Regional Rural Banks Consolidation Raises Questions over Local Banking and Last-Mile Rural Credit Delivery

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Recent Developments:

- Former **RBI Governor C. Rangarajan** has criticised the continuing consolidation of Regional Rural Banks as **"a step in the wrong direction"**, arguing that excessive consolidation could weaken their distinctive local character and eventually facilitate their absorption into universal banks.
- His remarks have renewed the debate over whether the consolidation of RRBs can simultaneously deliver **economies of scale** and preserve the institution's original developmental purpose of providing locally responsive credit to rural and vulnerable communities.
- Under the latest **"One State-One RRB"** phase, 26 RRBs across 11 States/Union Territories were amalgamated with effect from **1 May 2025**, reducing the total number of RRBs from 43 to 28. The Government has stated that the reform seeks to retain RRBs' proximity to rural communities while improving scale efficiency and reducing costs.

Regional Rural Banks: Concept and Evolution:

Origin and Legal Framework:

- **Regional Rural Banks (RRBs)** are scheduled commercial banks created to expand institutional credit in rural areas, particularly for **small and marginal farmers, agricultural labourers, rural artisans and other priority-sector borrowers**.
- The first RRBs were established in **1975** following the recommendations of the **Narasimham Working Group**, while the **Regional Rural Banks Act, 1976** subsequently provided the statutory framework for their functioning.
- RRBs were conceived as a supplementary channel to the **cooperative credit structure** and were intended to combine the local orientation of cooperatives with the managerial capabilities of commercial banks.

Ownership and Institutional Structure:

- RRBs follow a distinctive three-way ownership model in which the **Central Government holds 50%**, the **Sponsor Bank holds 35%**, and the **State Government holds 15%** of the share capital.
- Each RRB is sponsored by a **public sector commercial bank**, which provides managerial, financial and institutional support, while the RRB operates within its designated geographical area.
- The **RBI regulates** RRBs as banking institutions, while **NABARD** plays an important role in their supervision, inspection, capacity building and development.

Core Objective:

- The fundamental rationale behind RRBs was that a **local and regionally focused banking institution** would understand rural borrowers, agricultural cycles, local economic conditions and community-level credit

requirements better than large, geographically dispersed banks.
- Their developmental mandate therefore goes beyond profitability and includes **financial inclusion, priority-sector lending, rural savings mobilisation and credit access for weaker sections**.
- RRBs form part of India's broader institutional architecture for inclusive finance, alongside **cooperative banks, Self-Help Groups, microfinance institutions, Local Area Banks and Small Finance Banks**.

Why Were RRBs Consolidated?

Evolution of the Consolidation Process:

- The Government began consolidating RRBs from **2005** to address concerns relating to their small operational scale, financial viability, overlapping geographical areas and limited capacity to adopt modern banking technology.
- During the first major consolidation phase between **2005 and 2010**, the number of RRBs declined from 196 to 82, followed by further rounds of amalgamation.
- The latest phase reduced the number from **43 to 28 RRBs**, with the new structure becoming effective on **1 May 2025**. The Department of Financial Services currently lists 28 functioning RRBs.

Government's Rationale:

- Consolidation is intended to create financially stronger institutions capable of achieving **economies of scale, technological modernisation, better risk management and cost rationalisation**.
- Larger RRBs can potentially strengthen their capital base, diversify products, invest in digital banking infrastructure and improve operational efficiency while continuing to serve rural areas.
- The Government has specifically emphasised that the **"One State-One RRB"** approach is intended to combine scale efficiency with continued closeness to rural communities.

Rangarajan's Concerns over Consolidation:

Loss of Local Character:

- Rangarajan's central concern is that RRBs were created precisely because their **local character** was expected to improve the distribution of institutional credit, whereas large state-level entities may gradually become less responsive to highly localised credit requirements.
- When decision-making becomes increasingly centralised, there is a risk that **local knowledge, relationship-based lending and understanding of informal rural economic activity** may weaken.

Risk of Mission Drift:

- RRBs were established primarily as **development-oriented institutions**, rather than simply as commercially optimal banks.
- Excessive emphasis on profitability and scale could therefore create a **mission-versus-commercial-viability dilemma**, particularly if lending to small borrowers is perceived as costly or risky.

Possibility of Eventual Absorption:

- Rangarajan has warned that consolidation could eventually create a pathway for RRBs to be absorbed into **universal banks**, potentially eliminating the institutional model that was specifically created for rural credit delivery.

Evidence on RRB Performance:

Improving Financial Viability:

- The case for consolidation should also be assessed against recent improvements in RRB performance rather than assuming that all RRBs remain financially weak.
- NABARD data show that between March 2023 and March 2024, the number of RRBs reporting profits increased from **37 to 40**, while the number reporting losses declined from 6 to 3.
- During the same period, **net profit increased from ?4,974 crore to ?7,571 crore**, CRAR improved from 13.4% to 14.2%, and GNPA declined from 7.3% to 6.1%.

Strong Priority-Sector Role:

- RRBs continue to play an important role in directed rural credit, with NABARD reporting that RRBs achieved **88.6% priority-sector lending** against a 75% overall target in FY2024.
- Their lending to **small and marginal farmers reached 19%**, compared with a prescribed target of 10%, while lending to weaker sections reached 84.8% against the applicable target.
- These figures indicate that RRBs retain substantial relevance as instruments of **financial inclusion and priority-sector credit delivery**, even as their institutional structure changes.

Arguments in Favour of Consolidation:

Economies of Scale:

- Larger RRBs can spread the fixed costs of **digital infrastructure, cybersecurity, compliance, human-resource management and technological upgrades** across a wider customer base.

Stronger Financial Capacity:

- Consolidated entities may possess greater capacity to absorb shocks, maintain adequate capital and diversify their loan portfolios.

Better Technology and Products:

- Larger institutions can invest more effectively in **digital banking, mobile services, data analytics, financial literacy and modern risk-management systems**, potentially improving rural customer access.

Reduced Administrative Duplication:

- Amalgamation can reduce duplication in management, branches, technology platforms and compliance functions, allowing resources to be redirected towards productive banking activities.

Arguments Against Excessive Consolidation:

Erosion of Local Knowledge:

- A very large geographical footprint may weaken the **relationship between bankers and local communities**, especially where agricultural lending depends on local knowledge.

Reduced Regional Responsiveness:

- A single RRB covering an entire State may face difficulties in responding equally effectively to diverse **agro-climatic conditions, local occupations and regional credit needs**.

Risk to Last-Mile Credit:

- If consolidation is accompanied by branch rationalisation or excessive centralisation, the availability of affordable institutional credit for **small farmers, landless workers and rural micro-enterprises** could be affected.

Developmental Mandate versus Commercial Logic:

- The success of RRBs should not be evaluated only through profitability because their wider objectives include **financial inclusion, priority-sector lending and reduction of dependence on informal credit**.

Small Finance Banks and the Rural Credit Gap:

Need for More Inclusive Banking Institutions:

- Rangarajan has also argued that India needs greater encouragement for the establishment of **Small Finance Banks (SFBs)** because the existing number remains limited relative to the country's unmet credit requirements. Recent RBI listings identify **11 SFBs**.
- SFBs are designed to promote financial inclusion by primarily serving **small business units, small and marginal farmers, micro and small industries and other underserved borrowers**.

Structural Challenge:

- Rangarajan has argued that prospective promoters may have limited incentives to establish additional SFBs when they must comply with substantial regulatory requirements similar to other banking institutions.
- At the same time, the RBI permits eligible SFBs to **voluntarily transition into universal banks** subject to conditions including a satisfactory track record as an SFB for at least five years and fulfilment of prescribed capital and regulatory requirements.

Broader Significance for Rural Financial Inclusion:

Persistent Rural Credit Gap:

- Despite decades of institutional development, many **small farmers, landless workers, rural artisans and micro-enterprises** continue to face difficulties in obtaining timely and affordable formal credit.
- Inadequate access to formal finance can increase dependence on **informal lenders**, potentially resulting in higher borrowing costs and debt vulnerability.

Institutional Balance:

- India therefore needs an institutional structure that combines **financial viability with developmental responsiveness** rather than treating the two objectives as mutually exclusive.
- RRBs, cooperative banks, SHGs, microfinance institutions and SFBs can complement one another if each institution retains a clearly defined role within the broader financial-inclusion ecosystem.

Way Forward:

Preserve Local Character with Scale:

- Consolidation should be accompanied by mechanisms that preserve **local credit assessment, decentralised decision-making and community-level engagement**.
- Regional offices, local credit committees and specialised agricultural banking units can help larger RRBs retain their grassroots orientation.

Strengthen Viability without Mission Drift:

- RRB reforms should focus on **technology, governance, capital adequacy, risk management and human-resource capacity** while protecting lending to priority and vulnerable groups.

Expand Last-Mile Financial Access:

- India should strengthen the complementary role of **SFBs, cooperative institutions, SHGs and digital financial services** rather than relying on consolidation alone to solve rural credit constraints.

Measure Developmental Outcomes:

- Evaluation of RRBs should include not only profitability and asset quality but also **financial inclusion, credit access, agricultural lending, women's access to finance and outreach to underserved regions**.

Conclusion:

- The debate over RRB consolidation is ultimately a question of **institutional design**: whether scale and efficiency can be achieved without sacrificing the local orientation that justified the creation of RRBs.
- Recent improvements in profitability, capital adequacy, asset quality and priority-sector lending demonstrate that RRBs can become financially stronger while continuing to perform their developmental role.
- The optimal approach is therefore neither unconditional consolidation nor preservation of every existing institution, but **efficient, technologically capable and financially sustainable RRBs that remain locally responsive and committed to last-mile credit delivery**.

Value Addition for UPSC:

Key Concepts:

- **RRB model:** Local orientation + commercial banking expertise + developmental mandate.
- **One State-One RRB:** Consolidation model aimed at combining **scale efficiency with rural outreach**.
- **Core dilemma: Economies of scale versus local responsiveness**.
- **Policy principle:** Financial institutions created for inclusion should be evaluated through both **financial sustainability and developmental outcomes**.

Mains Enrichment:

- **"Scale should strengthen the last mile, not replace it."** The RRB debate illustrates the broader challenge of balancing efficiency-oriented institutional reforms with India's objective of inclusive and equitable credit delivery.

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