract enforcement problems, even when borrowers are able to meet the loan collateral requirements. Restrictions on the transfer of land received through land reform programs limits its value as collateral –even when sound entitlement exists. In many developing countries the poor and especially women have most difficulties in clearly demonstrating their legal ownership of assets. Innovative approaches which draw on the practices of informal lenders and provide incentives to low income borrowers to pay back their loans have been developed in micro-credit programs.

**Moral hazard risks in distorted credit culture**

Potentially serious risk problems have risen from the effects of failed directed credit programs. The impact on the loan repayment discipline is pervasive. Borrowers who have witnessed the
emergence and demise of lending institutions, have been discouraged from repaying their loans. Further people have repeatedly received government funds under the guise of “loans”. Loan clients have been conditioned to expect concessionary terms for institutional credit. Under these circumstances, the incidence of moral hazard is high. The local “credit culture” is distorted among farmers and lenders. Borrowers lack the discipline to meet their loan repayment obligations, because loan repayment commitments were not enforced in the past. Lenders, on the other hand, lack the systems, experience and incentives to enforce loan repayment. There is also an urgent need to change bank staff attitudes and the poor public image of financial institutions in rural areas.

Another effect of distorted credit culture on the risk exposure of agricultural lenders is the priority that borrowers give to repaying strictly enforced informal loans. These are settled before they comply with the obligations associated with “concessionary” institutional credit. This is explained by the fact that losing the access to informal credit is viewed as more disadvantageous than foregoing future bank loans [due to the uncertain future of rural financial institutions]. Very often informal lenders have stronger enforcement means than banks.

**Risk from changes in domestic and international policies**

Policy changes and state interventions can have a damaging impact on both borrowers and lenders. For the latter they can contribute significantly to covariant risks. Many low-income economies under the structural adjustment program have slashed their farming subsidies. This has had, for instance, a serious effect on the costs and the demand for fertilizer. Reducing government expenditures as an essential part of structural adjustment programs may also affect employment opportunities in the public sector. Costs may even reduce agricultural production levels, if extension services are suddenly discontinued.

**International Experience**

**Directed Credit**

Since the early 1950s government and donors have spent large amounts on agricultural credit programs in developing countries. The World Bank alone committed over US $16 billion to these efforts from the mid-1950s to the late 1980s and other donors also spent substantial amounts. In several countries such as Brazil, India, Indonesia, Mexico and Sri Lanka, supply-led and directed credit programs were the dominant tools used to spur agricultural development during the three decades prior to the 1990s. In centrally planned countries directed lending was likewise a prominent instrument used to implement agricultural production plans. However, directed credit programs still continue to play a strong role in some developing countries viz. Philippines, India etc.

The assumption behind these efforts was that many farmers faced liquidity constraints that limited their ability to make farm investments and to use additional modern inputs. Relaxing these constraints by providing them with loans, therefore, was thought to be an easy way of stimulating farm investments, boosting the use of modern inputs and augmenting farm production.

The proponents of the directed credit approach assign many tasks to financial markets on the one hand, but on the other hand pay little attention to providing and maintaining the financial infrastructure needed to carry out these assignments. In contrast, the new market approach assigns more modest role to financial markets. The new approach stresses the importance of the processes of financial intermediation. The principal goal in improving this process is to enhance the efficiency of resource allocation in the economy. This is done by efficiently mobilizing deposits from savers who otherwise, have only low-return options for investing their surplus funds, and then efficiently allocating loans to creditworthy borrowers who have too few funds to capitalize on viable investment opportunities.

The users of financial services in a system strongly influenced by directed credit tend to be borrowers rather than depositors; the system is borrower dominated. By contrast, the new approach stresses the importance of mobilizing local deposits, and efficiently intermediating
between savers and borrowers. In India while commercial & regional rural banks mobilize savings, Primary Agricultural Credit Societies are not allowed to mobilize rural savings even from their borrowers. Both commercial & regional rural banks have yet not developed saving mobilization instruments/products best suited to rural areas.

Typically, the volume of information associated with directed credit programs is substantial. Managers of directed credit programs are able to provide detailed information or data required by funds providers, but are unable to generate critical up-to-date management information, such as the status of loan recovery at any point of time. While banks in India have to collate, compile & furnish data under agricultural credit programs in the form of several returns periodically, leaving practically very little time for business development, return on recovery of loans is annual that does not provide status of recovery/over due at any point of time.

To justify subsidies associated with directed credit programs, it is common for credit planners to require that credit impact studies be done on these programs. These studies usually require collection & analysis of costly primary data that is not ordinarily assembled by lenders. The costs of managing the dense volume of information generated by directed credit activities typically augments loan transaction costs for both lender and borrower.

In contrast, the new approach generates less but more useful data. The absence of numerous directed credit lines eliminates the need to process data for each sub-program & make staff available for development of business including recovery mobilization.

Since the new approach stresses making loans based on creditworthiness of borrowers & projects, rather than on the basis of need, there is likewise much less data processed on the characteristics of borrowers and the impact of these programs. The essence of data collection and processing under new approach is to manage financial intermediaries efficiently and prudently. The performance of financial institution is measured by indicators such as deposit mobilization, transaction costs, loan recovery, number of clients, and financial & operational sustainability.

The support for these traditional directed agricultural credit efforts began to wane in the 1980s and by the end of the decade most donors and some Governments sharply reduced their support to agricultural credit. In part, this decline in support was due to the unsatisfactory performance of these efforts. Critics increasingly argued that relatively few of the credit subsidies were captured by poor people and that subsidized and directed credit had a weak effect on farm production and investment. Serious and chronic loan recovery problems, dependency on outside funding, and overall costs eroded the support for these efforts. Poor performance and the lessening of donor and Government support led to the collapse of many public agricultural development banks and [Government directed] rural cooperatives in the 1980s. In some countries like Peru and Bolivia traditional agricultural banks were closed down. In other countries such as The Gambia and ex-USSR all or part of the development banks were sold or privatized. Still in other countries these development banks and rural credit cooperatives persist but their financing activities have been sharply reduced, such as in Guatemala, Nicaragua and Uganda. In India where directed credit & Government sponsored programs still persist, commercial/cooperative banks & regional rural banks face serious problems of recovery of dues & had to be re-capitalized whereas co-operative banks are now being considered for re-capitalization.

**Subsidised Interest Rate**

The proponents of directed credit argue by justifying an interest rate subsidy on loans for people because they are poor, and justifying loan waiver/write off because poor borrowers later turned out to be “too poor” to repay the loans.

Under the new approach there are no subsidies associated with loans so there are no favors associated with lending. Financial intermediaries treat their borrowers and depositors as valued clients if they are to stay in business. This forces intermediaries to be attentive to the quality of services they provide, to the transaction costs they impose on their clients and to financial innovations that reduce these costs.
It was further assumed that most farmers were too poor to save, that informal financial markets were dominated by monopolist money lenders who charged usurious interest rates, and that commercial banks were too conservative to lend to most farmers. Based on these assumptions Governments and donors developed and funded numerous directed credit programs around the world. Most of these efforts were heavily subsidized by charging concessional interest rates or tolerating loan defaults.

A common arrangement for providing rural financial markets with donor or Government funds was to open concessional rediscount windows in the country’s central banks to disburse funds to selected groups, regions or activities. Banks and other financial institutions were stimulated to grant targeted lending by making concessional funds available from the rediscount window. The interest rates on these funds were typically lower than the rates lenders were paying for alternative sources of funds. In the later, 1970s, for example, the central bank in Indonesia administered nearly 200 directed credit lines, many of which were aimed at agricultural activities, and most of which were subsidized. In India National Bank has been providing refinance at concessional interest rate to the banking system for farm & non-farm sector development. In fact, National Bank’s financial resources need to be deployed directly for long term investment purpose in developing irrigation potential, horticultural & plantation projects, establishing agro-processing units, cold chains, markets etc.

In some cases, the availability of rediscount funds was augmented by imposing loan portfolio requirements on commercial banks, as for example in India stipulated agricultural lending at 18% of net bank credit & un-lent portion to be lent for Rural Infrastructure Development Fund at concessional rate of interest to National Bank. These requirements were intended to compel banks to either make more loans for purposes targeted by Government, or to lend on concessional terms to other institutions, especially agricultural development banks that were doing targeted lending. In Thailand, for example, during the 1970s and 1980s the Government required all banks to lend an increasing percentage of their total loan portfolio to farmers. If they were unable to comply directly with this requirement, they were allowed to fulfill their obligation by lending money at concessional rates to the Bank for Agriculture and Agricultural Cooperatives. In some countries subsidized loan guarantee schemes were also established to further encourage agricultural lending, as for example in India Deposit Insurance & Credit Guarantee Scheme was established in early 1970s. The assumption behind these schemes was that by transferring part or all of the loan recovery risk to the insurance program, lenders would be induced to do more of the lending preferred by policy makers.

These subsidies take the form of concessional interest rate on funds provided to lenders, subsidized interest rates on loans made to beneficiaries, implicit subsidies involved in loans that are not repaid and written off, Government or donor grants to cover costs of institution involved in directed credit, and subsidies for supporting loan guarantee schemes.

An important objective of new approach is to eliminate subsidies in rural finance. Form of subsidies, if any, should be temporary and transparent and not linked to the lending activities but rather to institution building. To help reduce transaction costs, for example, training of bank staff in new lending practices or for banking operations and automation may be subsidized.

Since financial institutions are not processing subsidies under the new approach, they are much less susceptible to rent seeking and corruption, common features of the directed credit approach. As part of this process, many countries formed or expanded agricultural development banks to handle the bulk of the targeted lending. In many countries political considerations were involved in loan approval and recovery decisions. Government mandated loan forgiveness in Bangladesh and Loan Melas and loan write-offs in India during 1980s being examples of such political interventions in financial sector operations.

Shifts in political priorities and donor preferences have often resulted in substantial changes in roles assigned to rural financial markets. Sometimes farm production and farm investments were stressed, while at other times poverty alleviation, pacifying the countryside, or disaster reliefs
were the primary objectives of directed credit efforts, as for example in India provision of targeted & sub-targeted credit under the Integrated Rural Development Program focusing on direct attack on rural poverty from 1978 & provision of credit on soft terms to existing borrowers when natural calamities visit them in certain geographical areas.

Policy Framework
Following suggestions need to be considered for evolving a policy that can make rural financial intermediaries operationally sustainable & reduce their transaction costs.

• Farming activity at small farmer’s level should be diversified & made bankable such that income realised is adequate to meet all expenses viz, cultivation, interest, risks, family’s livelihood. This is the responsibility of farm universities & Krishi Vigyan Kendras to evolve & transfer the proven & demonstrated technology among small farmers. Productivity of crops per unit area & time is very low, leave alone the quality of products, as compared to that of many countries. Research & application of biotechnology is one such area which needs serious attention.

Agricultural insurance has a significant role in farming, in particular for small farmers. However, its applicability in any given situation is defined by the test as to whether it is the most cost-effective means of addressing a given risk. Experience of existing insurance operations needs to be evaluated in order to take advantage of existing insurance expertise, record keeping and accounting systems and equipment. Agricultural insurance operations require some special skills. This approach can partly be supplemented by personal observations through study tours of efficient crop insurance programs. The USA and Australia have been implementing crop insurance scheme which was studied by Nigeria and Iran. A special area of concern is the whole loss adjustment process, including assessment and attribution of loss. FAO has produced training manuals on loss adjustment. As far as crop insurance planning is concerned, FAO has also produced a book entitled “Strategies for Crop Insurance Planning” which describes the conditions necessary for crop insurance operations to be worthwhile and affordable. Accuracy in terminology is important when dealing with contractual matters such as the sale and purchase of insurance. This needs to be studied by the Expert Committee & modified to suit our conditions. Besides, Comprehensive agricultural & rural insurance policy may need to be evolved replacing the existing crop insurance/livestock insurance/krishi bima yojana.

• Focus of providing credit to farm sector should be shifted on provision of credit for all sectors of rural economy viz, agriculture, manufacturing & processing, business & service segments.

• Financing Primary Agricultural Credit Societies by commercial/regional rural banks & establishing Farmers’ Service Societies by banks need to be reconsidered through modifying the concept & operational aspects in the light of new changes.

• High transaction cost may need to be significantly reduced through adoption of a series of measures viz, public investment in creating rural infrastructure particularly road, transport & communication facilities; broadening the scope of kisan credit card to cover all kinds of small farmer’s economic [farming & non-farming, short & long term] & social needs for credit including consumption & housing; credit linked with savings; loan products be adequately flexible, tailor-made to suit to different agro-ecological regions & socio-economic status of borrowers; credit needs & repayment based on house-hold’s cash flow & business plan and evaluated in terms of character & capacity of the borrower;

• Specialised, trained & experienced loan officers posted at rural branches to evaluate credit proposals, guide clients & take decision within a maximum week’s time.

• Month-wise calendar focusing on flow of credit & receipt of interest & repayment to be prepared to ensure productive deployment of funds & expected returns.

Government’s role
• Government should refrain from imposing/dictating stipulations on banks viz, , resource allocations; directed/targeted/sub-targeted credit; fixation of interest rates; restricting
geographical area for financing; loan write offs/interest waiver; Government sponsored programs linked with subsidy for farmers & with no consideration to provision of backward & forward linkages as well as supported by technical feasibility & financial viability of credit based farm sector projects.

- To refrain from intervening in the business and personnel policies of financial institutions
- Abstain from any interference in the operational autonomy and management of financial intermediaries, both public and private.
- Government should invest in the development of water resources & efficient drainage system; sol & moisture conservation projects, create enabling environment & establish institutional infrastructure.
- To create essential basic rural infrastructure such as roads, electricity, communications, marketing infrastructure.
- To assist in the provision of so called “public goods” such as information, human resources development and agricultural research
- To lay down an appropriate financial system development policy, which supports effective financial intermediation, reduces financial transaction costs and increases the access of farmers to financial services, facilitates the use of appropriate loan collateral and develops a proper regulatory and supervisory framework for the different types of financial institutions.
- To provide facilities in particular, for term lending to selected financial intermediaries through second tier or apex financial institutions.

**Training**

- From numerous expert reports and meeting documents, it is evident that agricultural credit expansion is hampered by farmers’ lack of knowledge about the availability and conditions of credit, and by the shortage of well trained bank staff, who have experience in dealing with small farmers and rural people. Training, therefore, should focus both on bank staff and farmers clients.
- Bank’s field staff should have appropriate education and training in business and farm management, agriculture and banking. In their work they should interact closely with agricultural extension agents and organizations, who provide essential non-financial support services to small farmers and rural people. Such liaison should involve sensitizing farmers about the availability and conditions of bank credit and assist farmers in preparing proper farm and business plans and submitting loan applications. Extension agents and similar technical staff, however, should not be involved in loan approval and loan recovery, which remains the exclusive task of banks.
- Banks should accept staff training as an investment, forming part of overall manpower development. This needs to be reflected when recruiting staff bearing in mind that poor recruitment practices may result in poor recruits which cannot be rectified easily by training. Measures should also be taken to provide adequate incentives to bank staff who work in rural areas. Salary levels and fringe benefits, compensation for over time work, appointment and career perspectives need to be in line with similar employment in the urban sector in order to promote agricultural lending. Bank staff performance-based incentives should focus in particular on loan recovery and saving mobilization.
- The main objective of farmer training should be to increase the benefits of borrowing for production purposes and should be oriented at improving the business skills of individual farmers. Topics to be included are farm planning and farm management, risk management, book keeping and cost accounting, savings and liquidity management, the role and use of credit, the costs of credit [interest and related financial charges], collateral requirements, loan repayment obligations, legal measures against loan defaulting etc. Such training can be prepared by banks and delivered to farmers in conjunction with or by agricultural extension staff.
- Non-financial services such as information, training and extension can be provided by the State, by the private sector or by a combination of these. The problem is finding the right combination and identifying how to institutionalize these arrangements. Many drawbacks in the provision of support services can be traced to their high costs, to inefficiency and to non-involvement or non-commitment of the final beneficiaries, when they are provided directly by the public sector. The private sector strengths are in identifying the immediate needs of different clientele, in organizing the supply of services to meet the demand, and in managing effectively the financial transactions involved. However, there is still an important role for the public sector in providing a proper policy and legal environment within which private sector business activities can take place.
Conclusion
The lessons of the past are that fragmented interventions do not work. What is needed is a clear, consistent and favorable policy environment which on the one hand helps to make the farming more profitable and on the other facilitates sustainable provision of banking services to the agricultural sector. More than this is the essential element of institutional development. Grassroots entities providing financial services at the farm level in the form of savings and loan facilities are one of the more promising approaches for building a viable and sustainable financial system for small farmers. Their possible integration in an apex organizations and/or their effective linkage with existing banks remain a challenge and a precondition for an expanded outreach of financial services to the rural population.