REPORTS ON
INFORMAL CREDIT MARKETS IN INDIA:
SUMMARY

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A. DAS-GUPTA

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PREFACE

The study of Informal Credit Markets in India presented here forms part of a study of Informal Credit in five developing member countries of the Asian Development Bank. The study has been initiated and funded largely by the Asian Development Bank. It was funded partly by the National Institute of Public Finance and Policy (NIPFP). The study has been carried out at the NIPFP, New Delhi and at the Centre for Development Studies (CDS), Trivandrum. The NIPFP carried out the study of urban markets and the CDS of rural markets. The NIPFP was entrusted with the task of coordinating and integrating the main findings of the study. Part of the study done by the NIPFP was undertaken jointly in collaboration with State Bank of India.

The project coordinator for the NIPFP study was A. Das-Gupta who took over the task from Srinivasa Madhur shortly after its commencement. C.P.S. Nayar coordinated the field work in South India for informal institutions dealt with in chapters 18 to 23 and 26 of the report. A. Das-Gupta coordinated the field work for the remaining chapters. Research and field personnel associated with the project were, M.L. Bijlani, K.S. Dinesh, Thomas Gomez, A.K. Jain, S. Kumar, Krishnamurthy Maya, Sadhna Marwaha, K. Mathai, Sanjeev Mohanty, Hiranya Mukhopadhyay, A.L. Pandya, P.K. Gopalakrishnan Nair, N. Parameswaran Nair, J.K. Pandey and S. Radhakrishnan. They have our grateful thanks.

The NIPFP project coordinator Dr. Das-Gupta had overall responsibility for the urban and summary reports and has written or revised all material in these reports. The urban study was planned and for most part conducted by him. First drafts of some chapters in the urban report were prepared by the following persons.

1. C.P.S. Nayar : Chapters 18 to 21, 22 (the South India case study), 23 (the South India case study) and 26 (with S.Radhakrishnan).

2. Krishnamurthy Maya : The Delhi case study in Chapter 22.

3. Sadhna Marwaha: Chapter 33 and the Appendix.

4. Hiranya Mukhopadhyay : Chapters 24 and 31.

5. J.K. Pandey : Chapters 27 and 28.

C.P.S. Nayar has primary authorship for the chapters to which he has contributed. Sadhna Marwaha, Hiranya Mukhopadhyay and J.K. Pandey are the primary authors of the appendix and chapters 24 and 27 respectively.

The focus of the study is on the operation of Informal Credit Market (ICM) in India and its role and impact from the angles of efficiency in resource use, social justice and efficacy of monetory control. The authors have made painstaking effort to provide an idea of the working of the ICM in India, based on a survey of selected sectors. Secondary data have also been used wherever found relevant and useful. An attempt has also been made to estimate the size of the ICM, though very tentatively. The study brings out several aspects of the operation of the ICM which were relatively neglected in previous studies on the subject such as the possible significance of unaccounted incomes in funding the ICM and the importance of the market structure. It also brings to light the sources and uses of funds in a number of sectors not covered in past researches. An important finding of the study is that even after the rapid expansion of banking services in the country after nationalisation of the major banks in 1969, the ICM continues to finance trade and business activities in a big way, and not merely in the unorganised sector. Some of the case studies documented here also reveal that existing regulations governing the functioning of the ICMs leave much to be desired.

It is hoped that the findings and conclusions of the study will be of interest to a wide audience.

The Governing Body of the Institute does not take any responsibility for any of the views expressed in the report. That responsibility lies primarily with the authors.

New Delhi
August, 1989

Amaresh Bagchi
Director, NIPFP

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Generous help from various government and bank officials, officials of associations of intermediaries, traders or producers, researchers and others was received during the course of our investigations. While they are too numerous to acknowledge individually they have our grateful thanks. However, we would especially like to thank Thomas Timberg and Chandrasekhar Aiyar for their advice early during the project and for making available copies of background material for their celebrated study.

None of those acknowledged can be held responsible for shortcomings in the report the responsibility for which rests with the authors.

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A. DAS-GUPTA
Project Coordinator

CONTENTS

PART A

OVERVIEW OF THE URBAN STUDY

CHAPTER 1

OVERVIEW

1.1 Objectives

1.1.1 The objectives of this study of urban informal credit in India are:

1. to derive estimates of the size and importance of informal credit,

2. to examine the informal credit market structure and the impact of government regulation on informal credit markets,

3. to examine the impact of informal credit on allocation, distribution, growth and the effectiveness of short run macro policy, and

4. to make policy suggestions as to regulation of informal credit markets and formal sector credit operations.

1.2 Definition of informal credit adopted

1.2.1 The concept of informal credit used in this study roughly corresponds with the concept 'non-institutional credit' used by the Reserve Bank of India (RBI) in its surveys of households. It excludes banks of all types, government financial institutions, housing finance institutions and the organised capital markets for shares, debentures, fixed deposits and government bonds. For the remaining sources of finance, all are (potentially) taken note of when analysing the sources of credit of credit using sectors. A selection of informal intermediary sectors is also covered in this study. Finally, if credit users are also suppliers of credit, this is taken note of to assess their net credit position. However, a systematic attempt to study sources of supply of study.

1.2.2 The definition of informal credit is motivated primarily by considerations of government regulation. Implicitly, the notion of the <u>formal</u> sector which we seek to capture is of that portion of financial markets which are effectively subject to government control in the matter of allocation of credit and deposit mobilisation. In particular financial institutions which are directly affected by central bank short run monetary policy measures, including among these measures, reserve requirements and selective credit controls, are classified as belonging to the formal sector. Attempts by the government to curb money supply growth or to curb credit availability for different purposes and to different sectors will have their primary impact on what we classify as formal credit markets.

1.2.3 While this does not imply that informal credit markets are entirely beyond central bank regulation, the extent of direct control over activities of informal lenders and intermediaries is substantially less than that of formal intermediaries. As shall be described, controls are limited to licensing, interest rate ceilings, restrictions on deposit taking and reporting requirements for even the most highly regulated informal credit suppliers. The definition adopted here has the additional advantage of dovetailing with the definition of informal or unorganised credit used in earlier examinations of credit markets in India. In particular, we may mention studies by various government committees and by the World Bank (see the references at the end of the report).

1.3 Coverage

1.3.1 A total of 6 credit using sectors, 9 intermediary sectors, 1 integrated credit market, 2 cases of litigation by the government and 3 Reserve Bank of India Surveys of households and firms are covered in this study. The credit using sectors were chosen on the basis of where earlier work or discussions suggested the prevalence of informal credit. However, at least one sector, garment exports, was chosen to examine conditions in a sector which, being in the vanguard of export promotion efforts, is thought to be well served by the formal sector including, in this, fiscal incentives. Secondly, sectors dealing with food products were excluded, though ´clothing´ and ´shelter´ are represented. While the bulk of informal credit from intermediaries is covered on a sample basis, certain interesting informal credit segments, such as the leasing industry, pawnbrokers and bail bond brokers, remain uncovered. The samples used in the various sectoral studies are given in Table 1.1. The total number of units surveyed (from which quantitative information was obtained) was 415. In addition, over 200 interviews with bank and government officials, officials of informal intermediary associations and producers associations and also other knowledgeable persons were conducted. The initial sample designs were however, in several cases, larger than given in Table 1.1. These were reduced due to non-cooperation of interviewees.[1] The quality of interview data varied from sector to sector but is on the whole, acceptable. Questionable data, when used, is carefully noted in the case studies. The secondary data sources covered between them over 1 lakh units (1 lakh equals a hundred thousand and one crore, used later, equals ten million) . Finally, the legal case study is based on newspaper reports, court transcripts, company financial statements and an RBI report.

1.4 Analysis

1.4.1 In view of the small sample size for each sectoral study, only means, variances, correlations and ratios have been computed. More sophisticated statistical analysis has been eschewed, except for a solitary regression. In one case, a mathematical model has

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1. In the case of Housing Finance, the sample size for quantitative information dropped from 25 to 0! Also, in the case of film finance no quantitative data was provided by interviewees.

been constructed on the basis of stylised facts drawn from the field study. More sophisticated analysis has been attempted only in the chapters dealing with RBI surveys. This is, of course, a limitation of our work which may be seen to have breadth of coverage rather than great depth in view of the comprehensive terms of reference and the limited time at our disposal.

1.5 Main findings

1.5.1 While these are given below in the next two parts, we briefly indicate the major conclusions here, while reminding the reader of their tentative nature in view of the small sample sizes and the cross section nature of the study.

a. Informal deposit interest rates generally exceed formal sector rates as do loan rates of informal intermediaries. However, given the importance of credit from friends and relatives, the average cost of borrowing in the productive sectors studied in this report, for informal credit users is lower than the average for all units taken together (Chapters 2 and 4).

b. Though credit is fungible making it difficult to determine the extent to which loans for a given purpose are actually used for that purpose, informal credit is largely used for productive activities (rather than consumption) and, inclusive of trade credit, is the dominant source of credit for all productive sectors studied (including the RBI surveys). However, loans from informal intermediaries are unimportant to all but one productive sector studied. That they are clearly of importance to such sectors as transport operators and handloom weavers emerged in the course of studies of intermediaries (Chapter 3). Furthermore, even for credit from informal intermediaries, loans are largely for production or trade.

c. Monopoly profits are not an important component of informal lending rates for the major types of informal intermediaries in urban India (Chapter 6).

d. Informal credit markets are generally at the competitive end of the spectrum of market types. Fragmentation, defined to be a situation where interest rate differentials for similar loans to similar borrowers persist is present due largely to informational obstacles (Chapter 7).

e. Aggregate informal credit forms about 73% of gross bank credit (at a conservative estimate) though operations of informal intermediaries are much less important (Chapter 8).

f. The evidence suggests that in some case informal credit promotes efficiency of resource allocation though negative and inconclusive evidence has been found in other cases. The evidence supports the view that informal credit serves economically weak sections relatively more than formal credit (Chapters 10 and 11).

g. That informal credit is, by and large, complementary to bank finance, given current banking practice, finds support from the data from case studies, though not from the RBI surveys of firms. Informal credit is said to complement bank credit when they serve different groups of borrowers or are used for different purposes so that the two sectors are not in competition for the same custom. It is possible that informal credit lowers short run monetary policy effectiveness, though there is less reason to believe that it renders it totally impotent (Chapters 10 and 11).

h. The hypothesis of financial repression finds some support from the evidence (Chapter 12).

1.5.2 The following eleven points provide a summary of other conclusions reached from our study and also the main policy recommendations.

1. Informal loans show greater diversity and readier adaptability to borrower convenience than formal loans.

2. The average and maximum duration of informal loans are less than formal loans (though not necessarily commercial bank loans).

3. Informal credit assessment and loan sanctioning procedures are speedier than formal procedures.

4. The range of activities financed by the informal sector is greater than the range financed by the formal sector.

5. To the majority of households and unorganised enterprises, informal loans are the main source of borrowed funds.

6. Informal credit is more important for working capital and capital maintenance finance than for financing the purchase of capital goods.

7. Informal credit agencies have an absolute and comparative advantage in the provision of credit to small activities.

8. Due to informational disadvantages and extant technologies for making payments for goods and services, modern banking may not be able to replace informal credit in the medium term even with complete financial liberalisation.

9. Optimal policy for formal agencies requires them to confine their direct activities to deposit taking and lending only where they have an advantage. Methods of refinancing informal credit agencies should be devised in order to ensure efficient credit delivery to other activities.

10. Regulation of urban informal credit should be directed at:

    (i) Ensuring improved information about informal credit and informal intermediaries.

    (ii) Ensuring the financial probity of informal intermediaries. Such measures should be designed separately for relatively homogenous groups of intermediaries and should err, if at all, on the side of non-interference with the efficient functioning of informal financial markets.

11. When required, monetary control can be exercised by the central bank by varying the rate at which refinance is available.

1.6 Organisation

1.6.1 This summary report is divided into 3 additional parts. Part B contains short chapters which describe salient features of urban informal credit. Part C contains chapters in which findings on the economic impact of urban informal credit are discussed. Part D has a self contained summary of the companion study of rural informal credit markets. Policy suggestions are in Part E.

TABLE 1.1

Sample Characteristics for Sectors Studied

Sector	Secondary data source for financial data				Field data	
	Name	Year	Location	Sample size	Location	Sample size
			Intermediary Sectors			
1. Finance corporations	Nayar(1984)	1982	All India	450	South India	42 companies 31 users
2. Chit funds	RBI(1)		See note(1)	1066	South India	37 chit funds 42 members
3. Hire purchase (1)	RBI(1)		See note(1)	481	South India	30 HPF
	FIHPA(2)	1986	Madras city & surrounding areas	1110	and Delhi	12 borrowers
4. Nidhis	RBI(1)	1986	See note	65	Tamil Nadu & & Andhra Pradesh	12
	(2)Ramani(1985)		South	1344		
5. Auto financiers	Local Ass. of finance corporations	1986	India		Namakkal (T.N)	10
6. Handloom Financiers	-	-	-		Karur / Bangalore	10
7. Shroffs of Western India	Bombay Shroffs Association	1988	Western India	N.A.	-	
8. Intercorporate funds market	-				Metro Cities	60
			Credit Using Sectors			
1. Road construction	-				Delhi and Western U.P.	35
2. Garment exporters	-				Delhi	19
3. Film finance	-				Madras	-
4. Powerloom units	-				Surat(Gujarat)	18
5. Textile wholesale trade	Jain et.al.(1982)	1979	All India	950	Bombay	37
6. Housing finance of households	V.D. Lall(1984)	1984	All India	728	-	-
			RBI Surveys			
1. Households	RBI	1981-82	All India	31014	-	-
2. Small Scale Industry	RBI	1976-77	All India	12356	-	-
3. Traders	RBI	1979-80	All India	12057	-	-
4. Transport operators	RBI	1979-80	All India	6129	-	-
TOTAL						415

Notes: 1. RBI, Survey of Deposits with Non-Banking Companies, RBI Bulletin, Various Issues.(All India Coverage)
2. Federation of Indian Hire Purchase Association.
3. Over 200 interviews were also conducted to elicit qualitative information.

PART B

DESCRIPTION OF URBAN INDIAN INFORMAL CREDIT AND INFORMAL CREDIT MARKETS

CHAPTER 2

URBAN INFORMAL CREDIT AND INFORMAL INTERMEDIARIES

2.1 Introduction

2.1.1 Urban informal credit, informal intermediaries and "unorganised" money markets in India have been examined in the past by various government bodies and scholars (see the references at the end of the report). Recent government committees to study informal credit have been the Banking Commission (1971), James Raj Committee (1975) and the Reserve Bank of India (Chakravarty Committee) (1985). Among recent studies by individual scholars, Karkal (1967), Nayar (1973, 1982 and 1984), Radhakrishnan (1975) and Timberg and Aiyar (1980) are the best known. A detailed review is in the appendix to the report. In this chapter a brief guide is provided to the types of informal credit and to participants in informal credit markets in urban India.

2.2 Trade credit

2.2.1 Perhaps the most prevalent form of credit in the economy is through credit sales or through advance payment for goods purchased. the two together are collectively known as trade credit. The former is typically reflected in the bills receivable and bills payable accounts of firms. Such credit is obviously not intermediated by specialised intermediaries. Furthermore, trade credit is by definition interlinked with a transaction on a particular goods market. Most other major forms of informal credit except for loans between friends and relatives involve intermediation.

2.3 Informal credit instruments

2.3.1 A variety of credit instruments exist in urban informal markets. These are discussed more fully in the main report. The most prevalent instrument is a demand promissory note, which is used extensively by Finance Companies and Shikarpuri Shroffs. An indigenous financial instrument, which was much in use till recently, is the `hundi', a form of demand or usance bill which has been in use to finance interregional and international trade for centuries. Several types of hundis were and are in use particularly by shroffs. Other methods of provision of credit are though the discounting of post dated cheques, trade bills and waybills (lorry/railway receipts), and so on. Among these instruments, hundis issued by bankers with sound reputations were highly liquid in that they were readily accepted in certain business in settlement of claims. No other indigenous instrument appears to have this particular `near money' characteristic. Hundis (the `darshani' hundi of Gujarati shroffs) are also considered a cheap and risk free way of making remittances. Among depositing instruments, the `sarkat' employed by Rastogi bankers is described by Timberg and Aiyar (1980).

2.4 Informal intermediaries and lenders

2.4.1 There are several types of informal intermediaries and lenders in India and much diversity in the kinds of transactions undertaken by them. Ten types of intermediaries and lenders, chit funds, finance corporations, hire purchase firms, nidhis, (shipping) clearing agents, intercorporate brokers, textile wholesalers, aratiyas, angadiyas and shroffs in Western India have been studied in greater detail. Brief descriptions of the important types of intermediaries at present are now given.

2.4.2 Chit funds: These are indigenous rotating savings and credit organisations. While chit funds are prevalent among household and small businesses all over India, chit funds are also organised by chit fund firms, especially in South India.

2.4.3 Finance corporations: These institutions have activities essentially similar to commercial banks except for non-issuance of cheques and no provision of funds transfer services.

2.4.4 Hire purchase firms: Such firms are generally active in vehicle and durable finance, specialising in market segments not served by commercial banks. Most such firms accept deposits from the public.

2.4.5 Nidhis: These are single branch institutions similar to credit unions. They are found mainly in South India. Much of their credit goes to finance investment in housing.

2.4.6 Clearing agents: Also known as dockyard financiers or railyard financiers they give short term accommodation to their clients.

2.4.7 Wholesalers and other intermediaries in the distribution of goods: Such agents typically combine sale of goods with (trade) credit. The volume of finance by such agents is large relative to the total size of credit markets.

2.4.8 Aratiyas or commission agents: Act as intermediaries between local and outstation traders in chains for the distribution of goods. They intermediate large fractions of total outstation sales in many commodity markets and provide financial accommodation to their clients. Their main role however is in reducing information costs of both buyers and sellers.

2.4.9 Angadias: Strictly, these agents are not purveyors of credit. However they play an important complementary role in facilitating funds flows between different centres at costs much below that of banks. Aiyar (1979) holds that they are also important agents in the underground economy.

2.4.10 Indigenous bankers or shroffs: These age old Indian institutions serve business, usually trade. They are grouped into various types (Multanis, Shikarpuris, Gujaratis, Shekhawatis, Rastogis, Marwari Kayas, Chettiars, etc.) along community lines and operate in different parts of India. Among the major groups, Chettiars in South India have almost disappeared.

2.4.11 Brokers: There are a bewildering array of brokers in informal markets whose main and sometimes only role is informational. Timberg and Aiyar (1979) have studied Shikarpuri brokers in some depth. Intercorporate brokers and black money brokers (Aiyar 1979) are other important types of brokers. Unusual though minor segments such as bail-bond brokers are also to be found. Many large brokerage houses combine various functions and others are gradually limiting their business to (formal market) stock-broking. The intercorporate funds market has been examined by the Chakravarty Committee (1985).

2.4.12 Leasing companies: Due primarily to the tax code, there has recently been a sharp increase in the number of equipment leasing firms and the volume of financial leases, enabling companies to engage in off balance sheet capital finance. Some commercial banks have also started leasing subsidiaries in competition with informal leasing companies.

2.4.13 Pawn brokers: They have been examine by Aiyar (1979). Found mainly in South India, they both accept deposits and provide pawn finance. Aiyar estimates a total volume of loans between Rs 250 crore and Rs 300 crore in 1979. However their business has adversely been affected by Pawn Brokers Acts and Debt Relief Acts passed in the 1970s. Many pawnbrokers in South India are from the Chettiar community (Aiyar 1979).

2.4.14 Money lenders: While not as widespread as in rural areas, money lenders who rely primarily on their own capital, are to be found in various parts of India.

2.4.15 \`Piggy back´ intermediaries: These informal intermediaries are of recent vintage and come in various forms, their essential characteristic being close association with formal credit markets. Along traditional lines, there are bank loan brokers who undertake to obtain bank loans in their own or clients names for business clients for a fee. Obviously, such brokers have found the means of circumventing banking sector credit controls in some way. More innovative are firms which undertake to pay premiums for endowment type life insurance policies in return for one or more payments during the initial years of the policy. Thus for example, if total premium payments over 20 years are Rs 10,000, the insurer may be asked to pay Rs 6000 over 3 years to the firm.

2.4.16 Investment and loan companies: Investment companies are essentially mutual funds in the company sector. Many of these are simply holding companies or investment subsidiaries of large industrial houses. The RBI designation `loan company' includes many government finance institutions. Some firms use this designation while awaiting sanction to start hire purchase firms, Nidhis and so on. Therefore, loan companies are not, strictly speaking, informal lenders. Investment companies do fall under our definition of informal lenders (with the exception of the Government owned Unit Trust of India). Some of their activities are indirectly studied in the chapter on the intercorporate funds market. Nayar (1984) makes a detailed study of these firms.

2.5 Regional informal markets

2.5.1 This study of informal credit markets has adopted a sectoral approach. Thus, except in a few instances when the major markets were geographically concentrated, no details of characteristics of markets in different centres are given. In the course of investigations a few interesting features of markets in different centres have been covered. Two interesting cases are worth reporting.

2.5.2 Trade finance in Calcutta, the most secretive major trading centre, is reportedly controlled, in the main, by a few syndicates of lenders organised along community lines. We had no success in discovering much about these syndicates. A story told to this researcher was how the head of a major Indian business house was kept waiting in an anteroom for hours by the head of a syndicate before he was allowed to meet the head and ask for a large short term loan (Rs 8 crore). If true, this reflects great market power on the part of these syndicates.

2.5.3 Brokers exist in various markets to intermediate between individuals and traders in need of working capital Aiyar (1977). In Surat such individuals include doctors, lawyers, government servants and so on. Loans there reportedly fetch interest of 2.5 to 4 per cent per month for 30 to 90 day loans.

CHAPTER 3

DEPOSIT MOBILISATION AND SOURCES OF FUNDS

3.1 Sources of funds of intermediaries

3.1.1 Data in Timberg and Aiyar (1989) show that except for Multani Shroffs, deposits formed the main source of funds of informal lenders. In our study except for clearing agents, the main dockyard financiers in Calcutta, deposits from individuals are the main source of funds for all intermediaries studied. Own funds are the main source of funds for clearing agents and the second most important source of funds for hire purchase firms in Delhi. Own funds are relatively more important for hire purchase firms that are not in the company sector as compared to those in the company sector, though deposits form the bulk of resources. Limited formal funds are directly or indirectly available for dockyard financing and for hire purchase. There is some evidence of diversion of bank finance to the intercorporate funds market and also some evidence of inflows of funds from informal intermediaries to this market. Own funds formed a similarly small fraction of total resources of finance corporations and chit funds. A summary of sources of funds is given in Table 3.1.

3.2 Pattern of deposits with intermediaries

3.2.1 Call deposits, term deposits and specially designed saving schemes are all used to mobilise deposits from individuals. The use of recurring deposit schemes in India was pioneered by Nidhis in 1882, while Peerless has managed to mobilise phenomenal amounts of small deposits through its endowment certificate scheme (Rs. 6 billion in 1984). The period of deposits vary from deposits on call to ten year deposits. Brokerage is paid by hire purchase companies to brokers obtaining deposits for them. That brokers in some regional markets who take a commission from individual lenders for arranging borrowers exist, has been pointed out earlier (Aiyar (1979), Timberg and Aiyar (1980)).

3.3 Deposit ceilings

3.3.1 Most types of intermediaries in the company sector are subject to controls on deposit taking, deposit interest rates and on the duration for which they can accept deposits. Deposit ceilings are usually specified as a ratio to own funds (share capital and reserves). A few are also subject to "reserve requirements" in that there are stipulations on the minimum ratio of deposits which has to be invested in specified securities. Firms and individuals not in the company sector face restrictions on the number of depositors they can have. Chit funds are covered by special, though broadly similar, regulations and there is a five year ceiling on the duration of chits, though this is under appeal in the courts.

3.4 Deposit interest rates

3.4.1 Deposit interest rates vary between 6.7 per cent per year (for Peerless: now statutorily increased to 10 per cent) and 21 per cent per year (for auto finance and handloom finance firms). Except in the case of Peerless, some evidence of rates of interest varying positively with the period of deposits exists. In one case, hire purchase, interest rates ceiling prevented higher interest rates from being offered, though "under the table payments" in this case cannot be ruled out. The now defunct Sanchaita Investment paid interest at the rate of 48 per cent per annum, three quarters of which was not accounted for. The median rate exceeds the maximum rate of interest on commercial bank fixed deposits, which is currently 11 per cent per annum for deposits of 3 years or more. Chit funds pay average rates estimated at between 10 and 16 per cent per annum. However, it is difficult to distinguish between borrowers and lenders solely from financial details of chits. Details of interest rates are in Table 3.2.

3.5 Growth of deposits

3.5.1 Reserve Bank of India statistics show that deposits with Nidhis, Chit funds and hire purchase companies have been growing faster than bank credit in the eighties though aggregate deposits with informal intermediaries continue to remain small relative to the formal sector (See Chapter 8).

TABLE 3.1

Sources of funds of surveyed sectors

(percentage of total liabilities)

Sector	Own funds	Bank loans	Deposits/ other sources
Finance Corporations	9	Nil	91
Chit Fund Companies	2	Nil	98
Nidhis	6	Nil	94
Hire-purchase	13	4	83
Auto financiers	25	Nil	75
Handloom financiers	0-5	Nil	95-100
Shroffs of Western India	25	Nil	75

TABLE 3.2

Interest Rates in the Informal Sector

Sector	One year or less	More than one year
1. Finance Corporations		
(a) Deposits	9 - 12	16 - 21
(b) Advances	48 - 16778	24 - 48
2. Chit Funds		
(a) Deposits (average across members)	10 - 16[2]	
(b) Advances (average across members)	21 - 25[2]	
3. Hire-purchase		
(a) Deposits (i) South India	14 - 16	14 - 22
(ii) Delhi	12	14
(b) Advances (i) South India	-	28 - 38
(ii) Delhi	-	28 - 41
4. Dockyard Financiers (Advances)	60	
5. Nidhis		
(a) Deposits	9 - 12	16 - 22
(b) Advances	-	16 - 23
6. Auto-finance (Namakkal)		
(a) Deposits	19	21
(b) Advances	-	40
7. Handloom Financiers (Bangalore and Karur)		
(a) Deposits	18	20
(b) Advances	44 - 68	-
8. Shroffs of Western India		
(a) Deposits	8 - 14	
(b) Advances	18 - 21	
9. Commercial Banks		
(a) Deposits	8 - 9	9 - 11
(b) Advances	-	16.5

Note: 1. The interest rate 16778 per cent per annum is for a daily loan at 5 per cent per day assuming 100 working days per annum.

2. `Interest rates´ of chit funds are the net present values per rupee invested at a discount rate of 11% plus 11%. No completely satisfactory method of estimating interest rates has been found for chit funds.

CHAPTER 4

DEPLOYMENT OF INFORMAL CREDIT

4.1 Sectoral deployment of funds of intermediaries

4.1.1 The experience here is quite varied.

a. Hire purchase firms provide finance primarily for new and used commercial vehicles through one to four year hire purchase agreements. Hire purchase firms also finance consumer durables and non-commercial vehicles.

b. Handloom financiers, of course, provide working capital finance for production by handloom weavers in the unorganised sector.

c. Finance from Nidhis is available mainly to households, though small business is also financed. The bulk of loans goes to finance the construction, renovation and repair of houses and other buildings. Loans may be for as long as seven years.

d. Peerless invests much of its deposits in government securities and term deposits with nationalised banks.

e. Intercorporate loans average three to six months for private sector corporations and six to twelve months for public sector corporations.

f. Chit funds mainly finance trade, self employed persons, agriculturalists and, to a limited degree, consumption.

g. Shroffs in western India largely finance domestic trade through 'hundis', though they also finance exports and industry.

4.1.2 The main point to note in this deployment of credit is that consumption loans form a small part of informal credit. Timber and Aiyar (1980) provide data showing that finance for trade, export and industry make up the bulk of informal credit except for that from pawn brokers and finance corporations. Summary information is given in Table 4.1.

4.2 Bad debts and overdues

4.2.1 Bad debts were reported in the intercorporate market, in auto finance in Namakkal, in chit funds and with Shroffs and in textile distribution. Except for the intercorporate market, here, most cases were more in the nature of delayed payments rather than outright defaults. Furthermore, auto financiers are able to repossess vehicles from defaulting borrowers. Bad debts in other sectors were negligible. Thus recovery problems do not tie up a lot of available informal funds, except in the case of shroffs who claimed bad debts of between 5 and 10 per cent of earnings and chit funds who had 7 per cent bad debts on average (about 1 to 2 percent of loans for the former and less than one per cent of chit capital for the latter). Even this level is, reportedly, low compared to commercial banks.

4.3 Importance of informal credit to productive sectors studied

4.3.1 One sector, film finance in Madras, is almost wholly dependent on informal finance. Trade credit proved to be the most important external source of finance for the productive sectors studied, especially for the smaller firms (where a small/large categorisation was feasible). However, owners' capital is the dominant source of finance in road construction. In textile distribution, trading agents (wholesalers) rely more on own funds than non trading agents (brokers and commission agents). While it was learnt that finance from professional financiers is the main source of finance for road construction contractors in Kerala, pure informal intermediaries played next to no role in any productive sector studied. Informal credit from friends, relatives and other associates was, however, of importance, being more important than bank finance in road construction and textile distribution. Whether such funds really reflect informal finance or represent illegal funds is not ascertainable for individual firms but are, in all probability, largely illegal funds in the aggregate given that we estimate such funds to exceed net household sector dues receivable as estimated by the RBI (1987). However, that informal finance plays a dominant role in the finance of handloom weavers and used truck operators was ascertained from studies of intermediaries. That bank finance is not the main source of finance even to garment exporters, despite various export incentives and concessions, is revealing. Formal credit is more important only for households (including for house construction) and perhaps for transport operators.[1] Details are in Table 4.2.

4.4 Inequality of credit distribution

4.4.1 According to data from the RBI surveys, informal credit is more evenly distributed between households in different asset groups than is formal credit (the gini index for urban households is 40.2% for informal credit and 55.1% for formal credit). However, Lorenz curves cross when more than 3 asset groups are used since a relatively large share of formal credit goes to the household asset group Rs 1 lakh to Rs 5 lakh. Thus, asset poor and wealthy households receive relatively more informal credit.

4.4.2 For samples of productive units except for transport operators, RBI data show, once again, that informal credit is more equally distributed (in the Lorenz sense) when firms are classified by gross sales or earnings into 3 to 5 groups. Informal credit is still the main source of finance for small industrial and trading units.

4.5 Flow of funds between formal and informal financial sectors

4.5.1 While instances of flow of funds in both directions between formal and informal sectors have come to light, the flow of funds from the informal to the formal financial sector is by far the larger of the two, even if the fact that all intermediaries and firms studied hold current accounts with banks is ignored. The three main instances of this, the case of road construction, chit

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1. The figure given in the table is based on a sample of bank assisted units. It is thus biased against informal credit.

funds and the Peerless case, between them result in at least Rs. 5 billion flowing to the formal sector in recent years. In the case of Nidhis about 11 per cent of their assets are held as bank balances.

4.6 Overall credit position of credit using sectors

4.6.1 While no specific information is available about film finance, it is clear from our study that film production would be greatly affected in the absence of informal finance.

a. Garment exporters, particularly the larger firms, are net receivers of credit and are able to generate large internal surpluses due to the combined operation of three factors: Cheap bank credit to finance exports, export tax concessions and the manner in which the quotas under the Multi Fibre Agreement are allocated between competing firms.

b. Road construction contractors are net providers of credit to the monopsony buyer of their services, the government, due to the need to provide security deposits and due to delayed receipts of dues.

c. Textile distribution intermediaries in the middle of the distribution chain are net providers of credit, the beneficiaries being retailers.

d. Powerloom units reloan about half their borrowed fund as trade credit.

e. Bhole (1985) reports that large, and after 1970, small companies were net receivers of trade credit basing this conclusion on data for 1956 to 1978. On average, firms in the RBI surveys are net receivers of credit, though for wholesale traders the net credit receipts are marginal.

4.6.2 This evidence, while attesting to the importance of informal credit and transmission of credit received from sellers to buyers also attests to the fact that some sectors are constrained to own fund for capital formation and working capital.

TABLE 4.1

Sectoral Deployment of Funds of Intermediaries

Intermediary	Trade	Agriculture	Construction	Transport	Industry	Consumption	Other
Finance Corporation	35	10	9	4	6	12	24
Chit funds	45	8	Nil	Nil	Nil	37*	10
Hire Purchase	Nil	Nil	Nil	Bulk	-	Minor	-
Nidhis	Housewives: 25 %, Businessmen 25%, others 50 % largely for house construction and repair						
Shroffs	50	NA	NA	NA	10	Neg	40

* Including self-employed.

TABLE 4.2

Sources of Funds of Using Sectors

Sector	Own funds	Formal credit	Informal credit
Road construction	62	6	32
Garment exports	31	26	43
Film finance	5	Nil	95
Powerloom units	43	10	47
Textile Trade Units	42	10	48
Housing Finance of Households	66	20	14
	RBI SURVEYS		
Households	N.A.	61	39
Small Scale Industry	28	32	40
Traders	28	19	53
Transport Operators	49	41	10

Notes:
1. RBI surveys cover only units receiving bank assistance
2. NA = Not applicable
3. Shroffs do not include Multanis who do receive bank refinance estimated at about 5 - 10 per cent of their loans outstanding.

CHAPTER 5

LOAN TERMS AND CREDIT APPRAISAL METHODS

5.1 Interest rates

5.1.1 Annual compound interest rates on advances are given in Table 2.2. The rates are, in general, higher than bank rates as are the deposit rates.[1] One point of interest is that interest rates do not increase with the duration of loans in all cases. When short term loans have higher rates of interest, this is invariably because of higher transactions cost or riskiness. In the case of dockyard financiers interest rates are unusually high given the lack of risk or transactions costs. The average interest rates for productive sectors, in Table 5.1 below, are surprisingly low and are comparable to that of banks (the State Bank of India advance rate is currently 16.5 per cent). Trade credit rates vary with the period of credit since cash discounts were typically specified. They tended to be somewhat higher than rates for direct loans given that the average period of trade credit was of fairly short duration.

5.2 Loan duration

5.2.1 The generalisation that informal loans are short term is incorrect. While it is true that Shroffs and finance corporations mainly have short term loans not exceeding 3 months, chit funds, Nidhis and hire purchase companies have loan durations measured in years - upto seven years in the case of Nidhis and before enactment of recent Chit Fund Acts, 10 years for chit funds. Trade

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1. The huge rate of 16,778% is the annualised interest on one day loans at 5% by finance corporations. However, it should be noted that such loans are small and have high transactions costs to the lender.

credit periods of upto 200 days were reported in wholesale trade and the powerloom sector, though two months is approximately the average. At the other end, finance corporations serve the very short term end of the spectrum - starting from one day loans - a segment not served by the formal sector.

5.3 Collateral

5.3.1 Nidhis, hire purchase firms, chit funds and auto financiers give secured loans. In the case of vehicle finance, security consists of margin money and hypothecation of the vehicle. The margin may be as high as 50 per cent. Otherwise loans are mainly unsecured, though loans against jewellery are fairly widespread. However, long standing relations or borrowers being known to lenders is important especially among Shroffs, finance corporations and in hire purchase. A recent trend, is the advertisement of loans available from informal lenders in national daily newspapers such as the 'Hindustan Times' and the 'Hindu'. This suggests that, in some segments, long term relationships may be losing importance.

5.4 Credit assessment

5.4.1 While Nidhis and hire purchase companies had an elaborate but speedy credit assessment procedure, most intermediaries rely on long standing personal contact with borrowers or their reputation in the 'market'. Thus, in most cases, the informality between lenders and borrowers and speedy sanctioning of loans for which informal markets are noted was maintained.

5.4.2 Clearly, no generalisations about loan terms in informal credit markets can be made. The stereotyped 'loans from moneylenders' are clearly not representative of informal intermediaries of all kinds.

TABLE 5.1

Cost of Informal Credit

Using sector	Range of interest rates	Average informal interest rate	Average cash discount on trade credit
1. Road construction	15 - 24	15.89	-
2. Film finance	67 - 99	-	-
3. Powerloom	12 - 16	12.03	11 - 13
4. Textile wholesale trade	12 - 18	15.31	-

CHAPTER 6

COST OF INTERMEDIATION

6.1 The decomposition of interest rates

6.1.1 The main purpose of this chapter is to examine the decomposition of the lending rate of informal intermediaries following Bottomley (1975).[1] The decomposition of loan interest rates is into four components: transactions cost, risk premium, opportunity cost and economic or monopoly rent. Essentially, from financial figures of the firm this can be deduced ex post. The method we adopt is the following. Per rupee of funds loaned, pure rent (R) can be represented by the identity

$$R = (1-P)(1+r) - T - Oe$$

where, P is the percentage of loans defaulted, r is the average interest rate charged to the borrower, T is the ratio of total expenditures to total loans, O is one plus the opportunity cost (o) per rupee of own funds and e is the ratio of own funds to total funds available.

6.1.2 T can further be decomposed into E + I, where I is the interest cost on borrowed funds per rupee of loans and E is the residual (establishment) cost per rupee of loans. I can further be written as (1+i)(1-e), where, i is the average interest rate on deposits and (1-e) is the faction of borrowed funds in total funds (under the accounting convention that borrowed funds are repaid, though they may, of course, be borrowed again immediately and lent anew). Thus we get the relation:

$$r = E + P(1+r) + [i(1-e)+oe] + R \qquad (1)$$

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1. See also Hanson and de Rezende Rocha (1986).

here, E is the per unit establishment cost (or transactions cost)

$p(1+r)$ is the risk premium (or, accurately, the cost of defaults)

$[i(1-e)+oe]$ is the opportunity cost of funds employed (or the actual cost in the case of borrowed funds)

and R is the economic rent.

6.1.3 One adjustment needs to be made before the decomposition can describe the situation of a risk neutral lender (and we assume risk neutrality in this study). There is clearly a real opportunity cost to running out of loanable funds, a situation which gives rise to an increasing term structure of interest rates from the lenders viewpoint. Comparing the lender's demand for borrowed funds of different maturities to the market term structure,[2] The deposit maturity which gives the greatest surplus to the firm will be selected by it. If it is in fact observed that the lender borrows funds of all maturities, then this suggests indifference on the part of the lender to all maturities or the operation of price or quantity controls (whether imposed by the government or other private agents) on the borrowing market. In the former event the highest interest rate, (j), should be substituted for i and the difference, $(j-i)(1-e)$ should be added to the risk premium, where the term itself represents the cost of unavailability of borrowed funds. In the latter event it is clear that the risk premium should be augmented but there is no easy way of estimating the required increment. In order to bias the results towards high monopoly profit and because of estimation problems, we ignore such corrections and retain the formula (1). In the event of risk averse lenders or anticipated costs higher than ex-post costs, (1) will over estimate monopoly rent.

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2. Under the assumption of price taking on the market for borrowed funds.

6.1.4 The main interest in such a decomposition is in order to ascertain the extent of monopoly rent and in order to compare across institutions. However the latter objective requires that loans be taken individually, or that lenders with identical loan portfolio be considered.[3] The data for such an exercise is not available. The problematic parts of the decomposition are the portions concerning transactions and default costs. Deposit costs, opportunity costs and economic rent are still comparable across sectors. In general, transactions costs could be expected to be higher for firms with predominantly short term loans and when individual loans are small relative to the total loan portfolio. However, data on the number of loans are not available in all cases, and sample sizes are too small to attempt a standardisation on this basis. This caveat must be borne in mind when analysing the estimates presented.

6.2 Estimates

6.2.1 Estimates were computed using average figures across all firms, ignoring inter-firm heterogeneity.[4] In consequence the figures reflect the average position of firms. Our estimates are given in Table 6.1 for 6 intermediary sectors. These estimates assume an opportunity cost of own funds of 18 per cent for all sectors except shroffs for whom an opportunity cost of 14 per cent[5] is assumed. The estimates show that there is reason to suspect "monopoly power" only among auto-financiers in Namakkal. However, the second hand auto-finance business is growing rapidly and it is more likely that the rent estimate captures an element of disequilibrium profits. For shroffs, analysis for 1979 revealed a rent element of 35%. The decline in the use of darshani hundis

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3. I am indebted to T.N. Srinivasan for pointing out the problems with intermediary comparisons based on average values.

4. When firmwise data were available. Otherwise other approximations are used.

5. 14% is assumed on the basis of discussions with respondents in the field survey.

and the sarafi system as a whole due to the impact of recent repressive legislation may explain this, given that shroffs were the sole suppliers of this instrument. The position for the inter-corporate funds market, for risk adjusted interest rates, similarly appears to indicate lack of monopoly pricing, though given the `joint producer´ nature of corporate lenders no estimate were made. Thus the evidence does not support the hypothesis of monopolistic intermediaries in the sectors studied.

6.2.2 The high establishment costs reported in this table appear to contradict the presumption of informal lenders being efficient purveyors of credit. In fact commercial bank costs contributed about 27 to 38 per cent of the interest rate on loans (assumed at 16.5 per cent) in 1984 and 1985. Though the caveat in paragraph 3 should be kept in view and though it should be kept in mind that banks could probably not replace informal intermediaries in the credit submarkets served by them, these figures do tend to suggest that all informal intermediaries are not efficient suppliers of credit compared to banks in the sense of having low transaction costs. This finding is at variance with earlier studies, such as Timberg and Aiyar (1980). They, however, do not attempt an explicit decomposition. From what is reported in the popular press, and from the little evidence available, informal intermediaries have substantially lower risk costs than banks, a finding which is reflected in the Table. Before leaving this chapter, we briefly summarise findings on informal credit to using sectors. Details of computations for banks are given in Tables 2 and 3.

6.3 Cost of funds versus duration of loans of credit using sectors

6.3.1 While most loans were found to be for working capital purposes and were thereby short term loans or even loans on call, the mean effective loan duration was greater than that for formal sector credit in road construction. Furthermore, while the cost of informal finance for film making was between 67 per cent and 99 per cent per annum, the average informal interest rate was estimated to be lower than the cost of bank finance in the other sectors, though the median rate was higher and the dispersion was large in road construction. The main reason for this is that low, often zero, interest rate loans from friends and relatives are often used by firms. Furthermore, a regression, using inter-State data on the pooled samples from the RBI surveys of firms, of interest cost on the ratio of formal to informal finance showed no significant link between the two.

Finally, persons interviewed in the textile wholesale market reported that the effective cost of bank credit, inclusive of their transactions costs, was higher than that of informal credit.

TABLE 6.1

Estimated Decomposition of Loan Interest Rates of Informal Intermediaries and Scheduled Commercial Banks

Sector	Intermediaries (Figures in %)				
	Default cost	Establishment cost	Opportunity cost/ cost of borrowed funds	Economic rent	Average spread (in percentage points)
Finance corporations	4	25	68	3	10[3]
Hire-purchase	3	33	66	-3	9[3]
Nidhis	Neg	19-20	78-79	1-3	5-7
Auto-financiers in Namakkal	7	26	26	45	19
Handloom financiers in Bangalore/ Karur	7/8	23/25	51/67	20/Neg	35/26
Shroffs of Western India	14	20	60	16	8-9
Indian Scheduled Commercial Banks					
(a) No default assumption	-	33-38	54-67	0-7	6-10[3]
(b) 2% of loans defaulted	16-18	27-34	48-54	Neg	

Notes:
1. Opportunity cost assumed to be 18 % for own funds except for shroffs (14%)
2. Neg: Negligible.
3. Difference in earnings per rupee of loans and per rupee of deposits.
4. Bank calculations are from Table 6.3.

TABLE 6.2a

Basic Data on Indian Scheduled Commercial Banks

(Rs lakh)

Item	1984	1985
From Annual Reports as on December 31		
Paid up capital	18,381	65,070
Reserves	87,007	118,958
Deposits	8,468,447	10,028,467
Profit (balance sheet)	637	991
Total assets	11,119,422	13,120,176
Investments	2,378,883	2,947,510
Cash	1,314,775	1,593,727
Money at call	181,902	332,426
Advances in India	4,583,593	5,225,024
Advances outside India	761,000	796,493
Due from banks (assets)	2,204	2,089
Borrowing from banks (liabilities)	733,259	810,595
Interest and discount	815,683	944,056
Total earnings	889,546	1,030,752
Interest paid	585,826	682,629
Total expense	883,622	1,024,680
Profit (p&l)	5,924	6,072

Source: RBI, Statistical Tables relating to Banks in India, 1985.

TABLE 6.2b

Basic Data on Indian Scheduled Commercial Banks

(Rs lakh)

Item	1984	1985
From special returns to the RBI on Forms A1 & A2 (Total Business)		
Paid up capital	30,665	65,020
Reserves	74,434	118,451
Deposits	8,349,820	9,864,917
Cash	1,315,167	1,595,285
Investments	2,489,412	3,102,261
Money at call	186,659	332,399
Loans and advances	4,733,334	5,411,078
Bill business	610,992	611,299
Profit (balance sheet)	4,452	5,872
EARNINGS		
Inland bills	52,199.1	61,337.6
Loans and advances	547,067.5	660,127.6
Investment: government	109,319.7	139,037.6
Investment: trustee	48,267.9	69,332.5
Investment: other	40,747.3	5,855.1
Deposits with RBI	54,759.3	75,323.2
Deposits with banks	11,159.9	18,247.3
Total oper. earnings	949,279.2	1,123,404.1
Total earnings	970,979.1	1,145,832.`
EXPENDITURES		
Interest: deposits	513,563.2	607,641.9
Interest: borrowings	55,590.6	64,210.1
Rediscounts	10,393.1	13,199.6
Other business	10,210.7	11,576.4
Establishment cost	204,173.2	235,938.5
OTHER EXC. FEES ETC.		
Taxes on operations	1,468.1	1,655.0
Interest tax	13,458.8	4,016.8
Total oper. expense	872,896.0	1,014,407.4
Total expense	891,248.2	1,053,390.5
Pre tax profit	79,330.9	92,441.6

Source: RBI, Statistical Tables relating to Banks in India, 1985.

TABLE 6.3

Consolidated Data on Indian Scheduled Banks

(Rs lakh)

Item	From annual reports		From special returns	
	1984	1985	1984	1985
Own funds	20,365	67,055	105,099	183,471
Deposits	8,468,447	10,028,467	8,349,820	9,864,917
Total funds	10,387,550	12,310,679	9,335,564	11,052,322
Investments	2,378,883	2,947,510	2,489,412	3,102,261
Advances	5,344,593	6,021,715	5,344,326	6,022,377
Cash	4,765,495	5,557,450	1,501,826	1,927,684
Interest and discount	815,683	944,056	599,267	721,465
Total earnings	889,546	1,030,752	970,979	1,145,832
Interest paid	585,826	682,629	523,956	620,842
Establishment expense	297,796	342,051	367,292	432,549
Profit (balance sheet)	637	991	4,452	5,872
Loans	NA	NA	547,068	660,128
Bills	NA	NA	52,199	61,338
Return on investment	NA	NA	198,335	214,225
Return on bill bus.	NA	NA	52,199	61,338
INTEREST RATES				
Return on advances		17.66		13.50
Return on loans		NA		13.95
Return on bill bus.		NA		10.04
Return on investment		NA		6.91
Deposit rate		8.06		7.44
RATIOS TO TOTAL FUNDS				
1. Earnings		9.92		12.27
2. Deposit cost		6.57		6.65
3. Establishment		3.29		4.63
4. (2) + (3)		9.86		11.28
5. Opp. cost (18%)		0.03		0.17
6. Econ. rent		0.03		0.82
BREAK UP (NO DEFAULT)				
1. Required return		9.92		12.27
2. Deposit cost		66.23		54.18
3. Establishment		33.18		37.75
4. Opp. cost		0.30		1.39
5. Econ. rent		0.29		6.67

TABLE 6.3(CONTD.)

(1)	(2)	(3)	(4)	(5)
BREAK UP (1% DEFAULT)				
1. Required return		10.99		12.57
2. Deposit cost		59.78		52.91
3. Establishment		29.95		36.86
4. Opp. cost		0.27		1.36
5. Default cost		10.00		8.87
6. Shortfall		9.74		2.39
BREAK UP (2% DEFAULT)				
1. Required return		12.09		13.68
2. Deposit cost		54.35		48.60
3. Establishment		27.23		33.86
4. Opp. cost		0.25		1.25
5. Default cost		18.18		16.29
6. Shortfall		17.95		10.31

Note: For break ups with default (2)+(3)+(4)+(6) add up to 100% if the required return falls short of earnings <u>less</u> economic rent <u>plus</u> default cost.

Source: As for Table 6.2.

CHAPTER 7

STRUCTURE OF INFORMAL CREDIT MARKETS

7.1 Introduction

7.1.1 In this chapter, we describe our findings on the structure of informal credit markets in terms of various criteria used in industrial organisation theory. The evidence is reviewed in two parts. Firstly, we review the evidence on the market structure of intermediary submarkets for which field studies were conducted and also of the traders-cum-intermediaries in wholesale trade. Secondly, we address the issue of fragmentation or integration in informal credit markets as a whole.

7.2 Intermediary submarkets

7.2.1 In describing market structures of intermediary subsectors, ten criteria are used. The first six are the standard industrial organisation benchmarks of numbers and concentration (where the sample permits this to be studied), product variety, price/non-price competition, ease of entry and exit, price dispersion, evidence of market leadership and existence of economic rents. The latter is, of course, judged by the monopoly component of interest rates. In addition, informational aspects of such markets are discussed since this is crucial to the functioning of credit markets. Informational considerations manifest themselves in addition to price disperson and, on occasion, entry barriers, in at least two ways. Firstly, lenders can set maximum limits on interest rates and ration funds to borrower rather than allowing the interest rate to clear the market (Stiglitz and Weiss (1981)). Secondly collateral is taken or some other way of securing loans is in common use. Finally, the existence of price or quantity controls by the government is pointed out. Evidence for the intermediary submarkets is presented in Table 7.1.

7.2.2 Before reviewing the evidence, the nature of entry/exit barriers should be addressed. It is clear, a priori, that access to loanable funds is a pre-requisite for becoming an informal lender. Becoming an intermediary requires access, furthermore, to depositors. These factors are clearly barriers to most types of potential lenders with the possible exception of chit funds among friends and acquaintances. Since these barriers are common to almost all credit operations, the table below indicates the existence of entry barriers only when evidence of additional difficulties in entering and leaving were found. Such barriers may, furthermore, be permanent or temporary. Temporary barriers arise from lack of information about potential borrowers and other informational obstacles. Barriers along caste and community lines, for example, are of a more permanent nature.

7.2.3 The evidence summarised in Table 7.1 shows that with the exception of aratiyas in the wholesale trade, dockyard financiers and nidhis, informal intermediaries are generally at the competitive end of the spectrum. Informational imperfections, as evidenced by price dispersion, rationing and security, are significant and the major cause of inefficiencies. In hire-purchase, there are dominant firms in the regions surveyed. Aratiyas specialise by region which leads to short run information based entry barriers. For indigenous bankers, community based entry barriers and the need to establish a reputation are additional barriers.

7.3 Fragmentation

7.3.1 The concept of fragmentation first requires definition. Two conditions can be said to be sufficient to determine whether the informal credit market is fragmented. First, fund flows between markets should be insufficient to bring about equality of interest rates across regions for similar loans and borrowers.

Secondly, there is evidence of fragmentation if borrowers or lenders are excluded from credit markets due to some characteristic unrelated to their ability to lend funds or repay loans. Note that it is possible for markets to be fragmented on the deposit side (sources of funds) and not on the loan side or vice versa.

7.3.2 On the sources of funds side, there appears to be significant integration of urban informal markets with many major intermediary sectors in a region potentially having access to the same pool of depositors. Instances of depositors from distant regions have also come to light in hire-purchase.

7.3.3 On the lending side, the importance of reputation and long relationships argues for fragmentation within such submarkets. Impressions gained from field surveys tend to suggest fragmentation according to both criteria given above. Interregional and intergroup interest rate dispersion can be assessed by examining interstate RBI data from the All India Debt and Investment Survey, 1981-82. Though interest rate data is not available, we use as a proxy the proportion of household debt bearing interest at the rate of 20 per cent or more per annum. While causes of variation in this factor are clearly influenced by other factors (such as the spread of informal intermediaries itself), the variation across groups of borrowers and states is examined since lack of variation would still be grounds for rejecting the hypothesis. Necessary information is in Table 7.2. From this it can be seen that the data is consistent with the hypothesis of fragmentation both across states (the coefficients of variation) and across groups (the correlation coefficients). The most surprising finding is the high coefficient of variation among the urban self-employed testifying to the extreme hetrogeneity of this group.

7.4 Conclusions

7.4.1 Informal markets have widely varying characteristics so that the true economic efficiency of their functioning, relative to what is possible given environmental limitations, is hard to gauge on the basis of our limited study. Still, it seems fair to conclude that, with some exceptions, markets are at the competitive end of the spectrum of market types. Evidence of both integration and fragmentation has been reviewed. On balance one would hypothesise that loan markets, but not deposit markets, are still largely fragmented upto the 1980s.

TABLE 7.1

Industrial Organisation of Informal Submarkets

Sector	4-firm concentration ratio (%) (sample firms)	Entry/ exit barriers	Local price dispersion	Market leadership	Economic rents	Number of firms
Finance corporations	34.7	No	Small	No	Small	Large
Hire-purchase	87.7	No	Yes	Yes	No	Large
Nidhis	NA	Yes	Yes	No	No	65
Chit funds	66.6	No	No	No	NA	Large
Auto-financiers	NA	No	Yes	No	Yes(?)	Large
Handloom financiers	NA	No	No	No	No	Large
Aratiyas (textile trade)	NA	Yes	No	No	NA	Few serving a region (Regional specialisation)
Wholesalers (textile trade)	NA	No	No	No	NA	Large
Dockyard financiers	NA	Yes	Yes	No	Large	Small
Shroffs in Western India	NA(High)	Yes	No	Yes	No	Medium

TABLE 7.1 CONTD.

Sector	Rationing	Type of Security	Government interest(I) and Deposit (D) controls	(P) Price/ Non price (N) competition
Finance corporations	Floor amounts	Collateral	ID	N
Hire-purchase	NA	Marginal, reputation collateral, guarantors	ID (Company Sector)od	NA
Nidhis	Duration/ Amount	Collateral		None
Chit funds	Amount	Collateral	ID	N
Auto-financiers	NA	Margin, Guarantor, collateral	D	N
Handloom financiers	NA	DO		N
Aratiyas (textile trade)	NO	Reputation	D	N
Wholesalers (textile trade)	NO	Reputation	NO	P
Dockyard financiers	NA	Long Relationship	No	None
Shroffs in Western India	No	Reputation long relationship	D	N

TABLE 7.2

Inter-State Variations in High Interest Loans to the Household Sector

A. Percentage of Loans with Interest Rate of 20 per cent or More

State	Rural		Urban	
	Culti-vators	Non-culti-vators	Self-employed	Non-Self-employed
Andhra Pradesh	38.4	52.7	22.0	36.82
Assam	7.4	0.0	0.0	0.0
Bihar	25.5	46.1	23.4	6.3
Gujarat	7.2	3.7	0.0	0.6
Haryana	13.7	47.1	42.4	1.8
Himachal Pradesh	1.9	0.0	0.0	0.0
Jammu & Kashmir	2.8	0.0	0.0	0.0
Karnataka	6.1	9.9	8.0	8.7
Kerala	8.4	33.3	56.4	3.0
Madhya Pradesh	27.9	23.3	8.0	14.7
Maharashtra	4.6	5.3	6.8	3.5
Orissa	10.4	38.0	2.6	1.8
Punjab	12.3	16.1	5.5	14.8
Rajasthan	33.8	41.6	8.0	18.3
Tamil Nadu	30.1	33.5	15.0	26.8
Uttar Pradesh	28.7	47.8	22.9	15.0
West Bengal	14.9	7.4	26.7	17.6
Coefficient of variation	0.7391	0.8194	1.1038	1.0704

B. Estimated Correlation Matrix of Variables

Sector	Culti-vators	Non-culti-vators	Self-employed	Non-self-employed
Cultivators	1.0000	0.7595	0.2209	0.8295
Non-cultivators	0.7595	1.0000	0.5597	0.4863
Self-employed	0.2209	0.5597	1.0000	0.1414
Non-self-employed	0.8295	0.4863	0.1414	1.0000

Source of data: RBI, All-India Debt and Investment Survey, 1981-82.

CHAPTER 8

SIZE AND TRENDS IN SIZE

8.1 Preliminaries

8.1.1 Given the quality of data available, it is a moot point as to whether this chapter should have been written at all. However, no reliable estimates of the size of the informal sector are available and so even rough estimates such as are presented here are of some value. The estimates must, however, be found wanting by any absolute quality standard. This being the case no statistical confidence intervals for the data presented here are reported even when these were computed and found to be acceptable. Of the various estimates given, great confidence can be placed in the 'estimates' for Nidhis alone. This is because these are not estimates but population figures. No other estimate can be considered reliable in any absolute sense.

8.2 Methodological issues

8.2.1 Magnitudes reported: How is size to be measured? Our main focus in computing these estimates is to assess two factors. First, to the extent that the size of informal markets relative to the formal sector reflects on the ability of the central bank to control credit, monetary aggregates rather than numbers of clients or transactions intermediated are clearly appropriate. Secondly, given that our evidence shows that informal credit forms the more important source of funds for poor households and small firms, financial aggregates will give a lower bound (rather than numbers of customers or accounts) on the importance of informal finance to particular sectors relative to formal credit. Thus, our estimates are for financial aggregates only since it is these two factors which are of interest to us and, we believe, generally. In line with these objectives, for financial intermediaries the amount of funds intermediated is of interest. Thus, figures on both deposits and advances by them are of interest. Similarly total informal credit to all sectors is of interest and is accordingly estimated.

8.2.2 Measurement of magnitudes: A second issue is in the actual measurement of credit or deposits. The Reserve Bank reports both stock figures to capture size and changes in stocks to capture trends in size. A priori, however, stock figures are inappropriate. To see this note that two intermediaries, both with the same stock of loans outstanding on a given date may have very different impacts if one gives out one day loans (to take an extreme example) and lends available funds exactly once a year, while the other is fully loaned up throughout the year. Some way of incorporating the time dimension for different loans and deposits must be found to overcome this problem. One way is to add the stock of deposits/loans outstanding over each point in time (or day) over the entire year or the entire period for which a credit/deposit measure is sought.[1] This is then a flow estimate having the dimension `rupee-days per year´ (or rupee-years per year with appropriate normalisation). When stock figures are available only at widely separated points of time, then of course a trend curve can be fitted to estimate stocks at intermediate dates. For example, if a constant rate of increase of the stock between two points T1 and T2 is found, then for the interval (T1, T2) the appropriate measure is T1 plus half the difference between T2 and T1 or, that is, their simple average.[2]

8.2.3 Thus for most financial institutions, who may be assumed to have a constant level of outstandings throughout the year, or a repetitive pattern of fluctuations in each year, the stock figures

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1. Even this is open to objections. A more appropriate measure would, for example, weight loans of different duration differently. Other considerations may also be brought to bear.

2. The idea of this paragraph arose as a resuilt of discussion with CPS Nayar and Srinivasa Madhur regarding the measurement of deposits with chit funds.

themselves are reasonable proxies. However if the pattern of fluctuations differs for two different financial institutions, a comparison of stock figure will be misleading. One institution for which stock figures are clearly misleading for the purpose of comparison are ROSCAs (such as chit funds). This is because of the very nature of their `loan' and `deposit' transactions. Thus, in their case, flow estimates are needed.

8.2.4 Given data limitations our estimates are (except in the case of chit funds and one or two others) stock estimates as a proxy for rupee-year per year figures. Also, for bank deposits we use latest year stock figures in order to retain consistency with informal sector estimates and to `load' the results in favour of the formal sector (whose aggregate deposits and advances outstanding have grown consistently in India).

8.2.5 The conceptual problem as to the relevant credit magnitude to be used is problematic even with the correct choice of units.[3] Consider this example: Two firms A and B each borrow Re 1 from a bank. While A uses the borrowed funds to buy productive inputs from B, B redeposits the money in the bank intending to put it to use later. At the start of the next period, the bank calls in its loan from A but not B. B allows A to pay for purchases later and makes use of its bank loan to meet its payments. In both situations (periods), productive activity is the same. This example suggests that different levels of credit may finance the same level of productive activity depending on the volume of idle balances - in both cases the volume of productively employed credit is Re 1 (times the period length). If firms do indeed hold idle balances as a precaution against anticipated or unanticipated monetary stringency, then the "correct" measure of credit as a productive input would have to be net of such idle balances. In fact, even if there were transient idle balances, these would have to be deducted. Likewise, as the second part of the example

3. This paragraph was motivated by helpful discussion with Srinivasa Madhur, who however, does not necessarily share the view expressed.

shows, credit which is on-lent (sub-intermediated) should be counted only once.

8.2.6 Such corrections are important particularly when trying to gauge the importance of two alternative credit sources like formal and informal credit. However, the example is simplistic and does not discuss any benefits which may arise from the ability to hold idle balances and the ability to on-lend (the latter is, of course related to the question of fungibility of credit from different sources).

8.2.7 An additional issue raised by the second part of the example is attribution. Is the rupee of bank credit to B which is on-lent to A formal or informal credit? Again the answer is not clear since the loan is given by a formal institution and subintermediated by an informal agency. In practice, this raises the issue of the correct method of treating bank refinance of informal lenders and agents such as wholesalers who have significant on-lending.

8.2.8 Unfortunately, methods for correctly measuring credit have yet to be developed, to our knowledge. Thus, while recognising the limitations in the procedure, we stick conceptually to the simple minded method of adding up the (time integrals of) formal/informal liabilities from balance sheets of firms for our user based estimates in Table 8.1. Estimates for intermediaries in Table 8.2 are less affected given negligible inter-intermediary funds flows. We may mention that even though by this method credit in both parts of the example amounts to Rs 2, in general, it is not true that there is a one to one correspondence between `productive credit´ and our credit measure. However, what is true is that apportionment of credit into formal and informal components, Re 1 each in the second part of the example , remains straightforward.

8.2.9 Types of estimates: Three sets of estimates are reported. An estimate of aggregate informal credit broken down by broad credit receiving sectors, estimates of aggregate deposits and advances of informal intermediaries and estimates of informal credit going to selected sectors.

8.2.10 In making these estimates the basic approach was to use sample estimates of the ratio of informal credit to some magnitude for which aggregate information is available (such as bank credit or value added). Informal credit is then estimated as the sample ratio times the aggregate figure. When it was possible to use more than one magnitude, this was done. In such cases all estimates are reported. In some cases the resulting aggregate estimate was further blown up to arrive at an estimate for a broader grouping of sectors using value added figures (.e.g road construction is a narrow grouping with construction as the broader grouping). Dates for estimates given refer to the date for which aggregate figures were available. Thus, implicitly, we assume that the sample ratio is unchanged between the sampling period and the date of the estimate. Also, the procedure clearly assumes a unitary elasticity of informal credit with respect to the aggregate magnitude used. For one large subset of estimates used to compile estimates of informal credit by receiving sectors the assumption of unitary elasticity was statistically tested and not rejected with high confidence. Details of aggregates are in Table 8.1. Sources of data for estimates are listed in the Appendix.

8.2.11 In compiling the estimates of aggregate informal credit to using sectors, we have deliberately chosen to bias the estimates against informal credit so as to get a lower bound rather than an upper bound estimate for informal credit. Details of bias deliberately introduced are as follows:

a. Ratios of informal credit to formal credit and of informal credit to value added[4] were based on Reserve Bank of India

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4. Value of production in the case of small scale industry and a weighted average of credit per vehicle of different types for transport operations.

surveys of Small Scale Industries, Traders and Transport Operators. These surveys were biased against informal sectors as only units receiving formal credit were included in the survey.

b. Even though a statistical test failed to reject the hypothesis of a unitary elasticity of informal credit per firm with respect to income, using cross sectional data and state domestic product as the income variable, the preferred estimate uses an average of two estimates, one using bank credit (the low estimate except for transport operators) and the other using value added.[5]

c. Though the test reported is for informal credit per firm yet no attempt was made to correct for growth in the number of firms.

d. Only selected sectors were used in compiling aggregate estimates whereas the bank credit figure used for comparison is for all (urban and rural) sectors.

e. When aggregate estimates were not available for the most recent year (1986-87) no attempt was made to project these figures. In contrast, the bank credit figure is the most recent available.

f. A large portion of informal credit was subtracted from the gross total obtained as possibly consisting of black money.

One source of double counting, between private limited companies and other sectors, could not be eliminated. However, the overlap between such companies and figures for other sectors is less than one per cent. In fact the bias does not exceed Rs 250 crore and should in fact be much lower.

8.2.12 In compiling other estimates, while caution was used, no deliberate bias was introduced.

8.3 Estimates of size

8.3.1 The estimates of informal credit to receiving sectors is given in Table 8.1. As can be seen, despite the anti informal credit bias, our estimate shows that informal credit is 73.2 per cent of gross bank credit. The sector absorbing the greatest

5. See the previous footnote.

amount of informal credit is the trade sector.

8.3.2 Estimates of credit and deposits of intermediaries are given in Table 8.2. As can be seen, financial activity by intermediaries is unimportant relative to bank credit. Only 18 per cent of advances and 11 per cent of deposits are with informal intermediaries. Madhur (1987) estimated informal deposits for a different subset of firms at 16 per cent. The bulk of the 'others' figure consists of trade credit. Trade credit is therefore seen to be the most important component of informal credit.[6] Among intermediaries, the dominance of chit funds (by the middle estimate), finance corporations and hire purchase may be noted. Also of note is the large size of the unclassified firm, Peerless General Finance and Investment Limited.

8.3.3 Informal credit estimates for specific sectors from field surveys which are included but not reported separately in Table 8.1 are in Table 8.3. As mentioned, the basis of computations is in the Appendix. A problem with the inter-corporate funds estimate is that it cannot be reconciled with the estimate of informal credit to public limited companies in Table 8.1. Though the two estimates are based on different aggregate firm populations, there is a large overlap. This suggests that corporate reliance on informal credit is much higher than is reported in Table 8.1 or that our estimate of inter-corporate funds is seriously biased.[7] The latter may be ruled out since even the total intercorporate credit in the sample exceeds the relevant RBI figure. No attempt was made to adjust the Table 8.1 figure upwards in keeping with our general approach.

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6. Thought there is no separate chapter on trade credit, it has been studied in the context of all credit using sectors. See also Bhole (1985), whose results are summarised in chapter 13.

7. In fact Bhole (1985) finds that trade credit alone is as important as bank credit for the sample of firms he studied and the years to which his data pertain.

8.4 Trends in size of intermediaries

8.4.1 Since our data is largely cross sectional, limited evidence on the growth of informal credit is available. Thus, while the impression has been gained of a rapidly growing informal sector, we have only limited direct evidence. For intermediaries, the position is much better due to the availability of RBI estimates.[8] The following trends emerge from here:

i. Hire Purchase : Growth of deposits faster than bank deposits.

ii. Finance Corporations: Declining (See Appendix 2 of the chapter on Finance Corporations).

iii. Chit Funds: Growth of credit/deposits faster than banks. Growth in popularity outside South India, its traditional stronghold.

iv. Nidhis: Growth faster than bank credit (from a small base).

v. Indigenous Bankers (Based on estimates provided by the Bombay Shroffs Association): Declining sharply.

Relevant figures for the first four categories are to be found in the respective chapters of the report.

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8. Survey of deposits with Non-Banking Companies conducted annually. These surveys exclude non company intermediaries.

TABLE 8.1

Aggregate Estimates of Urban Informal Credit in India by Sector of Use

(Rs Crore)

	Sector	Year	Estimate		
			Low	Middle	High
1.	Private construction of	84-85	-	**865**	-
	which Housing (Private residential buildings)	84-85	-	559	-
2.	Small scale industry	Low:Jan,85 High:86-87 Mid:Ave	5840	**8953**	12066
3.	**Road construction**	**86-87**	-	**454**	-
4.	**Road transport, related** services and storage	**84-85**	-	**1391**	-
	of which road transport	Low:86-87 High:Jan,85 Mid:Ave	1040	1232	1423
5.	Trade, hotels & restaurant	84-85		**54472**	
	of which trade	Low:Jan,85 High:84-85 Mid:Ave	36759	51673	66586
6.	Recreation, entertainment & personal services	85-85	-	**1184**	-
7.	Public limited companies	84-85		**11871**	
8.	Private limited companies	85-86		**1214**	
9.	Urban household informal debt	81-82		**1193**	
9.	**Total informal credit**	-	-	**81597**	-
	of which estimated black money used in businesses			35849	
10.	**Net total**			**45748**	
11.	**Gross bank credit(P)**	March 87		**62543**	
12.	Ratio of (10) to (9) (%)	-		56.07	-
13.	Ratio of (9) to (11) (%)	-	-	130.63	-
14.	**Ratio of (10) to (11) (%)**	-	-	**73.15**	-

Notes: 1. P: Provisional
2. Years/dates given are for aggregate figures used to inflate sample estimates. Stock credit figures may be taken to prevail at the mid point of periods in cases where flow aggregate figures were used.
3. For the basis of estimates see the Appendix.

TABLE 8.2

Aggregate Estimates of Credit and Deposits Activity of Informal Intermediaries

(Rs. crore)

Sector/year	Advances			Deposits		
	Low	Middle	High	Low	Middle	High
1. Hire purchase	1555 (March 1987)	3759 (June 1987)	-		2827 (March 1987)	
2. Finance corporations (December 1986)		692			692	
3. Chit funds (March 1986)	2394	8163	8260	2394	8163	8260
4. Nidhis (March 1986)	-	70			74	
5. Peerless General Finance and Investment Company (December 1987)	-	26			612	
6. Indigeneous Bankers		1084			361	
7. Subtotal for major intermediaries		13794			12729	
8. Trade credit, friends & relatives and other informal intermediaries	-	31954				
9. Total		45748				
10. Gross bank credit/deposits		62543			108411	
11. Ratio of (6) to (9) (%)		22.06			11.74	

Note: See Appendix for basis of estimates.

TABLE 8.3

Sectoral Estimates of Informal Credit Based on Field Data

(Rs. Crores)

Sector	Date/year of estimate	Informal credit
Garment exporting units	86-87	259
Powerloom units	86-87	914
Film production		279
Intercorporate funds markets	March 86	
Public sector		3392
Private sector		600

The Basis of Aggregate Estimates.

1. **Housing (private residential construction)**:Ratio of total cost of new housing stock of homeowners to housing finance from external (informal) sources in V.D.Lall (1984),'Housing Finance In India' NIPFP, New Delhi, and gross fixed capital formation in housing, National Accounts Statistics, 1987.

2. **Private Construction:** Proportionate increase by relevant aggregate statistic using (1).

3. **Small Scale Industry**: Low estimate: Proportion of non-institutional credit to formal credit in RBI, Survey of Small Scale Industrial Units, 1977, and Scheduled Commercial Banks advances to small scale industry from RBI, Report on Currency and Finance, 1986-87.

High estimate: Ratio of noninstitutional credit to value of production and value of production of small scale industry in the same sources respectively as for low estimate.

4. **Road Construction**: Informal credit is estimated using Gross Capital Formation in Roads and Bridges in the Public Sector from National Accounts Statistics and sample ratio of informal credit to value of production.

5. **Road Transport**: Low estimate: As for high estimate for small scale industry, using RBI Survey of Traders and Transport Operators, 1978-79 and number of vehicles (of different types) in 1984-85 from Basic statistics relating to the Indian Economy,1986.

High estimate: As for low estimate of small scale industry using the same source of aggregate data and using the RBI Survey of Traders and Transport Operators for the informal to formal credit ratio.

6. **Road transport, related services and storage**:As for (2), using the middle estimate of (5) and value added proportions.

7. **Trade**: Both low and high estimates as in (3), but using RBI survey of Traders and Transport Operators,1978-79 for survey data and gross value added for the high estimate. Aggregate gross value added was taken from National Accounts Statistics, 1987.

8. **Trade, Hotels and Restaurants**: As in (2), using (6) and value added on the middle estimate.

9. **Recreation, Entertainment and Personal Services:** Residual Estimate using value added with and without this

sector from the National Accounts Statistics, 1987.

10. **Public and Private Limited companies:** Sample figures from 'Finances of Public Limited Companies 1982-93 to 1984-85', RBI Bulletin, May,1987 and 'Finances of Private Limited Companies', RBI Bulletin, September, 1986, using residual category of borrowed funds (Item 14(iii)) and Trade Dues and Other Liabilities (Item E).

11: **Urban Household Informal Debt**: RBI All India Debt and Investment Survey, 1981-82, and household population figures from Census of India, 1981.

12. **Black Funds Employed**: Average proportion of credit from friends, relatives, directors, partners and shareholders for combined samples of wholesale trade, powerloom units, garment exporters and road construction contractors applied to estimate of total informal credit in Table 8.1.

13. **Hire Purchase**: Low estimate: Federation of Indian Hire Purchase Associations for 1982-83 and estimated growth rate of stock on hire in sample.

High estimate: Number of hire purchase companies from Nayar (1984) and growth rate of average deposits per company from RBI Survey of Deposits with Non-banking Companies for the years 1982-87.

14. **Finance Corporations**: Based on Nayar (1984) for numbers and RBI Survey of Deposits with Non-banking Companies for deposit growth using the fact that deposits were almost equal to advances for sampled firms.

15. **Chit Funds**: Low estimate: based on average deposits/advances per company in rupee years per year multiplied by number of companies in RBI Survey of Deposits with Non-banking companies,1986.

Middle estimate: average across sample firms of twelve times the monthly subscription, multiplied by number of firms from the RBI as in low estimate.

High estimate: Ratio of deposits in rupee years per year to monthly subscriptions per sample firm multiplied by RBI figures of deposits with chit companies.

16. **Nidhis**: RBI figures from Survey of Deposits with Non-banking Companies, 1986 for deposits. Deposit figure multiplied by sample ratio of advances to deposits for advances.

17. **Indigenous Bankers**: 25 per cent of the estimate in Timberg and Aiyar (1980), since the Bombay Shroffs estimate that business has declined by this percentage of the 1980 level.

18. **Trade Credit, etc.**: Residual estimate using total informal credit estimate from Table 8.1.

CHAPTER 9

REGULATION OF INFORMAL INTERMEDIARIES

9.1 The current regulatory environment

9.1.1 Regulations governing informal intermediaries have been briefly alluded to in Chapter 6 and described in more detail in the case studies.

9.1.2 Currently, the following major laws or directions in force govern the workings of non bank intermediaries aside from special acts governing chit funds and hire purchase the latter being ineffectively enforced if at all.

i. The Non-Banking Financial Companies (Reserve Bank) Directions, 1977 (as amended upto 1984). (abbreviated NBFD)

ii. The Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977 (as amended upto 1984). (MNDB)

iii. The Residuary Non-Banking Companies (Reserve Bank) Directions, 1987. (RNBD)

iv. Chapter IIIB of the Reserve Bank of India Act, 1934 (which came into force in 1963).

v. Chapter IIIC of the Reserve Bank of India Act, 1934 (which came into force in 1983).

vi. Chapter V of the RBI Act, 1934.

9.1.3 In addition ineffectively enforced money lenders acts impose interest rate ceilings in various states in India.

9.1.4 Chapter V relates to penalties for violation of a various Provisions and Directions laid down by the RBI.

9.1.5 Chapter IIIB applies to all incorporated non-banking deposit taking institutions and other non-bank financial institutions. The chapter defines the powers of the Reserve Bank over these institutions with respect to:

i. Issuing advertisements and other promotional material

ii. Information it is empowered to call for

iii. Directions it may issue

iv. Inspection and

v. Soliciting of deposits by such institutions.

9.1.6 Chapter IIIC appears to be an attempt to plug the loophole with respect to unincorporated bodies which came to light in the Sanchaita case and in other similar cases. The main provision of this section limits the number of depositors which an unincorporated body can accept to 25 per partner (or individual in case of an unincorporated association of individuals) and 250 overall. Certain powers of search, in case it is suspected that the number of depositors exceeds this limit, are also laid down under this section, the Reserve Bank recently took action against fly by night 'blade companies' in the states of Karnataka and Kerala which had sprung up in recent years. These firms are dealt with in greater detail elsewhere in the report.

9.1.7 The three sets of Directions apply to different groups of informal intermediaries. All of them however apply only to companies as defined in section 45I(a) of the RBI Act, 1934 and not to other unincorporated firms. All three sets of directions place limitations on the duration for which deposits can be accepted. In addition both Directions of the year 1977 lay down ceilings on the ratio of net owned funds to deposits. Deposit interest rate ceilings applicable to most firms are laid down in NBFD and MNBD and a cash "reserve ratio" for certain firms in also laid down in NBFD. As discussed earlier RNBD, which applies to Peerless, lays down stringent requirements for the loan portfolio allowed.

9.1.8 As can be seen from the brief description given above, all three sets of Directions as also Chapter IIIC are in the nature of quantitative restrictions on the extent of deposit taking business of an intermediary. Furthermore, deposit interest rate ceilings and restrictions on loan portfolios are also laid down.

9.1.9 The Chit Fund Act, 1982 lays down certain provisions to ensure that subscribers interests are protected but also provides ceilings on the duration of chits and the maximum bid in auction chits, the latter amounting to an interest rate ceiling. These ceilings, it is argued in the case study, are undesirable.

9.1.10 A Hire Purchase Act is also on the statute books though it is yet unenforced.

9.1.11 Finally, a Hundi Code Bill, drafted by the Rajamannar Committee (1978) in consultation with various business and shroffs organisations and which is seen by businessmen to be progressive, has yet to be tabled in Parliament.

9.1.12 In the light of our discussion currently in the previous paragraphs it is easy to see that, if enforced properly, the major laws governing informal credit intermediaries will stifle the healthy development of informal financial markets. Directions for information returns and for advertisements and also the powers of the RBI under Chapter IIIB appear, however, to be adequate for the formulation of suitable monitoring schemes. Also, as the case studies show, the current corpus of regulations does not in any way prevent questionable firms from winning the approval of the RBI or from indulging in counterproductive activities. It should be clear, without further discussion, that a drastic overhaul of the regulatory corpus and also its enforcement machinery is called for.

9.2 Self regulation:

9.2.1 Many shroffs' organisations and associations of traders have elaborate self-regulation and arbitration committees. In Calcutta, a traders association even has a two-level appeals structure. Due to the implicit threat of ostracism these organisations are reported to be remarkably effective. They are also much faster and cheaper than the courts (See also Timberg and Aiyar (1980)).

9.3 Government regulation at work:

9.3.1 Four cases of government regulation are discussed in the report. The first case study documents the progressive stifling of shroffs of Western India by regulations such as Chapter IIIC and requirements under the Income Tax Act that payments above a certain size by made by cheques rather than, say, hundis. The second case study concerns the government's attempts to regulate the intermediary firm Sanchaita Investments. Due to a weakly made out case the Supreme Court quashed legal proceedings against Sanchaita, even while acknowledging that it paid interest on deposits out of fresh deposits and had a questionable loan portfolio. The third case, that against the 50 years old Peerless General Finance and Investment Company was also thrown out of the courts since the Reserve Bank tried to classify the firm as a banned 'prized chit/money circulation scheme'. This classification is difficult to accept. In fact, though Peerless' activities were in some cases arguably sharp, it was by and large an innovative and dynamic financial intermediary. Thus the wisdom of attempts by the Reserve Bank to suppress it completely can be questioned. The fourth case relates to the RBI's action against finance corporations known as 'blade companies' in Kerala. These companies had expanded greatly in the wake of the sharp increase in remittances from Indian workers in the Persian Gulf. Many more clearly unsound and 'fly-by-night' firms took advantage of gullible depositors and secured borrowers alike. While the RBI succeeded in identifying and bringing action against a number of unsavoury firms, their action caused runs by depositors on a large number of finance corporations. In the process, several corporations, which were not fly-by-nighters, failed due to runs on them by depositors. It is not clear, that the RBI's action in this case was misguided, but the fact remains it that did have partially negative consequences.

PART C

ANALYSIS OF ECONOMIC IMPACT OF INFORMAL CREDIT MARKETS

CHAPTER 10

INFORMAL CREDIT AND THE EFFICIENCY OF RESOURCE ALLOCATION

Concepts of efficiency for financial markets

10.1.1 In analysing the efficiency of resource allocation, the ultimate focus must be on the nonwastefulness of factor use and on the allocation of factors to the most socially productive purposes. To analyse the impact of credit on the efficiency of resource allocation, a framework is required that relates credit availability and the cost of credit to these.

10.1.2 Tobin (1984, quoted in Fry, 1988) lays down four concepts for judging the efficiency of a financial system:

a. **Information arbitrage efficiency:** which is the degree of gain possible by the use of commonly available information. Efficiency is inversely related to the gain.

b. **Fundamental valuation efficiency:** The extent to which the present discounted benefits stream from an asset are reflected in its price.

c. **Full insurance efficiency:** The extent of hedging possible against future contingencies.

d. **Functional efficiency:** This is reflected in the transactions cost of borrowers and lenders combined (lower transactions costs reflect more functionally efficient the market). An extended discussion of this concept is in Fry (1988).

10.1.3 Implicitly, these concepts reflect the impact of credit markets on the efficiency of resource allocation. However, while information arbitrage efficiency and functional efficiency are certainly concepts which can be used in judging the relative efficiency of different components of a financial markets, the other two concepts are more difficult to apply. Valuation efficiency is certainly lowered by a credit market segment which is subject to quantitative controls and administered prices. However, freely functioning markets may ration credit and keep loan rates of interest below their market clearing level in a world in which there is asymmetric information and incomplete contingent markets, implying some degree of inefficiency by the full insurance criterion (see Stiglitz and Weiss (1981) and Santomero (1984)).

10.1.4 However, while accepting that actual credit markets will depart from full efficiency, it is still possible to examine the relative efficiency of resource allocation facilitated by different market participants if a set of criteria can be laid down to judge efficiency. A crude set of criteria that can be used to judge the impact of formal and informal credit on the efficiency of factor use in the Indian situation are the relative magnitudes of three ratios by firms primarily supported by formal/informal credit. The ratios are the capital-output ratio, the labour-output ratio and the capital labour ratio.[1] The rationale is as follows. In the Indian situation, the formal sector keeps rates of interest below their market clearing levels and rations credit through selective credit controls. Consequently, it can be expected that firms with access to formal credit will have an overly capital intensive choice of techniques, which detracts from the efficiency of factor use. Furthermore, due to less than perfect credit rationing, inefficient firms may receive finance while efficient firms are rationed out of the market. Inefficient choice of techniques are reflected in the capital-output ratio while relatively inefficient factor use is reflected in the factor ratios for firms within the same industry. It should be pointed out that low factor use ratios are neither

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1. The relative ranking by any two ratios do not necessarily determine the relative rank by the third. For example, suppose firm A has both factor output ratio higher than from B. The capital/output ratio ranking is still indeterminate.

sufficient nor necessary as proof of inefficiency. Furthermore, unless there are constant returns to scale a higher capital output ratio for a firm may simply reflect a different scale of operations compared to another firm.[2] Likewise, capital labour ratios may reflect nonhomotheticity. The measures are therefore crude. Thus, whenever it is possible to supplement the evidence of the ratios with direct evidence this is done.

10.1.5 Even if it is accepted that formal credit leads to inefficient factor use, it is by no means clear that the informal sector leads to relatively efficient capital use. This is since informal credit markets are themselves imperfect and segmented. Furthermore they can and do ration credit (by, for example, lending to known parties only in some segments). Informational considerations may also lead to suboptimal interest rates.

10.1.6 So much for factor use. It is much more difficult to judge the relative impact of the ICM on the efficiency of resource allocation to different activities. While, in an absolute sense, segmentation and rationing imply misallocation of resources, the position relative to the formal sector is still not clear. We restrict attention to the relative impact of informal credit on the mobilisation of saving and the financing of illegal activity, since there can be little doubt that greater aggregate saving in the current context Is to be desired socially. We now turn to the evaluation.

10.2 Impact on the efficiency of resource use

10.2.1 The ratios are presented for three productive sectors in Table 10.1. As can be seen, in no case do the ratios provide unambiguous support for the hypothesis that informal credit increases efficiency of resource use. More importantly, no single ratio supports the hypothesis for the item measured by it in all sectors. In fact, in road construction, informal borrowers are

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2. I am grateful to T.N. Srinivasan for these observations.

less efficient than formal borrowers by the factor use ratios. Thus no firm global conclusion can be drawn.

10.2.2 Additionally, a regression with interstate data of the capital output ratio on the informal credit/formal credit ratio for a pooled sample of the four RBI surveys of firms, revealed no link between the two.

10.2.3 The most striking piece of direct evidence that has come to light concerns the finance of used vehicles by auto-financiers in Namakkal and by hire-purchase firms in Delhi. Since interest rates on such loans can exceed 40 per cent per annum, the gross rate of return on such vehicles must clearly be very high. That transport operators who receive cheap bank finance are able to dispense with these vehicles, in a capital scarce economy, suggests that informal finance eases the bias towards the under-utilisation of scarce capital that arises due to the cheap interest rate policy of the formal sector. It should be clear that it is inappropriate to attribute social costs due to environmental pollution or congestion, if any, to a private sector source of finance.

10.2.4 In the study of the textile distribution system in India, where most credit and goods market transactions are jointly made, we argue in the report using a three-agent model based on the stylised facts of the system, that informal credit lowers distributional costs and distributes the cost of risk arising from demand uncertainty. That is, we argue that informal credit contributes to more efficient resource utilisation in trade.

10.3 Impact on the efficiency of sectoral resource allocation

10.3.1 Relatively more informal finance goes for consumption than formal finance. However, much of this credit is for housing investment. Nidhis and to a lesser extent finance corporations, contribute directly to capital formation in housing construction. Also, the majority of consumption loans go to groups who are asset poor. It is not clear that additional savings by such groups is necessarily in the social interest at all times.

10.3.2 In the absence of information on the interest elasticity of saving and on the degree of substitutability of different assets, it is difficult to estimate the additive savings impact of informal financial markets. However, such markets clearly contribute greatly to gross savings and chit funds, nidhis and Peerless may be singled out for special mention in this respect. The characteristics of nidhis and chit funds and the performance of Peerless, make it likely that additive contributions to savings are partially reflected in their deposit figures. Other factors that are normally held to aid savings, like higher deposit interest rates, increasing extent and diversity of financial intermediation and, in some cases higher income caused by more productive resource utilisation as with auto-finance, are clearly present.

10.3.3 Regarding the finance of illegal or undesirable goods and foreign exchange rackets, there is a clear presumption that informal credit markets lead to a greater provision of such goods than would otherwise be the case. However, by its very nature, such activity is hard to assess quantitatively (for qualitative evidence see Chapter 14). However, it should be noted that `market rumours' of formal sector financing are equally prevalent.

10.4 Information arbitrage efficiency

10.4.1 While fragmentation of the informal credit market ensures that they are functionally inefficient, examples of easily available arbitrage opportunities can be found for formal financial markets as well (See for example Das-Gupta 1989). On the other side of the balance, the case of `piggy back' intermediaries for life insurance shows how the informal sector takes advantage of arbitrage opportunities due to formal and informal sector price differentials.

10.5 Functional efficiency

10.5.1 Difficulties in decomposing loan interest rates for similar loans by intermediaries makes it impossible to directly compare relative establishment costs. However, three pieces of evidence indicate that informal sector intermediaries are more functionally efficient than banks.

10.5.2 Firstly, the impressions of all researchers who have examined the problem is that establishment costs of the informal sector are low compared to the formal sector. Without quantitative government restrictions, they would possibly be even lower in some submarkets due to scale economies. For example, we find that establishment costs of shroffs have risen due to the reduced scale of their operations in the wake of government regulation. Secondly, default costs of banks are known to be high. Nayar (1987) report commercial bank default rates of as much as 70 per cent of loans in some bank branches. Since commercial bank loan defaults are not revealed in their published accounts, accurate quantitative assessment for the sector as a whole is not possible. Finally, in field interviews with borrowers and depositors, with some exceptions for borrowers from finance companies and chit funds, convenience and incidental costs for informal credit markets were found to be smaller than for formal credit markets. In two cases where quantitative details could be found or calculated, effective informal sector costs to clients were found to be lower than formal sector costs.[3] Thus, by these criteria relative functional efficiency of the informal market is supported.

10.5.3 One remaining puzzle about informal credit costs needs to be addressed. It has been argued that the main component of informal sector interest on loans is the deposit interest rate and opportunity cost of own funds. But, why is this so with respect

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3. The cases are loans to textile wholesale traders and funds remittances through commercial instruments versus darshani hundis.

to deposits costs? Put another way, how can commercial banks, which have high inconvenience costs to depositors and also low deposit interest rates attract deposits despite the fact that informal intermediaries offer higher deposit rates and, for example in the case of nidhis, an equally large array of deposit schemes? Is it the case that these the interest rate differentials between formal and informal sector reflect hidden risk costs of deposits with informal depository institutions?

10.5.4 Except in the case of deposits with a section of finance corporations, we would argue that this is not the case. The primary reason for the differential is, we expect, the fact that bank branches are within easier reach of most depositors than offices of informal institutions. Secondly, informal intermediaries tend to locate near their loan clients to enhance information gathering potential and convenience to borrowers. In business areas, given restricted credit availability, the opportunity cost of deposits would not be reflected by bank deposit rates. Current accounts with banks, of course, reflect their regulation induced monopoly for certain kinds of payments.

10.5.5 Additionally, for loans from friends and relatives (at, it has been found, upto 18% per annum), chit funds and nidhis, high deposit rates reflect the surplus from high loan rates being passed on to depositors. This is true by the very nature of the first two institutions. In the case of nidhis, historically, these institutions have been set up by public spirited individuals for the mutual benefit of shareholders (which includes all depositors and borrowers).

10.6 Conclusions

10.6.1 While no global conclusions can be drawn, it is clear that in some, though not all, respects informal credit does contribute to more efficient resource utilisation particularly from the point of view of functional efficiency. However, it is difficult, given current research, to come to an unambiguous ranking of the formal and informal sectors.

TABLE 10.1

Efficiency Ratios for Productive Sectors

Sector	Capital-output ratio	Labour-output ratio	Labour capital ratio
1. Road Construction			
All borrowers[1]	0.349	1.197	3.43
Informal borrowers	0.233	3.809	16.35
Formal borrowers	0.079	1.037	13.13
2. Garment Exporters			
Informal borrowers	0.23	0.56	2.43
Formal borrowers	0.35	0.33	0.94
3. Powerlooms			
All borrowers	0.085	0.40	4.71
Informal borrowers	0.141	0.30	2.14

Notes: 1. Includes non-borrowers and borrowers from both sources.
2. Informal Credit excludes trade credit: All firms in these sectors are substantially dependent on trade credit.

EQUITY IMPACT OF INFORMAL FINANCE

11.1 Evaluation criteria

11.1.1 The relevant criteria here are firstly, the percentage total borrowed funds from informal credit sources received by smaller, presumably economically weak, units both absolutely and relative to large units. Secondly, for intermediaries, the criterion is the extent of finance going to economically disadvantaged sections both absolutely and relative to formal finance. The data summarised in Table 11.1 shows that informal finance to borrowers scores positively on both counts except that it fails the test relative to formal finance for transport operators. However, for these units the data bias in looking only at bank assisted units is particularly severe since vehicle finance is the major cause of borrowing. The sharp growth of hire-purchase (which is chiefly directed at vehicle finance) in India shows that substantial numbers of transport operators in India, especially of used vehicles, depend on informal finance. Thus, overall the conclusion must be of a positive association between urban informal finance and economically weak sections.

11.2 Cause and effect

11.2.1 Are weaker sections weak because of exploitative informal finance or despite it? At one level, the answer to this question does not matter: if borrowers can be taken to reveal their preferences for some informal finance to none, then informal finance is clearly welfare improving. However, if it is exploitative then this alone is insufficient and informal credit should be supplanted by non-exploitative sources of credit if possible. The direct evidence of borrowers in studies of intermediaries and in credit using sectors referred to earlier leads us to reject the hypothesis of universally exploitative informal credit, though in some relatively minor sectors this is the case with urban informal finance. This is despite the evidence, albeit not global, of higher informal sector interest rates.

11.3 Summary of disaggregated findings

11.3.1 Regarding specific intermediary sectors studied, the following brief remarks summarise the position. The evidence on chit funds, auto-finance in Namakkal, handloom finance and, to an extent nidhis, clearly shows that these sectors help small business and small borrowers and depositors. Hire-purchase has the opposite bias while Sanchaita and, probably, Peerless exploited small depositors. Bhole (1985) found that trade credit is of more importance to small rather than large firms in the company sector. Finally, the provision of informal finance to the textile distribution system, it has been argued, has positive inter-regional distribution effects.

11.4 Conclusions

11.4.1 We must conclude that informal finance is, by and large, welfare improving for economically weak sections. Regarding the position of informal finance relative to repressed formal sector finance, it is worth quoting the conclusions, regarding formal finance, of two recent studies. Little (1987), concluding on the basis of a study of small manufacturing enterprises in a selection of developing countries (including India) has this to say:

> " The tentative conclusion seems to be that controlled capital markets of most developing countries are likely to penalize the large-small or medium size firms (covering about 20 - 100 workers) that aspire to rapid growth and therefore cannot rely on their own finance. Unless they are in a specially favoured sector, either interest rates will be higher or access more difficult than with free capital markets (Little (1987), p. 221)".

Fry (1988) examines the available evidence for a selection of developing countries (excluding India) and concludes:

> "Specifically, financial repression and the ensuing credit rationing worsen income distribution and increase industrial concentration. The evidence presented ..... indicates that subsidised credit policies discriminate against rather than favor small borrowers, (Fry (1988), p. 165).

TABLE 11.1

Percentage of Total Borrowings from Informal Sector

	Sector	
	Large	Small
A. Field Studies		
1. Road construction (1)	93	78
2. Garment exporters (1)	67	62
B. RBI Surveys		
3. Small-scale industries(3)	55	39
4. Traders	72	61
5. Transport Operators(3)	31	20
6. Households (4)	80	41

Notes:
1. Below and above the sample mean
2. Market value of fixed assets less than Rs 1 lakh
3. Assets less than Rs 10,000.

CHAPTER 12

ARE INFORMAL AND FORMAL FINANCE COMPLEMENTS OR SUBSTITUTES ?

12.1 Three types of situations need to be distinguished here.

i. The first type of situation is where banks do not enter or are unable to enter a particular market segment, or when informal finance cannot substitute for bank finance. In such cases, formal and informal finance are clearly complementary. Most case studies in this report found this type of situation prevailing due to banks being unable or unwilling to compete with informal lenders and also (especially) trade credit. In one case study of a credit using sector (road construction), informal financial instruments were not acceptable as a substitute for bank guarantees.

ii. The second situation is when banks provide credit but up to a ceiling amount. In such cases, informal finance complements the credit flows to a particular section of credit constrained borrowers or the credit flow for particular uses. The inter-corporate funds market, field studies of productive and trade sectors, chit fund operations, loans against jewellery by nidhis and to a partial extent, hire-purchase, fall into this category.

iii. The third situation is when banks and informal intermediaries are in active competition. This does not appear to be the case in any loan market, though it is largely the case for the mobilisation of deposits by some, though not all informal intermediaries and. One area in which informal and formal sectors are in competition, to the latter's disadvantage, is in the transfer of funds between geographical centres. Informal couriers, known as `angadias' are seen as superior to banks by many businessmen.

12.2 A second finding relevant to the discussions here is the opinion of borrowers of the two sources of credit. In all field studies of credit using sectors and of borrowers from particular intermediaries informal credit was broadly speaking, viewed positively due usually to the expected speed and informality (and in some cases, low cost) of informal credit while bank credit was viewed negatively. Dockyard financiers in Calcutta and some finance corporations were the exceptions.

12.3 It is difficult to conceive of an aggregate statistical exercise which will reveal support or the lack of support for the kinds of situations outlined in the first paragraph. However, a positive link between formal and informal credit, both taken as the ratio of some indicator such as sales,[1] will support the hypothesis of complementarity. In order not to reflect scale effects, correlation coefficients of the two ratios mentioned above were computed from the RBI surveys of firms using interstate data. The coefficients (in percentage) were found to be as follows:

Correlation Coefficients Between the Ratios of Informal Credit to Sales and Formal Credit to Sales (Inter State Data)

Small-scale industry	61.04	(n=14)
Wholesale trade	39.46	(n=19)
Retail trade	29.25	(n=19)
Transport operators	-3.42	(n=18)

Thus, the hypothesis of complementarity finds weak support in the case of small-scale industry alone, but has the right sign for trade. The aggregate evidence may be taken to be inconclusive.

12.4 Thus, given the current state of banking, complementarity is supported by micro studies but not necessarily by the regional evidence. Given the discussion in the previous paragraphs, it would appear that the formal and informal sector specialisation in some areas identified in the micro studies should be deliberately strengthened.

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1. RBI surveys of productive units strongly suggest economies of scale in total credit use so that credit figures need to be corrected for scale by using figures such as for total sales.

12.5 At the aggregate level, defining complementarity and substitutability by the usual cross elasticities is feasible. Thus, if an expansion in bank credit (or a lowering of bank loan rates with no interest rate controls) leads to a decline in informal credit, other things equal, then they are substitutes. Furthermore, other things equal, if an increase in bank deposit rates causes informal credit demand to decline they are, once more, substitutes. The available evidence, cited at the beginning of the next chapter, is mixed.

CHAPTER 13

INFORMAL CREDIT AND MONETARY POLICY

13.1 Prior evidence and issues

13.1.1 Does informal credit frustrate short-run monetary policy? Limited evidence is available on this issue. Acharya and Madhur (1983) argue that excess demand for constrained formal credit spills over into the ICM driving up ICM loan rates in times of restrictive central bank operations thus leading to an overall credit squeeze. They test this with data relating to 'bazaar bill rates' (this RBI data series was discontinued in 1977) and find support for their hypothesis. Sundaram and Pandit (1983) criticise the data used by Acharya and Madhur and show that the conclusion is sensitive to the data series used. The debate in India between Acharya and Madhur on one side and Sundaram and Pandit on the other is inconclusive.

13.1.2 Fry (1988) cites studies relating to the Korean economy and concludes that time deposits in the formal sector are closer substitutes to assets which are primarily inflation hedges rather than to curb market loanable funds which are relatively insensitive to time deposit rates in a three asset portfolio model. On the basis of the econometric evidence he concludes that

> " ....an increase in the time deposit rate of interest would lead to an increase rather than a decrease in the total supply of credit in real terms", (Fry (1988), p. 161).

Edwards (1988), studying the Korean economy, finds a positive link between deposit bank time rates and curb market loan rates.

13.1.3 The relevant issues, to our way of thinking, revolve on five points.

i. Does lower money supply (including bank credit) necessarily lead to a fall in total credit availability (or can informal credit counteract this sufficiently)?

ii. A related point, do movements in the bank loan interest rates lead to general movements in informal loan interest rates or credit in the same direction?

iii. Is the opposite of (ii) true for bank deposit rates?

iv. Can selective credit controls, which are used in India, be effectively imposed in the face of informal credit?

v. Even if all four questions are answered in the affirmative, is the credit multiplier the same as it would be in the absence of informal credit (or is it lower or less prodictable)?

If the answer to all five questions is in the affirmative then the hypothesis that informal credit frustrates monetary policy can be rejected.

13.2 Evidence

13.2.1 Firstly, the sheer size of informal credit markets and their likely rapid growth argues against points (iv) and (v). Secondly, the links with the black economy (see below, chapter 14) and the estimated size of productively deployed black funds (Chapter 8) strengthen this position. Thirdly, the rapidity with which informal credit is deployed could go against the third point above for short run monetary policy but is not, by itself, conclusive. While detailed time series evidence is lacking, the evidence in Tables 13.1 and 13.2 tends to argue against the first two points for short run monetary policy except in the case of nidhis who make up only a small part of the informal credit system (Chapter 8, Table 8.2). However, over a longer horizon, interest rates in informal and formal sectors do appear to move together.

13.2.2 To go into sectoral detail, the following observation may be made. Except for the inter-corporate funds market, no evidence has been found of short run responsiveness of informal credit to formal interest rates or credit availability. However, the cross section nature of the study is a limitation that has to be kept in view. The hypothesis that the inter-corporate market increases the variability of the money multiplier and reduces the effectiveness of selective credit controls has been advanced in the report though the evidence is not of the type permitting a firm conclusion to be drawn.

13.2.3 Trade credit and on-lending in general rises serious doubts on the effectiveness of selective controls. The findings of Bhole (1985) may be cited for other points. Bhole used Reserve Bank of India data on the company sector for the years 1952 to 1978 to study the impact of trade credit on monetary policy. In the study he examined inter alia, the effect of the short run bank lending rate and bank credit availability on trade dues, trade receivables, net trade credit and the credit period of dues and receivables in days. His results give affirmative support to points (i) and (ii) above though the evidence is not always robust. However, his findings tend to reject an affirmative answer to point (iv). There were some differences between different groups of companies for the impact on the volume of trade credit though not the credit period. In sum, his results argue for a weakening of the predictability of monetary policy for the company *sector but not for its frustration in terms of direction.

13.2.4 In conclusion, the limited evidence presented here argues for a weakening of the impact of monetary policy with the informal sector either unresponsive or, in the case of trade credit, counteracting monetary policy. However, complete frustration of monetary policy cannot be inferred from the evidence here. The question is, therefore, still open.

13.3 Towards a short run macromodel with informal credit markets

13.3.1 Work on macro models with informal credit include work by Rakshit (1982, 1987), Taylor (1983), Van Wijnbergen (1983), Buffie (1984) and Chang and Jung (1984). Of these, the work of Rakshit is based on the stylised realities of Indian experience.

13.3.2 Rakshit (1982) examines the consequences of informal credit in a model in which a pivotal role is played by wholesalers who demand credit for inventory investment and who have access to both formal and informal (organised and unorganised in his terminology) loan markets. The supply of organised sector loans is fixed exogenously as is the interest rate. Demand for loans then depends on the return to inventory investment relative to loan rates and the formal sector constraint. Since the supply of formal loans is rationed, there is a discontinuous demand function for informal loans. He then goes on to show how a change in bank loans can either raise or lower informal rates depending on if the supply curve of informal loans passes through the discontinuity in the demand curve or not. However, expansion (contraction) in bank credit does result in more (less) credit to wholesalers. It is difficult to determine if this result will continue to hold in the face of stylised facts of Indian ICMs thrown up by this study to which we now turn.

13.3.3 An important stylised fact that must be taken note of in a properly specified macro model is the fact that formal sector interest rates have little relation with Informal rates. On the deposit side this is because of limited access by most depositors to informal deposit channels due mainly to geographic or informational barriers. On the loan side this is because of formal sector credit restrictions.

13.3.4 A second stylised fact is the existence of implicit contracts (long standing relations) in markets for trade and sometimes production finance leading to stable nominal informal interest rates.

13.3.5 A third fact is that informal markets are subject to quantitative controls on deposit taking and interest rate restrictions in some cases.

13.3.6 The consequences of fragmentation and links with the black economy must also be explored. Dasgupta and Ray (1989) study aggregate demand with a black economy but without an `white' informal market. Rakshit (1987) studies fragmentation.

13.3.7 Clearly, adequately accounting for these factors in a parsimonious macro model is no easy task. However, it is essential to attempt such a task if proper appreciation of the short run impact of ICMs is to be had.

TABLE 13.1

Growth in Aggregate Advances/Credit of Informal Intermediaries and Banks, 1982-1986

(Per cent per annum)

Year	Bank	Nidhis	Finance Corporations	Chit Funds
1982	17.68	(1.3)	(0.14)	33.1
1983	19.54	14.47	(5.09)	9.2
1984	15.75	11.2	(18.66)	67.6
1985	17.90	52.2	(15.55)	15.4
1986	14.52	21.7	(13.81)	56.7
Rank correlation with Banks	100	90	30	-90

Note: Negative figures in parentheses.

Sources:
1. RBI, Report on Currency & Finance, Various Issues.
2. Field Surveys.
3. RBI, surveys of deposits with non banking companies, various issues.

TABLE 13.2

Interest Rates of Banks and Informal Intermediaries

(Per cent per annum)

Year	Bank	Finance corporations	Hire-purchase companies	Shroffs
1970-71	9.3	NA	18-30	15
1980	16.5	NA	NA	18
1982	16.5	18-29	NA	NA
1983	16.5	19-31	NA	NA
1984	16.5	22-33	35	NA
1985	16.5	25-36	37	NA
1986	17.5	32-37	38	NA
1988	16.5	NA	38	21

Sources: As in Table 13.1 notes 1 and 2 and Bombay Shroffs Association.

CHAPTER 14

TWO ISSUES: COMPLEMENTARITY AND LINKS WITH THE BLACK ECONOMY

14.1 The McKinnon (1973) complementarity hypothesis[1]

14.1.1 By this hypothesis, financial and physical assets are complements due to the existence of credit constraints and low interest policy as part of repressive formal sector policy. This happens since an increase in the supply of credit adds to the stock of financial assets and while stimulating greater investment activity. The hypothesis has received limited support from cross section intercountry studies (Gonzales Arrieta, 1988). While formally a macro-economic hypothesis, it would find support at the microeconomic level if investment by firms was limited by cash in advance constraints made binding due to supply constraints on credit. Net funds for the purchase of productive factors (as distinct from raw materials or stock in trade) are limited to own funds on average, in road construction and for trading agents in textile wholesale markets (Table 14.1). Thus for specific sectors in India, support for this hypothesis exists. Indirect evidence that such a situation prevails for handloom weavers is also present. At another level, purchase of productive capital in the second hand commercial vehicle markets would appear to be less prevalent in the absence of informal finance. We may tentatively conclude that the hypothesis is valid for a part of the Indian economy, though at the macro-level, no conclusion can be drawn on the basis of this study.

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1. See, among others, McKinnon (1973), Fry (1988), Gonzales Arrieta (1988) and Shaw (1973).

14.2 Links with the black economy

14.2.1 Informal intermediaries studied would obviously not reveal any finance of illegal activity. "Market rumours" indicate such activities on the part of finance corporations, some indigenous bankers and some traders. The Sanchaita and Peerless cases threw up clear indications of links with the black economy, with these institutions allegedly generating black funds and also providing "efficient" means to launder funds. All credit using sectors employed suspected illegal funds in the guise of informal credit (usually from friends and relatives), a suspicion that finds support for the aggregate economy (Chapter 8). In fact, the volume of laundered black funds is estimated to be almost equal in size to total informal credit (Chapter 8). The film finance study reports on black payments in the sector. Finally tax evasion by intermediaries and most firms is generally believed to be widely prevalent in India (Acharya and Associates, 1985). While black economy links have not been a central part of our field investigations, some evidence of links, perhaps strong ones, certainly exists. ADB (1985) expresses the opinion that most black money remains outside the formal credit market. Furthermore, they point out that black funds do play a positive role in promoting saving and investment given formal sector rigidities.

14.2.2 Methods by which informal credit markets facilitate transactions in the black economy have been discussed in some detail by Aiyar (1979) and briefly by Timberg and Aiyar (1980). The main points made by them are the following

a. Black transactions take place through both formal and informal credit markets. Informal markets do not have any <u>necessary</u> link with the black economy and all submarkets do not facilitate black transactions.

b. The film industry, construction, hotel industry and transport sector rely heavily on black funds.

c. The main service of informal intermediaries is to facilitate payments for illegal goods through bank sight drafts while allowing transacting parties to retain their anonymity. The annual volume of such remittances in 1979 is estimated at Rs 450 crore in Bombay alone and Rs 750 crore for the whole of India.

d. The provision of brokerage services, by specialised brokers for the placement of black funds. Loan defaults for black money loans were almost unheard of even if white debts were defaulted. The interest rate on such loans was from 12% to 15% in 1979.

e. Records of black transactions on instructions for disposal of black funds were usually on scraps of paper and in innovative and oft changing codes.

f. The provision of bogus receipts or book entries allowing the laundering of black funds or the concealment of incomes by recording fake expenditure - both for a fee. An agent for these transactions is known as an Havala.

g. The facilitating of `kite flying´ operations by taking advantage of bank cheque discounting and delays in bank collection of outstation cheques. This service is reported to be provided by finance corporations in Kerala. Road receipts and letters of credit are similarly used.

h. Remittances of cash through Angadias.

i. Evasion of foreign exchange restrictions through overseas correspondents and arranging private remittances (the agent in India accepts rupees for remittance and pays out rupees remitted while the correspondent does the same in the foreign currency. No actual funds flows take place).

14.2.3 On the basis of this evidence, limited though it is, we must conclude that the informal financial sector as a whole serves the black economy and employs black funds. However, it should be emphasised that not all informal submarkets serve the black economy. Nor are links with the black economy limited to the informal sector. When the positive features of informal credit are weighed against the negative illegal links, the need for a sector by sector approach to regulation gets emphasised.

TABLE 14.1

Loans and Advances and Borrowed Funds of Credit Using Sectors

(In percentage of total assets)

Sector	Road construction	Garment exporters	Power-loom	Aratiyas textile trade	Textile wholesale traders
Loans and advances	43	39	26	72	57
Borrowed funds	38	70	59	82	37

PART D

INFORMAL CREDIT MARKETS IN RURAL INDIA

CHAPTER 15

INFORMAL CREDIT MARKETS IN RURAL INDIA

15.1. Introduction

15.1.1 Informal credit markets in rural India, unlike urban informal credit markets, have been studied on a more or less sustained basis during the past four decades. The exploitative village moneylender and the indebted rural peasant have, in fact, become a part of the commonly held view of backward South Asia agriculture. Besides several studies by individual scholars, many of them very well known, systematic information on the finances of rural households has been collected by the Reserve Bank of India through its decennial surveys, the first of which was carried out in 1951. Reduction of the dependance of rural households on informal credit and expansion of the overall supply of rural credit has also been a major goal of government policy. Measures include the setting up of an apex development bank, commercial bank branch expansion in rural areas, establishment of specialised financing agencies at various levels of government and strengthening of cooperative financing. Moneylenders acts and related legislation have also been enacted at various times since the beginning of this century to curb usury and informal lending in general.

15.1.2 As a result of these measures and also the gradual modernisation and development of rural India, various changes have come about in rural financial markets.

15.1.3 This chapter provides a brief overview of changes during the recent past and the current state of rural informal credit markets. The chapter is largely based on the study of rural ICMs conducted as part of this study of ICMs by a team from the Centre for Development Studies (CDS), Trivandrum. The CDS study made use of earlier studies and secondary data, besides conducting a questionnaire based survey of six villages. The objectives of the CDS study were based on the common terms of reference discussed in Chapter 1 of this summary report.

15.1.4 The chapter is organised as follows. The next section examines the aggregate size and trends in size of rural credit markets and also interstate variations in the importance of informal credit. Section 3 describes the CDS sample design and describes characteristics of rural household, debt and financial saving. It also describes characteristics of informal credit in the sample villages. The discussion is supplemented where necessary by selective references to earlier studies. Section 4 examines the structure of informal credit markets in the sample villages and also as described in earlier studies. The section includes a consideration of evidence of fragmentation, interlinkage of credit and other markets and determinants of interest rates. Section 5 describes the operations of professional moneylenders, the largest commercial source of informal loans in the sample villages. Section 6 uses sample data and earlier studies to draw some inferences about the allocative and welfare impact of rural informal credit. Concluding remarks are in the final section.

15.2. Size and trends in size of rural financial markets

15.2.1 The major sources of data on the finances of rural households in India are the Reserve Bank of India's All India Rural Credit Survey, 1951 and the three rounds of the All India Debt and Investment Survey (AIDIS) in 1961-62, 1971-72 and 1981-82. These sample surveys were based on All India stratified samples of households. The AIDIS rounds examine both assets and liabilities of households as well as borrowing, saving and investment during the reference year. Summary data from the AIDIS are presented in Table 15.1.

15.2.2 Before examining the Table, it is worth pointing out that there are doubts as to the comparability of the data from different rounds of the survey due to differences in sampling procedures. Essentially, (see the CDS Report, Appendix 1), the sampling procedure adopted, while generating reliable estimates of quantities per reporting household, underestimate the household incidence of any sampled characteristic. Furthermore, the problem of underestimation has been increasing in severity between different rounds. By implication, intertemporal trends revealed by the data are suspect but not necessarily cross section patterns. This caveat should be borne in mind while examining the data.

15.2.3 Parts A and B of Table 15.1 present intertemporal trends in cash dues outstanding of rural households. The data show that the real size of rural household debt has been decreasing between 1961 and 1981 (using the wholesale price index as the deflator), the decrease accelerating over the second decade. However, debt per reporting cultivator household (Part C.2) has increased both in nominal and real terms during these decades. As discussed above, intertemporal trends, except those per reporting household are likely to be biased downward.

15.2.4 The share of informal credit to households has decreased markedly from 85 per cent in 1961 to 39 per cent in 1981. It is likely (CDS (1988), p.23) that this reflects an actual decrease in the quantum of rural credit to households and a shrinking rural credit market (Part E).

15.2.5 Of the various types of informal lenders, agricultural moneylenders may be seen to be losing ground to other lenders. While they were the most important group of lenders in 1961, relatives and friends have this position in 1981. Among commercial lenders, professional moneylenders had almost the same market share as agricultural moneylenders in 1981 though their share in 1961 was only a third of that of agricultural moneylenders.

15.2.6 Finally the proportion of borrowing households continues to be higher for cultivators and the gap between the proportion of indebted cultivator households and non-cultivator households has been increasing (Part F).

15.2.7 Turning to statewise details, Table 15.2 shows that the share of informal credit has declined in all states over the past two decades, though the rate of decline has not been uniform. Consequently, changes in the rank of States according to the importance of formal credit have taken place. The most dramatic change has been that of Assam which moved from the third lowest rank in 1961 to the first rank in 1981.

15.2.8 The share of informal credit is found to have a negative correlation with per capita real State domestic product (-61.01 per cent) but, on the other hand, the rate of decline of the share of informal credit has a negative correlation with both the rate of growth of per capital real State domestic product and the growth rate of per capita real state domestic product from agriculture (the latter being -51.22 per cent). Thus, while informal credit is associated with backwardness, its rate of decline is slower in more developed states.

15.3. Informal credit to households in surveyed villages

15.3.1 The aggregate data presented in the previous section provide no indication as to characteristics of loans from various lenders and to different classes of households. It also fails to provides evidence on the nature of rural informal credit markets. To study these features, a field survey was conducted by the CDS in six villages in Kerala and Tamil Nadu. The survey was limited in coverage due to financial and time constraints. However (Table 15.3), a detailed questionnaire was administered to 408 households selected by stratified random sampling and 30 informal lenders. The survey villages were selected to ensure diversity of village types.

15.3.2 Table 15.4 the lists main findings of the survey regarding cash debt of households. As can be seen (Part A), the relatively small size of the informal market parallels the findings of the AIDIS, though the relative size of the informal sector is smaller than that reported by the AIDIS. However, (Part B), when the position of borrowings during the year rather than debt outstanding at the time of the survey is examined, the share of the informal sector is more significant and even larger than the formal sector in the case of agricultural and other casual labour. The other major difference is the disproportionate share of relatives and friends in informal credit in contrast with the AIDIS.

15.3.3 Kurup (1976) has also studied the credit economy of a village in Kerala. He found, at the time of his survey, that informal credit from `non-professional' moneylenders was the most important source of credit (57 per cent) and that informal credit was far more important than formal credit (86 per cent). Thus, granted that CDS (1988) and Kurup (1976) studied different samples, albeit from the same general area, these micro studies tend to support the decline in informal markets found at the aggregate level.

15.3.4 Further evidence comes from the study by Bhende (1983) who found, for 3 villages in Andhra Pradesh and Maharashtra in 1975-76 to 1977-78, that in 2 of the 3 villages formal credit to households was dominant. Even in the third village, formal credit formed 47% of total credit to households.

15.3.5 Turning to characteristics of informal loans to sample households, Parts C to F of Table 15.4 provide relevant details of loans to households. From the table it can be seen that most loans are small (less than Rs 1500) and for short periods (less than one year). In fact, in some cases, loans for less than a week were found. Across villages, the average correlation coefficient between size and duration of loans was 24% with a significant positive coefficient being observed in only one case.

15.3.6 About 60 per cent of loans were secured with over half of these being secured against immovable property. Thus, the usual presumption that the majority of informal loans are unsecured is found not to be supported. However in the sole village in the sample where informal credit was dominant (Thirunavaya), 95 per cent of informal loans were against personal security. Thus, the hypothesis can be advanced that easy access to formal loans increases the risk of default to informal lenders. This hypothesis is worth examining in future studies.

15.3.7 As is to be expected, informal credit is costly, with annual interest rates ranging up to 500 per cent (this from a professional moneylender). However, the large proportion (29 per cent) of zero interest loans (largely, but not entirely, from friends and relatives) is also to be noted. In one case, zero interest loans from traders were described in the CDS report with loan repayment being in kind but at the market price prevailing for the crop in question, at the time of loan repayment. In general most loans and loan repayments were in cash though instances of loans in cash or kind with repayment in kind the repayment being valued below the prevailing market price, were found. Regression exercises were carried out to study variations in interest rates. The broad conclusion was that "...estimates reflect the heterogeneity of informal credit markets.....Relatively few generalisations can be made". That the source of loans was an important determinant of interest rates was the main finding of these exercises.

15.3.8 The distribution of loans by source and interest rate is in Table 15.5. The table shows that professional moneylenders had both the greatest proportion of high interest loans and the highest average rate of interest.

15.3.9 Finally, we may examine assets of sample households. Table 15.6 shows that the bulk of household financial saving was in the formal sector, though (figures are not reported here) financial assets of sample households were very limited in contrast with non-financial assets.

15.4. The structure of rural informal credit markets

15.4.1 In all surveyed villages, there was more than one informal lender, though all households did not have access to all lenders. Details of operations of 18 informal lenders are in Table 15.7. The diversity of informal lending operations is evident from this table. Three unusual features which are worth highlighting are: (1) six lenders borrowed on occasion from other moneylenders or traders and even the banking sector with none of these lenders accepting regular deposited; (2) of lenders who provided information on defaults, many had fairly substantial levels of defaults; (3) 5 lenders relied primarily on deposits for their loanable funds. In addition, in individual cases, interesting examples of innovative business practices were reported. Thus, one moneylender (Row 1) collected weekly repayments from door to door; a finance company gave zero interest loans on occasion to door; a finance company gave zero interest loans on occasion agricultural labour (Row 12); another finance company visited a village it served every Friday from a neighbouring town. In general, interest rates reported by lenders were lower than interest rates on loans reported by borrowers. But borrowers attested to the speed, flexibility and lack of formalities of informal lenders, though in two sample villages which were hurt by the failure of some finance companies (see Chapter 9 above), respondents expressed serious reservations about informal lenders. There was also general dissatisfaction with high interest rates.

15.4.2 The responsiveness of informal lenders to borrower needs has been found by other researchers as well. To quote Desai (1976) who studied credit in a tribal area of Gujarat,

> "..formal agencies have been unfunctional in their role. Against this, the informal lenders have played a variety of roles in the economic life of the tribals through their amazing flexibility in evolving terms and conditions of credit" (Desai (1976) p. 90).

A similar conclusion is reached by Bhende (1983) for one of his sample villages.

15.4.3 That rural loan markets in India are fragmented, in the sense that different rates of interest prevail for loans with essentially similar characteristics to similar borrowers, is well accepted. Bhende (1983) reaches this conclusion for his study areas. Rudra (1975) provides data on sources of loans open to various types of borrowers in 76 West Bengal villages in the early 1970's. His data show that farm servants and casual labourers had access to fewer sources of credit (for general purpose loans) than tenants (Rudra (1975), p. 1052). Kurup (1976), also provides data which indicate fragmentation. For the present survey, while limited details are available on access of different borrowers to different lenders (Table 15.7, column 2), variation in interest rates across loans, for the same type of security (Table 15.8), provide some evidence of fragmentation.

15.4.4 Another feature of rural credit markets in India that is widespread is their interlinkage with factor and output markets. Evidence on interlinkage with various markets has been put forward among others, by Bharadwaj (1980), Bhaduri (1977), Bardhan (1980), Bardhan and Rudra (1981, 1983), Harriss (1982), Rudra (1976), Bhende (1983), Sarap (1986), Pant (1980), Kurup (1976) and Roth (1979). Such interlinkage has been seen by some of these authors to enable lenders to extract greater rents from borrowers than would be possible through the credit market alone while others see such loans as welfare improving for borrowers (the two views are not mutually exclusive). In the study areas, while no case of interlinked credit and land lease transactions were found, instances of interlinkage of credit and commodity markets and credit and labour markets were reported. While in one case of tied commodity-credit transactions (rubber cultivators and traders in Anikad) additional rent extraction by lenders is clearly absent due to competition among lenders (CDS (1988), p. 122), in other cases (vegetable cultivators and traders in Vilpatti; fish middlemen and boat owners in Thalikulam, fishermen and boat owners in Thalikulam), extraction of additional rents through tied transactions cannot be ruled out.

15.4.5 The diversity in the structure of informal credit markets is by no means exhaustively described by these paragraphs. Two institutions which are prominent in the study areas are chit funds and finance companies. As shown in Table 15.6, a fair proportion of financial savings in the informal sector are with chit funds. However, due to the recent failure of several finance companies in the study area, discussed in Chapter 9, the popularity of finance companies is on the decline. Again, this is reflected in Table 15.6. Among the different types of credit arrangements, mention must be made of the institution of reciprocal loans among fishermen in Kerala. Platteau et.al. (1983) study this unusual credit `market´ among subsistence fisherman in three Kerala villages.

15.4.6 To complete our description of market structure, the formal credit institutions in the study area need to be described. The sample villages are served by between 1 and 6 formal credit outlets (average four) including commercial banks and bank branches, cooperative banks and a land mortgage bank. Of these, two formal institutions were looked upon with great favour by respondents. These two institutions appear to be competing successfully for the custom of residents of their respective villages. However other institutions were far less successful: one was facing bankruptcy; others, in a village that had faced a major agricultural reverse (Vilpatti), had "almost suspended the grant of fresh loans" (CDS (1988), p. 76) due to high defaults; several cases of high defaults, poor service, outright corruption and failure to meet the needs of the poorest households have also been reported in the study. Thus, though successful formal agencies are not totally absent, the general picture of the formal sector is bleak.

15.5. Operations of professional moneylenders

15.5.1 As has been seen (Table 15.4), loans from professional moneylenders have the largest share of commercial informal loans. Consequently, the rich information on operations of professional moneylenders in the CDS report is worth summarising. Various types of loans, from daily repayment loans to longer term loans provided by moneylenders have already been alluded to. To summarise, different moneylenders have different groups of customers whom they serve, offer different types of loans in terms of interest rates, security, duration and terms of repayment and may or may not accept deposits. Interest rates for both deposit and loans are uniformly higher than formal sector rates, though the variation in loan interest rates is very large.

15.5.2 In Table 15.9 a statistical profile of a sample of professional moneylenders in the study area is provided. Part (A) of the table shows that most loans from moneylenders went to agricultural and casual labour, though the bulk of loan funds flow to cultivators. The former paid high interest and the latter relatively low interest on loans taken.

15.5.3 Consumption loans (but not necessarily total consumption credit) accounted for over 50 per cent of the loans and also carried the highest interest (Part B). Likewise the average interest on small loans was the highest (Part C). By implication, agricultural labour are the recipients of these high interest though small consumption loans. The distribution of loans by asset class (Part D) shows that the bulk of loans goes to the wealthiest group at the lowest average interest, though neither the average loan size nor the average interest rate is monotonically related to asset class. Finally, as would be expected, unsecured loans carry much higher interest than secured loans (Part E). Overall, moneylenders serve all types of agents in the study area with the bulk of their funds going to the relatively wealthy cultivators but most of their borrowers coming from the poorer classes.

15.5.4 Further insight into the operation of moneylenders can be gained from an examination of their finances and attempting a decomposition of the spread between their deposit rates. The CDS study analyses the spread between loan and deposit rates of informal lenders and concludes that the spread is largely accounted for by lender's opportunity cost of funds. However, no explicit decomposition is attempted. On the basis of data in the report and certain assumptions, a `Bottomley' decomposition of interest rates is therefore estimated here. Details of moneylenders finances and the decomposition along with assumptions underlying the estimates are given in Table 15.10.

15.5.5 According to this decomposition, 65 per cent of the total loan interest rate is accounted for by deposit cost and opportunity cost of funds. However, the estimate of loan interest is based on interest rates reported by lenders. To the extent that funds lie idle for a part of the year, the estimate will be biased upward; but to the extent that lenders underreport their interest rates, and there is evidence in the report that this was done, the estimate is biased downward. Nevertheless, the economic rent element is unlikely to overshadow opportunity and deposit cost even if earnings are underestimated. It should also be noted that imputed cost of moneylenders time is not accounted for. Singh (1967) attempted a decomposition for a sample of seven lenders of a village in Punjab. According to his estimate, opportunity cost of funds accounted for 54 per cent of interest charged while monopoly profit accounted for 6 per cent of the interest. Even though his sample is far removed in time and space, the estimates support the contention in the CDS report that high informal interest rates do not necessarily reflect usury.

15.5.6 This is not to say that informal lenders are uniformly non-exploitative. Evidence provided by, among others, Roth (1979), Bhaduri (1977) and Sarap (1986) suggests that monopoly rents may be important in some contexts and areas, though not for professional moneylenders in the area studied by the CDS.

15.6. Impact of rural informal credit markets on allocative efficiency and equity

15.6.1 There can be little doubt that informal lenders are more functionally efficient than formal intermediaries. In the study areas, and generally, the hypothesis that they raise the average efficiency of financial intermediation (that is, reduce the average cost of intermediation) finds support. The data in Table 15.10 and other evidence in the report may be cited in corroboration.

15.6.2 Again, since informal loans generally go to the highest bidder within the confines of their fragmented markets, the presumption is that allocative efficiency is raised in comparison with a lower level of informal loans, whether loans are used for production or consumption. Even if the narrow view is taken that consumption loans reduce the efficiency of credit use, Table 15.11 shows that about 70 per cent of net informal credit is taken for productive loans or for housing investment. Of course, the fungibility of credit must be kept in view when making this distinction a point stressed by Bhende (1983) for his sample of villages. Thus, even though informal lenders in the study area are not very active in mobilising deposits, the presumption is that informal markets increase allocative efficiency.

15.6.3 The presumption gains in attractiveness when the fact that informal agencies provide the bulk of credit to asset poor households, both in the study area and at the All-India level (CDS (1988), Chapter 6) is taken into account. Consumption loans to the poor can clearly by efficiency (that is x-efficiency) improving.

15.6.4 That informal credit is the main credit source of poor households in both the study area and nationally is sufficient evidence that informal credit increases the welfare of the poor. Kurup (1976) and Bhende (1983) also find that informal credit is the main source of credit for poor households. Since, informal credit also goes to the rich, the ultimate impact on the distribution of income and wealth cannot easily be inferred. What is clear is that informal credit markets lead to greater equality in the distribution of credit to households. However, it may be the case that cheaper credit will lead to a further increase in the equity impact of credit provision while not necessarily improving resource allocation. Thus, while it is difficult to support regulations which suppress informal markets, competition from formal credit - provided such credit can compete with informal credit, is likely to have a positive impact.

15.7. Conclusions

15.7.1 One feature of the picture of informal credit that emerges from the preceding discussion is striking. That is difficult to reconcile the decline in the relative size of the rural informal credit market despite its dynamism and efficiency especially when the latter is compared with the performance of formal credit. One hypothesis which fits these findings and also findings by earlier writers on exploitation by informal lenders is that the spread of formal credit institutions, however poor their services and however skewed their loan portfolios, has lead to a decline in the ability of informal lenders to extract rents because of the effects of competition. However, regulation of informal intermediaries could also partially explain this decline (as in the case of finance companies). The verification of this hypothesis must await further study.

15.7.2 Whatever the real explanation, it is clear that rural credit markets have undergone a sea change at least in the study areas. It is also reasonably clear that the poorest have been little affected by these changes and continue to rely on traditional credit sources since they do not have sufficient access to the newer sources. In closing, the limited coverage of the CDS field survey should be reiterated.

Except when corroborative evidence is forthcoming at the national level, the findings of the CDS study should not be taken to necessarily reflect the situation in the rest of India.[1]

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1. Since this study was prepared an important study by Ramakrishna (1989) on agricultural labour in one district of Orissa has appeared. His major conclusion is that slightly more than half the informal loans to them are nonexploitative.

TABLE 15.1

Trends in Aggregate Cash Dues Outstanding in Rural India

Item			1961		1971		1981	
			Rs crore	Per cent	Rs crore	Per cent	Rs crore	Per cent
A.	AGGREGATES							
	1.	Current prices	2788.93	-	3652.10	-	6006.23	-
	2.	60-61 prices	2788.93	-	1954.12	-	1220.78	-
B.	GROWTH DURING DECADE							
	1.	Current prices	-	-	963.07	34.53	2254.23	60.09
	2.	60-61 prices	-	-	(834.81)	(29.93)	(733.04)	(37.53)
C.	1.	PER HOUSEHOLD (RS.)	406.30	-	487.05	-	661.00	-
	2.	PER REPORTING CULTIVATOR HOUSEHOLD (RS.)	393.00	-	1330.00	-	3595.00	-
D.	DEBT - ASSET RATIO		-	7.87	-	4.30	-	1.83
E.	AGENCYWISE							
	1.	Formal	413.44	14.30	999.41	23.41	3675.00	61.20
	2.	Informal	2375.48	85.20	3270.06	76.59	2330.21	38.80
		2a. Landlord	25.03	1.1 (0.9)	324.05	12.2 (4.6)	242.59	10.2 (1.2)
		2b. Agricultural moneylender	1281.03	53.9 (32.0)	867.15	32.6 (10.7)	523.07	22.1 (2.6)
		2c. Professional moneylender	415.90	17.5 (11.1)	517.16	20.0 (6.5)	504.13	21.3 (2.0)
		2d. Trader	213.98	9.0 (7.0)	325.07	12.2 (4.9)	207.15	8.7 (1.0)
		2e. Relative/Friend	190.02	8.0 (8.3)	518.80	19.5 (8.8)	533.62	23.4 (2.9)
		2f. Other	248.87	10.5 (15.0)	105.52	3.9 (1.4)	338.58	14.3 (1.6)
HOUSEHOLD TYPES Proportion of Households								
	1.	All rural households	-	62.8	-	41.3	-	20.0
	2.	Cultivators	-	66.7	-	44.4	-	22.3
	3.	Non-cultivators	-	52.0	-	33.6	-	12.4

Notes: 1. Negative figures in paraentheses for (B).
2. Percentages in parentheses are proportions of households for (E).

Source: Tables 2.3, 2.5, 2.6, 2.7, 2.9 5.4 of CDS Report.

TABLE 15.2

Statewise Details of Cash Dues Outstanding

	State	Cash dues outstanding (Rs per reporting household)			Share of informal agencies in aggregate cash dues (Per cent)		
		1962	1971	1981	1962	1972	1982
1.	Punjab	1288	3118	9580	89.3	64.0	25.8
2.	Haryana	-	3394	13048	-	73.6	24.2
3.	Himachal Pradesh	-	1501	3077	-	76.1	25.5
4.	Gujarat	867	2331	5022	76.3	53.1	30.0
5.	Uttar Pradesh	482	971	2752	89.1	76.6	44.9
6.	Maharashtra	700	1477	4241	53.6	32.6	13.6
7.	Jammu & Kashmir	391	751	2995	90.4	79.6	56.5
8.	Bihar	599	840	1744	94.9	89.3	52.8
9.	Karnataka	975	1707	5715	83.9	70.3	21.8
10.	Rajasthan	1026	1617	4932	95.4	90.6	59.1
11.	Kerala	414	1108	3409	82.5	55.6	21.4
12.	Madhya Pradesh	660	1055	3005	84.3	68.4	33.7
13.	Andhra Pradesh	912	1655	4055	90.5	86.3	59.1
14.	Tamil Nadu	1081	1850	3911	86.5	77.9	55.7
15.	West Bengal	425	k623	1677	76.7	69.4	35.4
16.	Assam	330	758	1113	76.2	65.3	69.4
17.	Orissa	392	583	1803	73.6	70.0	18.1
	ALL INDIA	393	1330	3595	85.2	70.8	38.8

Note: 1. States arranged according to descending value of per household assets in 1981.

Source: Tables 2.9 & 2.11 of CDS Report.

TABLE 15.3

Demographic Characteristic (1971) and Sample Design of Villages in CDS Sample (1988)

Item	State/Village					
	Kerala			Tamil Nadu		
	Anikad	Ezhu-kone	Thiao-navaya	Thali-kulam	Vil-patti	Mookuperi
Area: Km	22.18	15.77	10.93	10.89	7.15	4.87
Population	11877	18661	13376	16751	7535	3373
Sex ratio (F&M)	963	999	1078	1158	933	1349
No. of households	2026	3959	2021	2622	1663	629
SAMPLE HOUSEHOLDS						
Cultivators	17	14	29	31	21	11
Other self-employed	8	21	8	17	6	34
Salary earners	1	9	6	16	1	13
Agricultural/casual labour	26	19	29	26	43	5
Skilled labour	6	1	2	1	4	2
Total	68	83	77	95	76	79

Notes: a. Sample households in Kerala were further stratified on the basis of monthly income.
b. Sample households in Tamil Nadu were further subdivided on the basis of source of income (agricultural/non-agricultural) and size of land holding.

Source: CDS Report Table 4.1 & Appendix 2.

TABLE 15.4

Characteristics of Aggregate Cash Dues for Sample Villages

A. TOTAL OUTSTANDING LOANS

	Amount ('000)	% of sample households indebted	Loans per household (Rs)	Loans per reporting houshold (Rs)
1. Formal credit	1540.83	40.58	3223.50	7942.44
2. Informal credit	387.44	16.32	810.54	4967.15
2.1 Agricultural moneylenders	15.01 (3.87)	-	-	-
2.2 Professional moneylenders	45.61 (11.77)	-	-	-
2.3 Traders	1.88 (0.49)	-	-	-
2.4 Relatives/Friends	324.9 (83.86)	-	-	-

B. BORROWINGS BY OCCUPATION (%)

	Cultivators	Other self employed	Salary earners	Agri/casual labour	All non cultivators
1. Formal	69.70	59.82	57.88	46.61	66.99
2. Informal	30.30	40.18	42.12	53.39	33.01

C. INFORMAL LOANS BY SIZE OF LOAN

1. Size class (Rs)	0-500	501-1500	1501-2500	2501-5000	5001-10000	Above 10000
2. Per cent of loan	24.47	27.66	11.70	21.28	8.51	7.45

D. INFORMAL LOANS BY SECURITY

1. Security	Personal	Gold	Land/Building	Others
2. Per cent of loans	40.06	17.17	37.05	5.42

E. INFORMAL LOANS BY DURATION

1. Duration (months)	1-6	6-12	12-24	24-36	36-60	60
2. Per cent of loans	39.36	20.21	1.06	6.38	3.19	29.79

Average Correlation Across Villages Between Loan Size and Duration: 0.24

F. INFORMAL LOANS BY INTEREST RATE (% PER ANNUM)

1. Range of interest rates	0	0-6	6-12	12-24	24-36	36-60	60 & above
2. Per cent of loans	28.96	0.68	1.37	8.27	27.58	3.44	30.34

Source: Tables 5.5, 5.6, 5.9, 5.10, 5.13A, 5.14A, 5.15A, 6.4, Page 114 of CDS Report and Computation.]

TABLE 15.5

Distribution of Loans by Agency and Interest Rate

(% of loans)

Interest range	Professional moneylenders	Agricultural moneylenders	Friends and relatives
0	1.14	Nil	97.96
1-6	1.14	Nil	Nil
6-12	Nil	Nil	Nil
12-24	7.95	18.18	Nil
24-36	37.5	72.72	Nil
36-60	3.41	9.09	Nil
Above 60	48.86	Nil	2.04
Average Interest rate (% p.a.)	51.86	29.45	3.28

Note: Traders in 2 villages give interest free loans. In another village the loan interest rate from traders averages 13.33%. In a fourth village one loan at 60% was reported.

Source: Tables 6.1, 6.2, 6.3, pgs. 130-131 of CDS Report and computations.

TABLE 15.6

Distribution of Financial Assets of Sample Households

Credit agency	Beginning of year		End of year	
	Amount	Per cent	Amount	Per cent
Formal sector	100	90.59	235.00	94.32
Informal sector	7.49	6.78	10.23	4.10
Chit funds	1.60	1.45	3.26	1.31
Professional moneylendrs/ financers	1.30	1.18	0.66	0.26

Note: For amount: Formal sector deposits at beginning of year=100.

Source: Table 8.3 of CDS Report and computation.

TABLE 15.7

Case Studies of Rural Informal Lenders

Sl. No.	Type of lender	Sources of funds (%): Own funds	Deposits: From F&R	Deposits: Others	Other	Deposit interest (% p.a)	Loan interest (% p.a)	No. of loans	Annual turnover (Rs)
(1)		(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1.	Moneylender	100	Emergency	-	Other money lender	N.A.	320 (28/week)	105	14000
2.	Farmer-trader-moneylender	100	-	-	Arecanut whole-saler	N.A.	About 50	8	7400
3.	Farmer-moneylender	100	-	-	-	-	About 20	13	2 lakh
4.	Farmer-moneylender	100	-	-	-	-	About 30	N.A.	25 lakh
5.	Finance Co. (Prop.)	N.A.	Rs 4 lakh	-	-	12-14	24	N.A.	N.A.
6.	Finance Co. (Prop.)	N.A.	Rs 22,000	-	-	10-13	24	N.A.	2-2.5 lakh
7.	Finance Co. (Prop.)		Mainly	-	-	12	24	N.A.	26 lakh
8.	Finance Co. (15 partners)	Rs 3 lakh	Rs 21 lakh	-	-	10-12.5	18-30	N.A.	N.A.
9.	Farmer-moneylender	Rs 2.5 lakh	Rs 4.5 lakh	-	-	24	36 (Ave.)	100-150	19 lakh
10.	Farmer-money-lender (4 cases)	N.A.	N.A.	N.A.	Coop. banks	-	36-60	upto 75	N.A.
11.	Rubber traders (8 cases)	100	-	-	Coop./commer-cial banks	N.A.	0	N.A.	5-23 lakh

TABLE 15.7 (CONTD')

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
12.Finance Co. (4 partners)	Rs 1.5 lakh	Rs 10 lakh	-	-	12-24	0-46	N.A.	19 lakh
13.Farmer-moneylenders	-	Rs 10,000	-	-	N.A.	36	154	N.A.
14.Farmer-moneylender	1.75 lakh	-	-	Money-lenders	24	301:long 500 (or 3.5/week): short	N.A.	2.4 lakh
15.Farmer-moneylender	N.A.	N.A.	N.A.	N.A.	N.A.	10	N.A.	N.A.
16.Finance Co.	0.5 lakh	-	-	-	-	24-90	N.A.	N.A.
17.Farmer-money-lender-trader	50,000	-	-	Credit purchase from wholsalers	18	24-36	N.A.	4000-15000
18.Vegetable trader	N.A.	N.A.	N.A.	N.A.	N.A.	in kind	N.A.	N.A.

TABLE 15.7 (CONTD')

Case Studies of Rural Informal Lenders

Sl. No. Clientele	Loan size (Rs)	Duration (weeks)	Security	Bad debts (% of	No. of employees loans/ % of borrowers)	Salary (Rs. p.a)	Premises	Land holding/ other income (Rs.)	Remarks
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
1. SF,ST,AL	300 (ave)	upto 10	None	N.A.	None	None	Home	None	Collection of weekly payment personally from house to house
2. Arecanut farmers	upto 1000	20 to 26	None	N.A.	N.A.	N.A.	N.A.	3.25/ 15,000	(a) arecanut trader, (b) repayment by delivering of arecanut below market price.
3. N.A.	500-35000	N.A.	None if land	Increasing	None	Home	Home	10.9/ 50,000	*
4. Known persons	2000 (ave)	N.A.	loan >5000	N.A.	None	None	Home	-	Retired Govt. servant
5. SF.AL.FI	N.A.	N.A.	-	16/4	5	43,000	Rented	-	
6. SF,AL,FI	50-1000	N.A.	gold/ none	20/5	2	70000	Rented	-	
7. N.A.	N.A.	N.A.	N.A.	1/1	N.A.	13000 N.A.	N.A.	-	
8. SF,FI	N.A.	13-52	gold/ none	N.A.	5	18,000	Rented	-	
9. SF	N.A.	13-32	gold/ none	N.A.	N.A.	N.A.	Rented (Rs 6000 p.a.)	4	Rubber cultivation
10. SF,AL	Upto 5000	13-426	gold/ land/ none	N.A.	N.A.	N.A.	N.A.	3-15/ 7000-30,000	
11. Rubber farmers	N.A.	1-4	None	N.A.	N.A.	N.A.	N.A.	N.A.	Loan repaid in kind by prior arrangement.

TABLE 15.7 (CONTD')

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
12.N.A.	20 to 2 lakh	26-150	None	N.A.	8	36,000	N.A.	-	Zero interest loans for poor borrowers.
13.SF,ST,AL	50 to 2000	13 (ave)	None	10/4	-	-	-	N.A.	
14.N.A.	N.A.	2-3	Gold	6-7/ N.A.	N.A.	N.A.	N.A.	5/N.A.	Claims high defaults from farmers
15.ST,AL	50-2000	N.A.	gold durables	N.A.	N.A.	N.A.	N.A.	5/(2 irri- gated	
16.SF,ST,AL	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	-	Comes from neighbouring town each friday.
17.SF,ST,AL	50-200 in kind to SF	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	Interest taken in advance
18.Vegeta- ble farmers	500-1000	Crop season	Growing crop	N.A.	N.A.	N.A.	N.A.	N.A.	Repayment in kind below market price potatoes: Rs 4 per bag turnip: Rs 2 per bag beans: 10%

Notes: SF: Small farmers.
ST: Small traders
AL: Agricultural labour
FI: Fishermen

Source: CDS Report, Appendix to Chapter 5.

TABLE 15.8

Interest Rate Distribution Across Sample Villages

(Average interest in per cent per annum)

Village	Security			
	Personal	Gold	Land/ Buildings	Other
Anikad	62	36	-	36[1]
Ezhukone	-	30	-	-
Thirunavaya	124	35	-	-
Thalikulam	93	28	-	-
Vilpatti	65	-	0[1]	-
Mookuperi	24	-	-	-

Note: 1. One observation. Source: Table 6.11 of CDS Report.

TABLE 15.9

Details of Credit from Professional Moneylenders

A. LOANS CLASSIFIED BY OCCUPATION GROUPS

	Group	Culti-vators	Other self employed	Salary earners	Agricul-tural & other labour	Others
1.	No. of loans (%)	13.48	26.97	4.49	42.70	12.36
2.	Amount (%)	38.73	26.63	5.44	13.57	12.21
3.	Interest rates[1]	21-40	N.A.	30	28-125	N.A.

B. PURPOSEWISE CLASSIFICATION OF LOANS

	Purpose	Product-ion	House construction/ repair	Consump-tion	Other
1.	No. of loans (%)	27.55	8.16	55.11	9.18
2.	Interest rate (% p.a.)	50.00	22.00	84.57	64.67

C. INTEREST RATES AND SIZE OF LOANS (RS.)

1.	Size	0-500	500-1500	1500-2500	2500-5000	5000-10000[2]	Above 100000[2]
2.	Average interest	33	41	44	43	36	24

D. ASSET GROUPS AND LOANS

	Asset group (Rs)	Average loan size	Average inte-rate (% p.a.)	Cumulative proportion of credit
1.	0-5000	799.84	50	10.23
2.	5000-10000	116.67	120	10.79
3.	10000-15000	633.37	35	12.31
4.	15000-20000	285.91	71	13.91
5.	20000-30000	668.00	104	21.93
6.	30000-50000	652.50	58	27.15
7.	50000-100000	1267.83	48	41.34
8.	100000 and above	4075.00	33	100.00

E. INTEREST RATE VERSUS SECURITY

	Security	Personal	Gold	Land/Building	Other
2.	Average interest (% p.a.)	95	29	0[2]	36[2]

F. AVERAGE INTEREST RATE : 51.86 % PER ANNUM
SHARE OF INFORMAL LOANS: 11.77%

Notes: 1. Range of villagewise averages.
2. One loan each.

Source: Chapter 6, CDS Report and computation.

TABLE 15.10

Finances of Professional Moneylenders

	Item	Rs'000	Percentage of loan interest	Basis
1.	Total loans	14820.90	-	-
2.	Total deposits	2488.82	-	@ 16.79% of (1)
3.	Own funds	12331.98	-	(1) - (2)
4.	Loan interest	4046.27	100.00	@ 27.30 % (1)
5.	Deposit interest	437.45	10.81	@ 17.5% of (2)
6.	Administrative cost	205.51	5.08	@ 1.39% of (1)
7.	Opportunity cost	2219.76	54.86	@ 18% of (3)
8.	Default cost	943.35	23.31	@ 5% of (1) + (4)
9.	Economic rent	240.20	5.94	(4)-(5)-(6)-(7)-(8)

Note: 1. Sample size: 4
2. Percentages used are averages across reporting lenders.

Source: Tables 6.8, 6.12 and 8.4 of Report and Computations.

TABLE 15.11

Purposewise Distribution of Credit from Informal Agencies

	Purpose	Amount (Rs'000)	Share of total for (1)+(2)+(3)
1.	Production	142.70	27.07
	a. Cultivation	30.65	5.81
	b. Non farm business	112.05	21.26
2.	Cosumption	166.15	31.52
3.	Construction/repair of houses	218.27	41.41
4.	Repayment of debts	64.80	10.95

Source: Table 8.10 of CDS Report.

PART E

POLICY PRESCRIPTIONS

CHAPTER 16

LESSONS FOR FORMAL FINANCE AND AN APPROACH TO THE REGULATION OF INFORMAL INTERMEDIARIES

16.1 Lessons for formal banking

16.1.1 Specific recommendations are given in the course of case studies for changes in current bank practice and lessons which the formal sector can profitably learn from informal intermediaries. Here we wish to propose an overall strategy of formal banking development.

16.1.2 Though there are problems, the formal sector serves, by and large, the needs of organised and large scale production. Banking needs of the government and of salaried, urban, households are also well served. Where bank service fails is in serving the needs of the small entrepreneurs and the trader. Furthermore banks are clearly less successful in serving the needs of the poorer sections as a whole (at least upto 1981-82 when the RBI Debt and Investment Survey was conducted). For such loans, defaults and overdues are also a major problem, though specific details are not available (but see Nayar (1987)).

16.1.3 Since it has been concluded in the case studies (subject to the usual caveats as to adequacy of information) that the informal sector is both better at serving the sectors neglected by banks and also recovering advances from these sectors, a policy of encouraging informal credit with, however adequate safeguards against fraud and exploitative practices (see below) suggests itself. In a sense, banks should relinquish areas of business where they do not have an absolute (or even comparative) advantage. Instead refinance facilities for informal intermediaries and even perhaps, to traders channelled through traders associations appear attractive. This is what we recommend.

16.1.4 Regarding specific innovative schemes for serving depositors and borrowers, while a few suggestions have been made in the case studies, banks in India, are by and large, innovative enough in serving those sectors where they have an advantage.

16.1.5 Regarding other formal financial markets it is worth citing the result of Cho (1985). He finds that increased equity finance through a strengthened stock market has positive allocation effects in a situation of assymetric information as to borrower risk.

16.2 Fraud, information and the regulation of informal intermediaries

16.2.1 One way of ensuring that no fraudulent organisation has access to deposit money is by banning informal intermediation altogether. The consideration of this possibility, while not being suggested as a serious policy measure, has the merit of throwing the consequences of overly restrictive regulation into sharp focus. If such an alternative was enforceable, then those with financial saving would be restricted to formal sector saving institutions and equity markets. However, it is likely that informal intermediaries can tap large reservoirs of public saving even after substitution between formal and informal saving instruments is accounted for. High interest, personalised service, deposit soliciting agents and informality of dealings and innovative saving schemes all make this likely. Further, deposits so mobilised, amounting to a sizeable amount in absolute terms, find their way into the formal sector, particularly the government sector. Thus, development of the financial sector and, in particular, the substitution of financial for non financial saving would suffer if informal intermediaries are banned. The point here is that certain informal intermediaries have an absolute advantage in mobilizing deposits from particular segments of the saving public. Secondly, certain informal intermediaries have an absolute advantage in ensuring the recovery of loans made to particular segments of investors. Banning all informal intermediaries will thus result in financial constraints being faced by a section of firms or, if they get formal accommodation, will result in raising the aggregate risk of formal sector loan portfolios. The efficiency of financial intermediation will be affected in either case. Thus, regulations which put (partial or total) quantitative restrictions on the deposits which an informal intermediary can mobilise should be made only after carefully weighing the costs and benefits. This may be taken inter alia as a criticism of the Prize Chit (Banning) Act of 1978. In fact, that money circulation schemes or prize chits, even if they have no loan portfolio, should be banned is open to debate. What is not at issue is that fraudulent intermediaries such as a section of blade companies or as described in the Raj Committee Report (1975) should be wound up.

16.2.2 Is there any alternative to quantitative restrictions on deposits? One possibility that merits further examination is the **licensing of deposit taking firms and periodical review of the operations of the firms by licensing authorities.** A further measure is to make **prior vetting of deposit acceptance schemes** (including provisions relating to penalties, forfeiture etc.) by regulatory authorities compulsory. Both these measures will of course require a much more sophisticated monitoring and review procedure on the part of the Reserve Bank than now appears to exist. Thus a careful enquiry into the reasons for the ineffectual handling of for example the Sanchaita and Peerless cases and appropriate remedial action are called for.

16.2.3 While the measures outlined in the previous paragraph would, if properly implemented, ensure that fraud and parallel market transactions are curbed, depositors may still be misled by aggressive and inaccurate promotion campaigns. In a largely rural and relatively backward economy like India's, the efficacy of any measures to prevent such practices is bound to be limited. Still, efforts can be made to inform savers as to the attractiveness of different saving schemes by instituting a method for rating different saving schemes. The rating can be based on scheme details, the intermediary's loan portfolio and its past performance. These ratings can then be given wide publicity. Armed with a rating chart and a list of licensed intermediaries, even a person with limited training or sophistication could serve as a competent financial adviser. Additionally, firms may be compulsorily required to supply certain items of information to depositors at periodic intervals. Similar rules could also be laid down for advertisements by financial firms. Loan schemes and lending practices should be subject to similar vetting as has been suggested for deposit schemes.

16.2.4 The kinds of measures outlined above along with a carefully thought out monitoring and inspection scheme should help contain fraud and improve the informational efficiency of Indian financial markets. Furthermore, once the Reserve Bank lays down appropriate guidelines based on which decisions on whether to allow or disallow any intermediary, deposit scheme or loan scheme, the need for multiple (currently four) sets of directions governing different types of non-bank financial institutions will disappear thus resulting in simpler laws.

16.2.5 The discussion in this section has been motivated by the need to foster and not fetter a healthy financial market while ensuring that fraud is prevented and that savers and borrowers are well informed about the various products available in the financial market. A presumption underlying the discussion is that informal intermediaries, if and when they become inefficient relative to the formal sector in the segments served by them, will die a natural death. Furthermore, natural death in this situation is preferable to death or crippling by regulation. The major affliction that has been implicitly identified as the main reason for evils discussed in a few case studies is the poor information environment. Accordingly the remedy proposed deals almost entirely with improved information flows.

16.2.6 It is clear of course that a poor information environment is not the only problem to be addressed in effectively regulating the informal financial market. Other features revealed by the case studies are the suspected nexus between the political establishment, the informal financial market and the underground economy; the difficulty and delay in getting regulatory moves upheld by the courts; the lack of coordination between different regulatory bodies; and the interaction between different types of government regulations which combine to create opportunities for financial exploitation by some agent (such as in the dockyard financiers case study). While specific recommendations have been made on a case by case basis, we nevertheless believe that **the major problem is the informational problem dealt with in this chapter.**

16.2.7 Regarding interest rate regulation, in one case, chit funds, the ceiling prevailing on interest rates (through bidding ceilings) appears to be unwarranted and should be lifted. However, given the pitfalls in hasty financial liberalisation, as is seen from the Latin American experience, it would be inappropriate to make a recommendation on interest rates without a careful policy analysis.

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CONTENTS OF "URBAN INFORMAL CREDIT MARKETS IN INDIA"

CONTENTS OF
"THE INFORMAL CREDIT MARKETS IN RURAL INDIA"

PREFACE TO THE CDS REPORT ON INFORMAL CREDIT MARKETS IN RURAL INDIA

The Asian Development Bank had commissioned a comparative study of Informal Credit Markets in a few selected countries in Asia. The country study on India was jointly undertaken by the National Institute of Public Finance and Policy (New Delhi), and the Centre for Development Studies (Trivandrum). The former took up the study of the urban informal credit markets, and we, at this Centre, covered the rural sector. The present volume incorporates the findings of our investigation of the informal credit markets in rural India.

The over all coordination of the work on the project was entrusted to a study team comprising Professors T.N. Krishnan, I.S. Gulati, P.G.K. Panikar (Principal Coordinator), Chiranjib Sen and Mr. D. Narayana. Drafting of the report was done by the following: P.G.K. Panikar (Chapters 1, 2, 4, 5, 6, 8, 9 and 10), Chiranjib Sen (Chapter 3 and 7) and D. Narayana (Appendix to Chapter 2).

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