

# FEATURES

## THE ROLE OF CO-OPERATIVE RURAL BANKS IN SRI LANKA'S RURAL SECTOR

M.W.Panditha

*This paper was read by M.W. Panditha, Deputy General Manager, Co-operative Development, Accounts and Planning of the People's Bank at the Senior Executive Group Study/Observations Programme 1984 of the Asian Pacific Region Agriculture Credit Association held in Colombo. Mr. Panditha was closely associated with the Rural Credit Department and during the period of the pioneering of the Rural Credit Scheme.*

Rural Banks or Co-operative Rural Banks (CRBs) as they were subsequently renamed (1) celebrated the 20th anniversary of their establishment in March this year. This banking system was launched by the People's Bank during its formative stages as an institutional device through which the Bank could supplement its programme for provision of banking facilities to the rural sector through the Co-operative Movement. A CRB is not a Bank in the conventional sense but, it is the financial arm of a Multi-Purpose Co-operative Society. It is not a separate legal entity and does all its business in the name of the Multi-Purpose Co-operative Society of which it is a part. At present, there are 298 CRBs and 576 CRB branches covering the entire island.

In this paper, an attempt would be made to describe the objectives and functions of these institutions, the rationale for their setting up and their role in rural credit.

### BACKGROUND

The concept of combining credit, marketing, resource mobilization and other general purpose activities at village level in one single organisation is not new to the Co-operative Movement. Raiffeisen, the father of the Credit Society himself appears to have harboured similar views. (2)

In Sri Lanka too, in 1957 when the proposal for re-organisation of the Co-operative Movement was

adopted and the single purpose Co-operative Societies were amalgamated into Multi-purpose Co-operative Societies, the inclusion of banking as one of the functions of these Societies was accepted as essential for the dynamic role they were expected to play in the development of the rural economy.

The Committee which recommended the formation of Multi-purpose Co-operative Societies in 1957 inter alia made the following observations:

"It should be noted that all Multi-purpose Co-operative Societies will be primary Rural Banks and their relation with District Bank or Co-operative Development Bank (3) are matters for settlement after discussion with the latter Bank."

(1) In 1972, with the amalgamation of Multi-Purpose Co-operative Societies into a large Primary Societies, Rural Banks were re-named Co-operative Rural Banks.

(2) "The object of the society is to improve the situation of its members, both materially and morally, to take necessary steps for some to obtain through the common guarantee the necessary capital for granting loans to members for the development of their business and other household needs, to bring idle capital into productive use for which purpose a Savings Bank will be attached to the Society"

(3) The Co-operative Development Bank referred to above however did not see the light of day, but in its place was established in 1981, the People's Bank with almost identical objectives.

(4) Census of Agriculture 1983.  
(5) To Government (2.5%); Co-operatives (4.1%); Commercial Banks (1.1%); Relations and Friends (44.2%); Landlords (8%); Private Money Lenders (15.5%); Traders (11.5%); Others (13%).

(6) In early fifties institutions which provided rural credit consisted of unlimited credit societies, Co-operative Agricultural Production and Sales Societies, Kacheries and the Dept. of Food Production.

I shall now outline briefly some facts of the rural setting as it existed before establishment of the People's Bank, as a backdrop to the understanding of the role of CRBs.

Of the 4.5 million acres of agricultural land, about 2.3 million acres were cultivated with tree crops, mainly tea, rubber and coconut which form the principal agricultural exports. These crops are run mostly on commercial lines. On the other hand, the agriculture of the small farmer is primarily paddy cultivation. The size of holdings in this sector is small, and are uneconomic at the lower end. The number of holdings stood at 1,189,801 of which paddy holdings accounted for 49 percent. An average holding being 1.9 acres the farm sizes differed widely. (4) Natural hazards pose a constant threat.

Approximately 72% of the population live in village areas and are engaged mostly in agriculture. Since agricultural incomes are seasonal and subject to wide variations, specially among small farmers, there is a constant need for credit in the rural sector both for purposes of production and consumption. Due to lack of adequate

institutional credit facilities in rural areas, (5) villagers have been compelled to obtain their credit requirements from private sources at high rates of interest. This heavy burden of debt had also contributed inter alia, to the poor productive capacity of the village cultivator. A survey of rural indebtedness conducted in 1957 (6) revealed that 48% of rural debts was from "undesirable sources of credit."

This survey also exposed the inadequacy of the then existing Co-operative Credit structure to make a significant contribution in the sphere of rural credit.

It also revealed the inherent weaknesses of the single purpose Co-operative Society and its inability to be an effective instrument in developing the rural economy.

Besides, the tenurial reforms which were introduced in the mid waranted the establishment of 50's institutions to finance tenants who were hitherto assisted by the land owners.

The re-organisation of the large number of single purpose Co-operatives into Multi-purpose Co-operative Societies was considered to be the answer. It was expected to be "the Village Bank, the Village Stores Society, the Marketing Society and the Labour Society, all rolled into one." The establishment of an islandwide network of Multi-purpose Co-operative Societies was therefore undertaken in 1957. Studies which made an identification of credit requirements of farmers in 1957 pointed out that the newly formed Multi-purpose Co-operative Societies should make arrangements for provision of not only productive credit but also non-productive credit such as expenditure on ceremonies, festivals, etc., and for redemption of existing debts.

#### The Establishment

##### of the People's Bank

Provision of funds for this vast network required the establishment of a powerful Co-operative apex Bank. This Bank was established in 1961 as a Commercial Bank under the name of People's Bank. The purposes of the Bank were to develop the Co-operative Move-

ment, rural banking and agricultural credit.

After the establishment of the People's Bank, provision of financial assistance to the Co-operative Movement increased in quantity to a marked degree. But this increase represented merely an expansion of the already existing services which were provided by the Co-operative Banks rather than a new departure to develop rural credit on the lines envisaged in the Bank Act. During the initial stages the Bank established a large number of branches, specially in areas which had not been hitherto served by commercial Banks. It also opened the doors to the people in lower income groups who could not obtain facilities from other commercial Banks. But these facilities were provided mostly to fixed income earners in lower income levels.

In contrast to the Bank's success in assisting such small fixed earners, was its inability to make a worthwhile impact in the sphere of agricultural credit. In the rural sector. Access to credit, absence of bankable securities, irregular pattern of income and other inherent defects in rural agriculture inhibited to a large extent the Bank's ability to expand its role in the rural sector. Besides, the inadequacy of the normal canons of commercial lending in assessing credit-worthiness of rural cultivators and the magnitude of the problem itself precluded the Bank from finding an effective solution to this problem on its own.

#### The First Step

##### Towards the Rural Sector

The Bank's lending to the rural sector through Co-operatives which was confined initially to financing of paddy purchases, consumer and other trading requirements of MPCSSs, was expanded for the first time in 1963 with the launching

of the Extended Rural Credit Scheme. Under this scheme, short and medium-term credit facilities were made available to certain selected MPCSSs for re-lending to their members. (7)

Short-term crop loans were however not provided as there was a scheme already in operation by the Government.

A review of the performance of this scheme by the Bank in early 1984 surfaced several weak aspects which are described below, and formed the basis for an improved system. (8).

- (a) The managerial capabilities of the staff had to be strengthened by providing external support and training.
- (b) In providing credit, pre-sanction and post-sanction evaluations of applications should be done in a methodical way.
- (c) Methods will have to be evolved (i) to accept securities available at village level such as lands without clear title (ii) to recognize the credit standing of borrowers who could not provide documentary evidence of their worth.
- (d) There is a need for delegation of authority of the Boards of Societies to sub-committees and Credit Managers to enable quick decision making in disbursing credit.
- (e) The procedures relating to (i) proper custody of documents; (ii) maintenance of up-to-date Book-keeping records; (iii) security arrangements and (iv) loan documentation, should be strengthened.
- (f) This scheme as it was constituted, was inadequate both in terms of its scope and its operations to meet the rural credit requirements and to act as a catalyst in promoting the rural sector.

(7) Facilities were granted for the following purposes initially Production (Rs.2,500/-); Consumption (Rs.500/-); House Repairs (Rs.2,500/-); Redemption of Debts (Rs.2,500/-); with a maximum of Rs.3,000/- per member and was extended later.

(8) This scheme continued till 1979 side by side with the Rural Bank Scheme.

(g) The provision of a credit line and supporting services in themselves were inadequate to restore the confidence of the rural community who had witnessed for nearly half a century the disbursement of credit by Co-operatives. The Credit Department of Co-operatives had to be given the image of a Bank.

(h) The Societies' lending should be linked to Bank lending.  
**Setting up of Rural Banks**

The lessons drawn from this experiment and the agonizing re-appraisals of its own limited role in the rural sector, led the People's Bank in 1964 to develop the concept of banking through Co-operatives into a practical and working proposition. The result was the formulation of the Rural Banking Scheme.

The objectives of setting up Rural Banks were then enunciated as follows-

- i) To provide credit facilities in a fruitful manner to members of societies.
- ii) To provide credit supervision for facilities granted.
- iii) To up-grade the book-keeping and documentation system.
- iv) To develop methods for savings mobilization.

And the scope and functions of Rural Banks were framed thus :

- i) To provide loan facilities for any purpose within a limit of Rs.3,000/-. Facilities above this limit to be considered by the nearest branch of the People's Bank.
- ii) Linking credit with marketing.

iii) Development of Rural Banking and Deposit Mobilization.

iv) Pawn Broking as People's Bank's agents.

To ensure their viability, the new scheme was thrown open to those MPCs which conformed to the eligibility criteria prescribed. (10) Priority was given to societies operating the Extended Scheme successfully.

Eligible Societies could make their applications to the Bank to join the scheme. Thereafter the Bank did the selection on a case by case basis after an inspection and scrutiny of the Society. Once selected, the Society and the Bank entered into an Agreement setting out the terms and conditions under which the Rural Bank was to operate.

As an initial step for the establishment of Rural Banks, the selected Societies were expected to amend their By-laws to enable them to establish Rural Banks. The People's Bank in turn provided the following : (a) financial assistance for on-lending; (b) managerial assistance by seconding one of its own employees; (c) safes, counters, stationary and equipment for pawning; (d) supervision.

Under this scheme, credit facilities were made available to members for production, housing, debt redemption, trade, consumption, emergencies and for rural electrification. These facilities were provided both as short-term and medium-term loans with repayments ranging from 1 year to 5 years.

These Rural Banks were authorized to engage in pawning as agents of the People's Bank.

Crop loan facilities of a seasonal nature however were not introduced as a scheme of granting cultivation loans, implemented by the Government, was in operation. However, provision of temporary Bridging finance facilities was envisaged against such loans.

Facilities were made available both for members and non-members to maintain different types of savings accounts such as, ordinary savings accounts, minor's savings accounts and Investment Savings Accounts. Members were expected to enter into a Marketing Agreement with the Society. All sales proceeds were expected to be credited to their accounts. Fixed Deposits were also accepted from members and non-members. Current Account facilities too were provided to members of the first three Rural Banks at the initial stage after which this facility had to be hastily withdrawn when certain legal impediments were encountered. Had these current accounts been maintained, more innovative credit facilities would have been evolved.

By 1971 this scheme had been extended to 111 Societies and the number of accounts attracted had grown to 60871. By this time this institution had not only gained the confidence of the rural population, but had also attracted the attention of academicians, researchers and officialdom as a new banking concept worth taking seriously. The establishment of banking sections in all amalgamated MPCs was accepted as Government policy.

**Changes in Rural Banks after Amalgamation of MPCs**

The amalgamation of a multitude of small MPCs to a relatively small number of large MPCs covering a wider area of operation, necessitated in 1973 certain organisational changes in the structure of Rural Banks. These Banks which were hitherto run on unitary lines, became a branch banking system with Head Office operations and Branch operations. Most of the former Rural Banks became branches of the new Banks. The name

(9) *vide Rural Credit and Banking Circular No.1/84 of 22-03-64.*

(10) (i) Minimum membership of 500; (ii) Shares of at least 75% members should be upto date; (iii) There should be no default by any creditor; (iv) Society is run at a profit; (v) Should be atleast 3 years after establishment; (vi) Should be an agent for paddy purchases; (vii) Should have a strong building.

Rural Bank too was changed to Co-operative Rural Bank. A new cadre of Co-operative employees designated "Marketing and Credit Manager"(11) was placed in-charge of these Banks. Accounting and maintenance of records were centralized. The role of the People's Bank became more supervisory. This change, brought in its wake a weakening of the People's Bank's control over these institutions.

In 1973, to cope with the newly introduced expanded crop loan scheme, functions of CRBs were re-defined and widened as follows - (a) Mobilisation of deposits from members. (b) Provision of loan facilities to members for production and consumption purposes attuned to MPCS development programme. (c) Pawn broking facilities for members and non members. (d) Provision of money, payments and transfer services. The provision of crop loans was also brought within the ambit of CRBs. The Co-operatives however lost their monopoly over cultivation credit as the Bank of Ceylon too joined the scheme in 1973. The concept of considering the farmer as a unit of production and assessing all his credit needs within a comprehensive plan under which a credit limit was to be approved for each farmer was introduced and was called the Comprehensive Credit Scheme.

Although different types of credit requirements came under a single credit limit, refinance from the Central Bank was available only for crop loans. Therefore, different lending schemes came to be maintained separately.

#### Lending Schemes

Thus, three main lending schemes came to be operated - (1) Short and Medium term facilities provided under the Comprehensive Credit Scheme and the original Rural Banking Scheme. (2) Seasonal crop loan facilities for paddy and other subsidiary food crops

(11) They are now called Banking Service Managers.

CRB CREDIT FACILITIES Purpose	Maximum Amount				Maximum Repayment Period
	1964	1968	1973	1980	
1. Production	2,500	5,000	7,500	15,000	1-5 years
2. Housing	2,500	5,000	7,500	15,000	3-5 years
3. Debt Redemption	2,500	5,000	6,000	5,000	5 years
4. Trade	-	-	1,000	2,000	
5. Consumption (Purchase of consumer durables like radios, sewing machines)	500	500	1,000	5,000	1 year
6. Emergencies	200	200	200	500	1 year
7. Electrification	-	600	1,000	3,000	5 years
Maximum loan limit per individual member	3,000	5,000	7,500	15,000	

TOTAL ADVANCES		
	No. of Accounts	Balance (Rs.)
1. Agricultural Production- Sub total	113082	23,901.671
2. Consumption	3,186	4,571.157
3. Industries	2,914	6,279.481
4. Housing	28,220	79,416.215
5. Redemption of Debts	7,677	12,425.440
6. Trade	8,441	5,725.127
7. Animal Husbandary	4,853	6,959.074
8. Electrification	978	1,800.458
9. Others	3813	6,625.096
TOTAL	67,364	147,703,669

provided under the Comprehensive Credit Scheme. (3) Pawning as People's Bank's agents.

#### Short and Medium Term Lending

Purposes for which these credit facilities are provided and their terms are given in Table 1. This also shows the gradual increase in limits under each purpose. The current rates of lending to Societies for CRB funding is 18% p.a. CRBs re-lend to members retaining a

margin of about 4 - 5 %. The People's Bank does not specify the on-lending rate. Loans upto Rs.5,000/- could be obtained against the guarantee of two acceptable members, and for those above this limited collateral security is taken. There is provision even to accept lands with undivided ownership as security. Village notaries attend to little investigations and mortgages. Loans against 90% of fixed and savings balances are also provided.

Within the prescribed ceilings, funds are provided for the full cost of a project, without calling for an equity contribution. (12).

As at 31.12.1983, Medium and Short-term loans outstanding was Rs.147.7 million in respect of 67,364 loans. A purpose-wise breakdown of these facilities are given in Table II

A regional-wise analysis indicates that 92% of the loan volume has been disbursed outside Colombo District thereby demonstrating the strong rural biased dispersion in lending.

Lending operations and credit disbursements have not been upto expectations. Apart from the minimum share requirements for borrowings, relatively high interest rates, internal administrative problems, the lack of emphasis on identification and appraisal of small scale rural projects too appear to contribute to this position.

### Crop Loans

Since 1973, the provision of seasonal crop loans too were brought within the CRB Scheme. Credit facilities are provided for paddy and sixteen Subsidiary Food Crops for purposes such as land preparation, seed, fertilizer, agrochemicals and for harvesting. The scales of finance per acre are periodically decided by the Ministry of Agriculture in consultation with the Banks. (13) Under this scheme the Central Bank provides 100% refinance facilities and the People's Bank lends these funds to MPCs which, in turn relend to member farmers through the CRBs. The performance of this scheme is summarised in Annex II.

(12) This is however counter-balanced by the share contribution requirement up to 10% of a loan.

(13) At present these scales vary from Rs.1,400/- to Rs.2,400/- per acre of paddy.

Since a fuller discussion of this scheme is being made in another paper, suffice it to add here that Proposals for major changes to expand the coverage of this lending scheme have been made by Bank to the Central Bank, under which due recognition has been given for the setting up of an inbuilt mechanism for re-scheduling of loans by way of a Stabilization Fund to cover loan defaults due to natural hazards, a problem which had bedevilled many a lending scheme in the past.

### Pawning

Loan Facilities granted against pledge of jewellery can be considered as the most successful lending operation of the CRBs. Societies could engage in pawning either with their own funds or after obtaining overdraft facilities from the People's Bank. Pawning loans are given both for essential purposes and consumer purposes to non-members and members. These advances are repayable within a year. Renewal of advances are however allowed after payment of the annual interest. The Bank lends funds for these purposes currently at 23% p.a. and the CRBs in turn re-lend at 28 - 30% p.a. As at 31.12.83, pawning advances stood at Rs.243.9 million in respect of 350,265 advances.

### Savings Mobilization.

CRBs have proved to be a very effective medium of mobilising rural savings. Both the volume of savings and the number of savers bear witness to this phenomenon. As at 31.12.83, Savings and Fixed Deposit balances outstanding were Rs.718 Mn. Of this Rs.590 Mn were held in 1,612,000 savings accounts. Another noteworthy feature of savings mobilization is that 63% of savings deposits and 59% of savings accounts were held by non-members, which demonstrates the extent of confidence reposed by the rural community in CRBs.

The deposits and advances position under the CRB scheme as at 31.12.1983 could be summarised as follows:-

	Volume (Mn)	No. of Accounts
<b>Advances</b>		
1) Short and Medium-term Loans	147.7	67,364
2) Pawning	244.0	339,816
3) Crop Loans scheme since 73/74 (Maha)	507.1	
	898.8	
<b>Deposits</b>		
Savings	589.7	1,612,485
Fixed Deposits	129.2	
	718.9	24,765

Although the gross loans/deposits ratio indicates a lending surplus, when cultivation loans for which Central Bank refinance is available, to the People's Bank are set aside, the advances/deposits ratio is only 54%.

Much has been said about the short-fall of lending vis-a-vis, the deposits mobilized. One cannot overlook the fact that the bulk of savers being non-members are ineligible for loans except pawning advances. Viewed in this light the position does not look so unfavourable.

### Investment of Supplies Funds

The People's Bank provides facilities for Rural Banks to invest their surpluses in the form of Fixed and Savings Accounts. Surpluses built in current accounts are periodically transferred to Savings Accounts maintaining only minimum balances required in current accounts. In addition CRBs too invest their surpluses in the National Savings Bank when their rates are more favourable. Besides, the healthy savings surpluses position has enabled a large number of societies to satisfy the demand for credit from their members

with their own resources. Latest figures indicate that, of the 843 Rural Banks 685 are managing with their own funds.

### **Profile of a Co-operative Rural Bank**

The Board of Directors of a MPCS holds the overall responsibility of the CRB through the General Manager who is assisted by an Executive Grade Officer designated as "The Banking Services Manager", whose sole function is the management of banking activities. Generally, a CRB will have 2-3 branches. These branches are under the control of Branch Managers. A typical CRB branch will be a small unit consisting of a Branch Manager and assisted by one or two clerks. There will be about 75 - 100 transactions a day covering savings accounts, pawning and other lending operations. Monthly about 10 loan applications would be handled during off seasons and a heavier work load during the cultivation season. The processing time of loan applications would vary from 1 - 6 weeks, depending on the nature of securities and the purpose.

Applications for credit by members are entertained at a Branch of the CRB or Society. These are examined by the Branch Manager and the Branch Committee of elected members and are referred to the Banking Services Manager at the Head Office of the society. Processing of applications are generally handled at the Head Office and are referred to the Sub-committee of the Board of Directors where the General Manager, People's Bank representative and a few members of the Board participate, in making recommendations to the Board of Directors. These applications are thereafter submitted to the Board of Directors for approval. The Banking Services Manager is delegated with authority to grant loans for emergencies, and he thereafter seeks the

covering sanction of the Board of Directors.

Banks are open for business generally from about 9.00 - 1.30 p.m. but in certain areas hours are extended upto about 3.30 p.m. Most CRBs are open for business on Saturdays as well.

### **Overall Profitability**

It may also be of interest to examine the overall profitability of Rural Banks. The main source of income of Rural Banks is the interest received from pawning advances. Their administrative costs are fairly low as these units are managed by a small staff. As at 31.12.83 of the 843 Rural Banks, are reported to be running at a profit. Their total profits were Rs.16.9 Mn and the total loss of the balance 42 were Rs.414,000/-. Thus, the CRBs have become one of the main profit centres of MPCSSs.

### **Financial Safeguards**

Certain safeguards have also been introduced to strengthen the financial viability of lending operations and safety of deposits. Under these arrangements (1) MPCSSs are expected to make an annual assessment of the delinquent loans and set apart a portion of their annual profits to a "Reserve for Bad and Doubtful Debts." (2) All CRBs are also required to deposit monthly to a special Savings account at the People's Bank styled "Rural Bank Deposit Guarantee Fund". An amount equivalent to one-tenth of 1% of the total monthly deposits made by depositors to Fixed and Savings Accounts maintained with them and (3) a Contingency Fund for pawning has been set up to which the CRBs contribute monthly a portion of the interest received, and is meant to recoup losses which are not covered by insurance.

### **Supervisory and Review Mechanisms**

Operations of these institutions are reviewed periodically by several

institutions. In addition to the internal audit conducted by the Society itself the Development Assistants of the People's Bank are also expected to audit all vouchers and transactions handled daily by CRBs. These audits are conducted normally during weekly visits. They are also subject to the annual Co-operative Department's Audit. The Regional Offices of the People's Bank carry out annual inspections and quarterly surprise checks to review lending operations and other activities. As at 31.12.83, 620 of 843 CRBs had been inspected by the Regional Offices during the year. In addition, the Rural Credit Department of the Central Bank of Ceylon also inspects the Rural Bank which are selected at random.

### **Conclusion**

Now that the CRBs have come of age and have demonstrated their capabilities to undertake wider responsibilities, some of the lines on which further expansion could be examined are -

- a) introduction of Current Accounts, enabling provision of facilities through these Accounts, as Overdraft facilities revolving credit facilities etc., for which amendments to existing law would be necessary;
- b) delegation of authority to CRBs to act as the People's Bank's agents and accept and transmit to the People's Bank, applications for larger facilities from members and non members,
- c) to bring these institutions closer to the development process by permitting them to lend under special schemes such as, Integrated Rural Development Projects, Dry Zone Development Project, etc.

Our Bank is presently examining the feasibility of expanding their services on these lines.