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Formal and Informal Finance in Contemporary India

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Estimates of the share of contemporary informal finance in India are very rough and inconsistent, but scholars agree on a decline during the past decades. Among the informal intermediaries the number of rural merchant lenders, crop dealers, commission agents, hire purchase financiers, pawnbrokers, and so on has increased, while that of traditional indigenous-style bankers, professional moneylenders and landlord-lenders has decreased as a result of both changing requirements of society and economy, as well as state interference with the financial landscape. In the first part of the article I shall reconsider the contemporary urban informal financial agents and institutions. In the second part I take a look at the rural financial landscape.

Estimates of the share of contemporary informal finance in India are very rough and inconsistent. According to Chandravakar (1982: 798), a sample survey of the Reserve Bank of India from 1951-2 on rural indebtedness assumed a share of informal rural credit of 90 percent. Two decades later, the Rural Credit Survey of 1971 estimated that 70 percent of all rural debts were loans from informal sources. Its share has decreased further because the Indian government pushed forward the banking infrastructure in rural regions. Bell (1990) even maintained that its share in the early 1980s was not higher than 24 percent, which to my mind is a considerable underestimate. It is safer to assume a share of around 50 percent.

It is difficult to assess whether this decline is only a relative one because of a major increase in available formal finance, or an absolute one since the tendency among different informal financial agents is not uniform (see Mamoria 1982). Case studies reveal that the number of rural merchant lenders, crop dealers, commission agents, hire purchase financiers, pawnbrokers, and so on has increased, while that of traditional indigenous-style bankers, professional moneylenders and landlord-lenders has decreased. Such structural change resulted from both changing requirements of society and economy, as well as state interference with the financial landscape.

In the first part of this paper I shall reconsider the contemporary urban informal financial agents and institutions, which consist of indigenously developed bankers and finance brokers, finance corporations, *nidhis* (mutual benefit funds) and *chit* funds (rotating savings and credit associations, which are often commercialised, see e.g. Nayar 1973). The latter two financial institutions have been excluded from this study. In the second part I take a look at the rural financial landscape. I include a few notes on formal finance, since its extension has affected informal finance.

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1 Urban Informal Finance: Indigenously Developed Bankers, Finance Brokers and Finance Corporations

1.1 Introduction

A detailed analysis of indigenous-style banking in contemporary India was provided by the SGIB (1971). Considering the density of banks and indigenous-style bankers, their appearance is not mutually exclusive. Particularly in commercial and metropolitan centres, such as Bombay, Calcutta, Madras, and so on, the 1961 Census outlined the clustering of indigenously developed bankers. The high level of economic activity in these regions facilitates the simultaneous existence of both indigenous and formal financial institutions.

Urban informal credit has been estimated at 42 percent (excluding black money) or 57 percent (including black money) of total urban credit, whereas the trade sector uses two-thirds of it. Urban household credit amounts only 1.5 percent of total urban informal credit. The proportion of consumer credit to total informal credit is therefore much lower in the urban than in the rural context. The urban informal financial sector seems to be rapidly growing (Ghate 1992: 66).

A break-down of indigenously developed bankers in India was provided by Timberg and Aiyar (1980) for the late 1970s. It shows only a small number in North India and a higher concentration in other parts. They counted 1,200 Multani bankers and more than 500 associated brokers, 5,000 Gujarati bankers and commission agents (the last-mentioned were not counted as indigenous-style bankers by these scholars), 2,500 Chettiar bankers and 25,000 pawnbrokers, 100 Marwaris in Madras plus various Marwari firms in Calcutta and other places and 500 Rastogi bankers (see Tab. 1). The few Kallidaikurichy Brahmins from South India went unmentioned.

These castes are all Hindus or Jains, but the assumption that there are no Muslim informal financiers because of the prohibition of taking interest by the Qur'an is refuted by evidence of Muslim moneylenders in India, such as the Pathans, Hadramouth traders and itinerant Muslim moneylenders in the Trichinopoly District of Madras (Chandravakar 1982: 776-7).

Multani Shroffs, Gujarati Shroffs, Nattukottai Chettiar and other indigenous-style bankers have organised themselves in associations, many of which go back to the 1920s and 30s. They take various functions which are carried out more or less strictly. They serve the exchange of information on customers, penalise the dishonesty of members (since it leaves a stain on the whole caste), sometimes fix maximum rates of interest, hold social functions, such as the organisation of festivals, and form a political lobby to defend the interest of the caste occupation against government interference with their business. According to Timberg and Aiyar (1980), urban informal finance is highly organised (which contradicts the misnomer of indigenously developed bankers being 'unorganised bankers' as did, for example, Karkal [1967]). Associations are formed according to caste/ethnic background and special business lines in which particular banking castes have specialised. Examples of such associations are the Shikapuri Shroffs Association in Bombay, the Bombay Shroffs Association, the Gujarati Shroffs Association in Bombay, the Hindustan Chamber of Commerce in Bombay, the Merchants Chamber of Commerce in

Calcutta, the Delhi Mercantile Chamber or the Kanpur Cloth Committee, which all have regulatory functions. The Bombay Shroff's Association has quite successfully tried to found a national organisation of the local bankers' associations.

The primary business of indigenously developed bankers was and still is the finance of trade (retail and wholesale), including the movement of agricultural produce (for the history of indigenous-style finance, see Schrader 1994). In addition they also finance small and medium-scale industries, but refrain from agricultural finance which is left to co-operatives and moneylenders. On the one hand, most indigenous-style bankers were even traditionally not involved in this field of activity, on the other hand, moneylenders' acts set certain limits to the financing of agriculture, requiring registration and licensing, and fixed interest rates. Definitions of categories affected by the moneylenders' acts differ from state to state.

The main activity of indigenous-style bankers is dealing in short-term financial instruments which have to be met on demand or by a certain date. Until 1970 the *hundi* was the usual credit instrument which was discounted to customers and with banks and it was used as an instrument to raise funds.

Hundis perform three functions: (1) the raising of money; (2) the remittance of funds, and (3) the financing of inland trade. A principal distinction, which will suffice here,[1] is made between *darshani* (sight or demand) *hundis* paid by presentation and *mudatti* (usance) *hundis* to be paid after a stipulated period.

Government interference with the negotiation of *hundis* in 1970 had severe effects on this traditional business of indigenous-style bankers. On the whole a re-orientation of the business of indigenous-style banking occurred, away from the long-established dealing in *hundis* to the instalment credit and commercial paper business, although the volume of *hundi* business is still considerable. Additional financial services of contemporary indigenous-style bankers are the transmission of money from place to place without the use of *hundis*, the receipt of deposits, the issuing of letters of credit to merchants requiring finance at several trade centres, and so on.

1.2 Organisation and Functions of Different Indigenously Developed Bankers

Like in medieval and colonial India, most contemporary indigenously developed bankers combine banking with trade or related forms, such as a commission agency business or hire-purchase financing. Only very few are pure bankers (like the Gujarati Shroffs of Ahmedabad). In what follows I shall consider the leading banking castes one after another, whereby I largely draw on the report of the SGIB (1971) and Timberg and Aiyar (1980).

The Shikapuri Shroffs or Multanis

For generations the Shikapuri have been involved in commerce and finance. From Shikapur in Sindh they carried out business with, or had offices in, places in the north-west, such as Bokhara, Khurasan, Kandahar, Kabul, Tehran and Kashgar.

1 For various sub-categories, see the SGIB (1971: 48ff).

Traditionally one of their activities was the provision of finance to local traders, shopkeepers, and so on. By the time the Multanis shifted their activities from Shikapur via Multan to Bombay and as far as South India. They combined the finance of the movement of goods with trade. With the opening of banks, the transfer of funds lost importance. Instead they developed the *khata* business, the opening of current accounts in the name of business and trading concerns and the provision of advances to them according to their credit and capacity. At the second stage they took up the *hundi* business. Nowadays they are pure bankers.

Bombay business started around 1870. A number of firms have branches in one or more of the major cities. According to Timberg and Aiyar (1980), a little less than half of the about 1,000 Multani firms (excluding the brokers) are organised in the Shikapuri Shroffs Association, which is quite informal.

The SGIB (1971: 21ff) considered the contemporary activities of the Multanis as an important financial intermediary service to small-scale industries and retail trade by securing access to working capital, with a very mobile mode of operation. Credit can be obtained on *hundis* or other commercial papers in about half an hour. Multanis work with their own capital, through bank loans and with investments by friends and relatives. Deposit acceptance from the public does not as a rule form part of the Multani business. Until 1964 another means of raising capital was the *purja*, the selling of obligations to the public. The Multani Bankers Association maintained that the *purja* business took an important function of savings mobilisation with the small man who was unwilling or unable to deal with a bank. This business was discontinued because the income-tax authorities no longer accepted the genuineness of this kind of sale. Since the dealing in *darshani hundis* was restricted by the financial authorities, too,[2] many indigenous-style bankers moved from ninety-day *hundis* to instalment credit operations.

Every borrower obtains a maximum limit which is checked and revised every quarter of the year. Since most customers are traders and small- and medium-scale producers, most loans are used for investment purpose, although Multani bankers do not explicitly ask for the loan purpose. Many families run two or three firms. In the case of large-scale loans Multani bankers share the financial risk. This caution in their dealings has generally prevented financial difficulties if a borrower defaults.

For the Multani business, close contact and knowledge of the customers' business standing is very important. In Bombay and some other places, this closeness cannot be maintained, so that the Multani bankers operate through brokers. Most of them originate from Shikapur, too. In recent years some brokers developed their own

2 Panjabi (1961) reported for the early 1960s that the number of banks which were interested in dealing with *hundis* was small, due to highly regulated formal finance in post-colonial India which largely required the banks to borrow from the Reserve Bank against government securities during the busy season and to prefer loan applications from big industrial firms. By then Multanis paid themselves seven percent interest at the banks and took twelve percent interest from their clients. Taking into consideration stamp costs, brokerage, etc. customers had to pay well over 13 percent. Compared with other informal credit sources, which take 18 to 24 percent, the interest is rather low. Compared with bank rates to which some of their clients also have access, the rate is high.

independent business. They collect and accumulate idle funds from various sources and lend them to a smaller number of other sources.

Gujarati Shroffs

The Gujarati Shroffs, too, have a long-established banking tradition, and their mode of operation is very popular. Some of these firms called *pedhis* are 150 to 200 years old. While most of the 1,500 Ahmedabad firms are pure indigenous-style banks, the 3,500 Bombay firms combine banking with commission agency business for the marketing of agricultural produce and crops. Associations are the Gujarati Shroffs Association in Ahmedabad and the Bombay Shroffs Association. These perform key disciplinary functions of the members, such as penalising them and setting maximum rates of interest. On the whole, they are less organised than the Multani bankers.

The Gujarati Shroffs provide business which in many respects is analogous to modern banking: receiving deposits on current and fixed accounts, advancing money on call or for fixed periods on security or on personal credit, arranging for remittance of funds by issuing and collecting *darshani hundis*, acting as commission agents and financiers for certain products, and so on.

The pure bankers among them accept deposits and provide clean and secured advances. They issue *hundis* to customers against payment in cash or on credit for transferring money from one centre to another, and for the purchase of goods they offer their customers sight *hundis* drawn on their or other Gujarati Shroffs' firms. They also honour *hundis* drawn on their customers for the delivery of goods.

The merchant-bankers combine commission agency business with banking. Commission agents are either purchasing or sales commission agents. The former purchase and deliver goods on credit to up-country customers according to order, and these repay the credit when they sell the delivered goods. The *shroffs* charge a certain commission plus extra charges and an interest rate. The selling commission agents advance money for up to 80 percent value of goods on railway receipts of their up-country clients, sell the goods once delivered, and remit the balance between selling price and advances minus the commission charge and other charges to their customers. Commission agents-cum-bankers facilitate the flow of goods from centres of production to remote centres of consumption and from centres of primary production to urban centres. Different firms have specialised in different product lines. Most firms are partnership concerns. Large enterprises have more than 30 branches. In addition *shroffs* have arrangements of reciprocal accommodation for the acceptance and payment of *hundis*.

The SGIB (1971) reported a number of accounts per firm ranging from 50 to 3,000, while one big firm had around 15,000 clients all over India. The firm's capital consists of its own capital plus deposits from the public and interborrowing, whereas bank borrowing is hardly used. The interest rates are more attractive than those of commercial banks.

Characteristic of the Gujarati Shroffs is their own call money market, comparable to the inter-bank call-money market. This market efficiently allocates idle resources of one Gujarati Shroff on the demand of another and enables the necessary liquidity of firms for short-term demands of their customers. The rates in this call money market are determined and reconsidered every month by the Gujarati Shroffs Association and react strongly to seasonal changes of demand.

Due to the decline in *darshani hundi* business resulting from government legislation, some Gujarati firms run a business which is similar to the Multani bankers. Since both Multani and Gujarati Shroffs operate in Bombay and various other places in the same business lines, this might result in competition which reduces the interest rates.

Nattukottai Chettiar and Kallidaikurichy Brahmins

These two banking communities which are involved in similar operations both have their days of indigenous-style banking behind them, due to structural change, a regulated financial system in India and competition from the Multani Shroffs as well as commercial and co-operative banks in their territory.

The Nattukottai Chettiar had the most elaborate branch networks, but interestingly outside India. It was largely set within the British colonial context. Since they were heavily involved in the finance of agriculture, they were called 'moneylenders' which, to my mind, under-estimates their importance as financial intermediaries and ignores the international aspect of their activities in Ceylon, Burma, Malaya, Singapore and, to a lesser extent, Mauritius, Indo-China and Sumatra. In India, the Nattukottai Chettiar operated in the Tamil Nadu Districts of Madurai, Ramnad, Trichinopoly and Tanjore. The Kallidaikurichy Brahmin bankers, on the other hand, operated mostly in the Tinnevelly District. In addition to agricultural finance, both castes were involved in *hundi* business, the acceptance of current and fixed deposits, the honouring of cheques, the provision of safekeeping facilities and acting as pawnbrokers of gold and ornaments.

Both groups organised business on the basis of joint families, and each firm was an entity in itself. However, strong community solidarity and mutual help accounted for their economic success at the same time. While the wealthier among the Nattukottai Chettiar operated their family or partnership firms, the less wealthy were employed as agents, with a salary and share in the profit. The extensive agency system of the Nattukottai Chettiar is characteristic of their business. The old Chettiar firms based on *hundi* business are said to be practically non-existent. The remaining Nattukottai Chettiar banking firms provide finance to small traders and artisans, and the business of most firms has changed from proprietary concerns to partnership concerns.

A category apart from the Nattukottai indigenous-style bankers are the numerous Chettiar pawnbrokers (see Table 1), most of whom belong to sub-castes other than the Nattukottai Chettiar. A detailed account of the latter was provided in another article (Schrader 1996).

Marwaris

Marwaris have been seen as the most important commercial caste of Western and Northern India. Being largely engaged in moneylending and crop dealing during the colonial period, the most successful became industrial entrepreneurs in eastern India who, by way of financing British firms, eventually took over British shares and even whole enterprises. One section of them, which has been often overlooked, were the Marwari *kayas*, who were and still are the private bankers of Assamese tea plantations. Another financial branch in Calcutta and Madras specialised in the discounting of commercial papers, cheques, post-dated cheques, truck receipts, and so on.

Another less important group of indigenous-style bankers, mentioned by Timberg and Aiyar (1980), are the Rastogis from U.P. who, like the remaining Chettiar bankers, finance small traders and artisans.

Having described the most important castes of indigenous-style bankers in contemporary India thus far, Timberg and Aiyar (1980) provided the following estimates for the late 1970s. Multanis received Rs 3 to 6 *crore*[3] in bank refinance and had Rs 7,5 *crore* in deposits. Gujarati bankers had as many as Rs 800 crore deposits. They paid 7.5 percent on current accounts and up to 12 percent on longer term deposits. Gujarati pure bankers' annual *hundi* turnover in Bombay was Rs 1,000 *crore*, of bankers and commission agents Rs 600 *crore*. Of the Chettiar who are pawnbrokers, 25 percent of their lending was for commercial purposes; and the bankers among the Chettiar held Rs 250 *crore* deposits. Among other things the bankers refinance pawnbroker lending. Rastogi bankers had roughly Rs 55 *crore* in deposits on which they paid 12-20 percent deposit rates. They lending rates of 18-24 percent mentioned were for secured loans only, while rates for unsecured ones were much higher (Timberg and Aiyar 1980).

Finance Corporations

To clarify the term 'finance corporations' (which are often called 'finance companies'), such institutions collect savings from the public by providing high interest[4] and lend them to commercial customers or even speculate in risky ventures. Many of the owners of such companies have their origins in indigenous-style banking, and the difference to such bankers or financial brokers is often only a legal distinction of registration. Timberg and Aiyar (1980) assumed that in the late 1970s such companies numbered more than 2,000 in India. They are involved in financing retail and wholesale trade, agriculture and hire-purchase agreements for used cars. Furthermore, such companies discount and collect remittances and commercial papers, maintain deposit accounts, provide cheques and run *chit* funds (commercialised rotating savings and credit associations). The financial development towards finance and investment companies has been observed all over the world as an urban phenomenon.

Tab. 1: Volume and Rates of Credit in Indian Informal Urban Credit Markets

Caste	No. of firms	Credit extended	Lending rates

3 British-Indian: 10 million.

4 Nayar (1982) reported that the differences of effective deposit rates of finance corporations and commercial banks amounted to 6.7 percent for one-year deposits to more than around 20.5 percent for five-year deposits.

		(Rs crore)	(Per cent p.a.)
Shikapuri, or Multani Bankers			
- Local association members	550	60.0	21-37
- Non-members	650	65.0	21-120
- Brokers	550	125.0	21-120
Marwaris (Madras only)	100	10.4	28-44
Gujarati Bankers			
- Pure bankers	1,500	860.0	average 18
- Bankers and commission agents	3,500		average 18
Chettiar			
- Pure bankers	2,500	380.0	18-30
- Pawnbrokers	40,000	1,250.0	18-30
Rastogi Bankers	500	100.0	18-24

Source: Timberg and Aiyar (1980: 280); estimated figures. Selected data.

1.3 The Relation of Urban Formal and Informal Finance

Contrary to the commonly assumed hypothesis that informal credit is accessible quite easily and quickly, Timberg and Aiyar (1980: 295) maintained that, with the exception of metropolitan financial markets, informal loans are more difficult to obtain. An advantage is that urban informal lending takes place in many cases without any collateral. Some of the negative aspects of urban informal finance are the usually higher interest rates, the brief lending period and the essentially fixed terms of repayment. Most larger enterprises, which also have access to bank credit, too, make use of mixed formal and informal finance.

Most of the informal loans in urban areas are aimed at trade and industries (see Tables 2 and 3). Gujarati Shroffs predominantly finance wholesale trade in agricultural goods and craft work commodities, while Shikapuri Shroffs provide loans to a wide range of trades and industries. The Rastogis and Chettiar finance smaller traders and artisans. Shikapuri brokers and others finance a wide range of activities depending on the market in which they engage. Special demands on the informal markets come from exporters, builders and restaurants who have no physical security to offer. None of the groups provides agricultural credit to avoid conflict with moneylenders' acts.

Film finance is a very risky business and relies mainly on black money. Estimates are around Rs 750 *crore*, of which two third is said to be black money.[5] More than 500 brokers, among them Chettiar, participate in this type of finance and take inter-

5 According to Sundaram and Pandit (1984: 676), the informal credit market consists of 'legal' (or, to be more precise, legitimate) informal institutions and illegal, black market institutions, the latter of which take lower interest rates since they operate with money which has been illegally obtained. This informal black money market is largely a response to government regulations, such as income and value-added taxation, restrictions on foreign exchange and import-export business, and so on. The suppliers and demanders are mainly businessmen who also have access to formal finance.

est of 36 to 60 percent and sometimes even up to 120 percent. Most informal lenders are not involved in such risky business.

Tab. 2: Destination of Informal Financial Market Funds (Percentages)

Financial Agents	Trade	Exports	Small-scale Industries	Large Industries	Other
Multani	32	20	16	7	25
Gujarati	60	10	5	10	15
Chettiar	45	10	5	20	20
Rastogi	55	12			33
Pawnbrokers	22		5		73
Finance Companies	40		8		52

Source: Timberg and Aiyar (1980: 295)

A break-down of the financing of particular branches showed that 50 percent of finance for the wholesale cloth trade and 20 percent of the grain trade in Calcutta came from informal sources. In other branches the share was 15 to 30 percent. A typical borrower had Rs 100,000 in assets. Loans per person ranged from the occasional Rs 100 (small shopkeepers) to Rs 1,000,000. The minimum loans of industrial firms were around Rs 100,000.

The Report of the Asian Development Bank (Ghate 1992) provided the following picture of finance for India in 1987.

Tab. 3: Sources of Funds of Selected Branches in India (1987)

Sector	Own Funds	Formal Credit	Informal Credit
Road construction	62	6	32
Garment exports	31	26	43
Film finance	5	--	95
Powerloom units	43	10	47
Textile trade units	42	10	48
Housing finance of households	66	20	14

Source: Ghate (1992: 110)

Considering the costs of funds, the interest rate in the informal financial market is generally higher than in the formal one. The interest rate consists of the cost of funds, the risk allowance and monopoly profit. These components vary from one lender to another if not regulated by the particular association (see Ghatak 1976) or the environment. The SGIB (1971) mentioned the following factors which generally determine the cost of credit and the availability of funds:

> (1) elements of risk involved in lending, (2) credit-worthiness of the borrower, (3) nature of the security and also the liquidity of the security, (4) ratio of owned to borrowed funds with the lender, (5) site and period of the loan, (6) monopolistic and monopsonistic situations of the traders-cum-bankers, and

> (7) elasticity of demand for funds coupled with inelastic and limited supply of funds. The price of capital in the unorganised market is also conditioned by the ability of indigenous banking agencies to (a) utilise and invest available funds, and (b) recover capital losses incurred through bad debts (SGIB 1971: 61).

Timberg and Aiyar (1980: 291) calculated the transaction costs of different formal and informal financial agents and institutions, which averaged between 3.5 and 5.5 percent. For small loans they are considerably higher. Comparatively speaking, the borrowing transaction costs of informal credit are lower because banks in India demand high extra charges, and a loan provision often involves a bribe.

Urban informal financial markets in India are strongly segmented in that they are localised and even sub-localised. Urban informal financial agents and institutions lend to and borrow from a limited number of parties, usually sharing the same occupational background, whereas particular banking castes have specialised in the finance of particular branches. Due to market intransparency and occupational segmentation, there is only a limited inter-market flow, so that the allocation of funds by indigenous-style bankers is not necessarily the most efficient one if seen from the national perspective. Exceptions are the contemporary Gujarati and Marwari networks who finance long-range trade.

Summarising Timberg and Aiyar (1980), in the late 1970s the lending rates of indigenously developed bankers and brokers in India ranged from 18-24 percent p.a. for larger established traders and 24-36 percent for smaller artisans and traders. Cheques and bills were discounted at 18-24 percent. Call money loans were sometimes provided for not more than 12 percent, while black money was available from 12 to 24 percent depending on the area. Commercial banks' lending rates were normally between 13 and 16 percent.

While banks take interest once the account is back in balance, Shikapuri bankers and some other lenders take interest in advance, which is disadvantageous for the borrower. Penal interest is uncommon except in hire-purchase financing. In some cases interest is paid on the basis of the initial loan amount and is not reduced as instalments are repaid. In other cases they accord with the bank standard on the basis of actual liabilities. Additional fees that are common are brokerage (one half to two percent, whereby brokers do not guarantee the loan), charity charges and stamp duties. They may raise the cost of a loan up to six percent and are common with loans from commercial banks too.

The money structure in the segmented informal financial markets and the formal is linked in various ways. Credit supply in the informal financial markets, for example, is very inelastic, and seasonally increasing demand can be satisfied only by diverting funds from the formal into the informal financial market. If credit contraction occurs in the formal financial market, the additional demand cannot be satisfied by the informal. A consequence is an analogous fluctuation in both formal and informal interest rates.

Politicians either aimed at regulating and suppressing the informal financial market (through moneylenders acts and other financial laws) or tried to subject indigenous-style bankers to the control of the Reserve Bank of India and link them with commercial banks. Both the 1929-30 Banking Commission and the SGIB (1971) promoted the linkage concept.

The linkage discussion, which started in the 1930s and was quite unsuccessful because indigenous-style bankers and their associations resented having to subject themselves to the control of the central bank (while the latter resented having to cooperate with the former), receded into the background with the nationalisation of the major commercial banks and their expansion into particular priority sectors like small-scale industry and agriculture, the former being one target group of indigenous-style bankers. The recent report of the Asian Development Bank (Ghate 1992: 198ff.), however, suggested that the sound practices of indigenous-style bankers should exempt them from regulations and allow them to take deposits. It claimed that sufficient control of their business is exercised by their own organisations.

The small-scale and medium-scale trade sectors are still not adequately provided with formal finance. Hence, urban informal financial intermediation of indigenous-style bankers is still required for some time to come.

2 Rural Finance in Contemporary India

2.1 Finance Policy

The Indian financial system was until recently heavily regulated by the government and the Reserve Bank of India. This policy was accompanied by mounting efforts to eliminate informal finance by way of regional and national legislation. According to Balamohandas et al. (1991), the early development plans largely neglected the agrarian sector. They were designed to develop infrastructure and industries. Secondary-sector development was considered to provide the impetus for self-sustained growth. As a consequence, the finance of agriculture was largely left to informal finance. Only with the onset of the Green Revolution did an awareness of the primary sector and backward areas increase.

The government applied a multi-agency approach to rural finance. In addition to the promotion of co-operatives, it encouraged commercial banks to offer more credit to priority sectors. In 1969 the government nationalised fourteen commercial banks, and six at a second stage in 1980. Thus the government systematically built up these banks' infrastructure in more remote regions. The number of offices rose from around 8,350 in 1969 to more than 42,000 in 1983, of which more than half were in rural regions and 9,000 in semi-urban ones. To put it another way, the share of rural branch offices increased by 32 percent from 22 percent in 1969 to almost 54 percent in 1983. The total outstanding advances increased eight-fold from Rs 3,06,400 *lakh*[6] in 1968 to 24,87,500 *lakh* in 1981, the share of agricultural loans amounting to 2.2 percent and 16.7 percent, respectively.

Savings mobilisation was also encouraged. Between 1969 and 1982 the credit-deposit ratio in rural regions increased from 37.2 to 58.7 percent. However, as Bou-

6 British-Indian: Rs 100,000.

man (1989) pointed out, due to the policy of interest rating, savings returns to borrowers are very low. This lack of incentive to maintain a savings account at a bank has led them turn to alternative private financial institutions which provide higher returns or investments in gold and other valuables. On the whole, it should be clear that the lower agrarian strata do not yet have sufficient access to commercial banks. One main criticism is that rural bank branches are advised to transfer savings to urban regions, instead of increasing credit supply where the savings have been raised.

The Banking Commission thus raised doubts whether commercial banks could efficiently provide rural credit and suggested the introduction of a new category of rural banks in remote regions. In 1975 the Regional Rural Banks (RRBs) were instituted to provide credit for the weaker and neglected sectors of the rural economy in a rural environment.

In 1983 the number of RRBs was 142 (sponsored by 22 commercial banks and one State Co-operative Bank). From 1976 to 1983 their deposits and outstanding advances increased considerably (a 39-fold increase in accounts and 87-fold increase in amounts outstanding).[7] In 1983 the share of agricultural credit amounted to 44 percent, followed by retail trade, small business and self-employment (23 percent) and crop loans (17 percent). However, the loans to rural artisans and village and cottage industries are underrepresented amounting to less than six percent (Balamohandas et al. 1991: 1-55).

The quantitative extension of formal finance, however, caused qualitative concerning financial security and rentability. In 1993 the government banks' balance of payment was deficitary. While for 1991/92 they had published profits amounting to Rp. 800 *crore*, the following year exhibited deficits of Rp. 3,370 *crore*, because a large percentage of the banks' assets was 'lost', 'dubious' or simply 'non-performing'. The reorganisation of the banking system has been estimated to cost Rp. 12,000 *crore*. The main issues are pursued: the adoption of international guidelines of banking and the deregulation of formal finance (DSE 1994).

From the point of view of total debts, rural India is no longer the crucial problem area. From the early 1970s until 1982 the share of rural informal finance in India declined from three quarters of total debts outstanding to less than two fifths (Ghate 1992: 63). However, this does not mean that indebtedness has ceased to be an issue in rural India.

2.2 Rural Informal Credit Suppliers

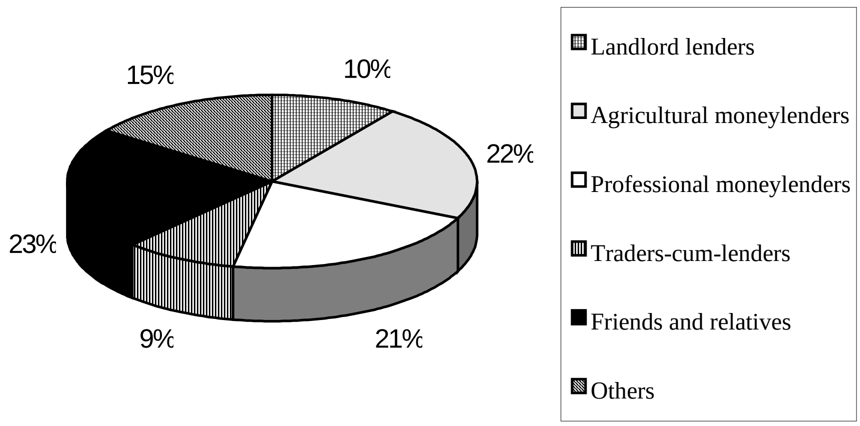
For an understanding of rural finance, scholars (for example, Harriss 1981, 1983; Jones 1994) have emphasised that it is impossible to separate the financial from the commodity markets, since both are directly linked in various ways. In analysing rural financial markets, one method of field research that takes these links into consideration is the identification of all those agents and agencies in a particular setting

7 Advances increased from Rs 711 lakh for 98,400 accounts to Rs 62,400 lakh and 3,845,000 accounts.

(village, region) which are in one way or another involved in finance. The majority of these are commercial-cum-financial ones.

The literature on rural finance in India is extensive and its analysis deserves a study of its own. In the context of changing financial landscapes, I shall largely confine myself to some recent studies and surveys. In addition to formal rural financial institutions, such as banks or, depending on the legal definition, co-operatives, surveys and case studies from India report the existence of a variety of rural informal agents and institutions, such as landlords, agricultural moneylenders, professional moneylenders, traders and crop dealers, pawnbrokers, friends and relatives, and voluntary savings and credit associations, with a widely fluctuating range of importance depending on the area.

Fig. 1: Types of Moneylenders in Rural India, 1982



Data from Ghate (1992: 45, FN 2)

According to the Report of the Asian Development Bank (Ghate 1992) in 1982, landlord-lenders had on average a market share of ten percent in informal finance, agricultural moneylenders of 22 percent, professional moneylenders of 21 percent, traders-cum-lender of nine percent, friends and relatives of 23 percent and others of 15 percent.

The most widespread credit instrument of village moneylenders is the promissory note, which is defined by the Negotiable Instruments Act, Section 4, as ”an instrument in writing containing an unconditional undertaking signed by the maker to pay a certain sum of money to or to the order of a certain person or to the bearer of the instrument” (quoted by the SGIB 1971: 44).

Promissory notes are either payable on demand or after a certain period. Another common instrument is the bond or *dastavez*.

> Bonds are written on stamped legal forms and are duly executed. All the terms and conditions of the advance agreed upon, such as the rate of interest, penalty for default, etc., are explicitly written in the bond. Bonds are used

> where it is considered safer to have all the terms of the advance clearly spelt out in writing. Where the borrowers are illiterate, the lender maintains '*bahis*' or stamp books in which he obtains either the thumb impression or the signature of the borrower as evidence of the debt. However, it is not customary to mention the terms and conditions of the advance which are settled orally (SGIB 1971: 44).

A third common instrument in rural lending is the mortgage or *rahan* of landed property, which is either simple or usufructuary. The loan commonly amounts to half of the market value of the land, and the interest is lower than in the case of promissory notes. A simple mortgage is allowed to run a maximum of 12 years.

Common among borrowing traders is the instalment credit (*kist*) on daily or monthly repayment. The first instalment is often reduced from the principal.

A relatively large part of informal credit is usually classified as consumptional. Consumption purposes are categorised as

- subsistence, emergencies (incl. medical expenditure) and other essential purposes;
- housing, education and purposes such as emigration;
- the purchase of consumer durable goods; and
- lavish, ostentatious or conspicuous consumption.

The latter is often associated with high expenses for social occasions. In India in particular life-cycle rituals such as marriages and funerals are a very costly affair and may indeed cause the indebtedness of a household, since the expenses are multiples of annual incomes. A study from Bihar on reasons for borrowing, for example, showed that marriage and funeral expenses accounted for 51 percent of all loans (Mundle 1979: 108).

The above categorisation is not very meaningful because the hidden purpose of borrowing is in many cases an investment. For example, emigration is a tool for income generation, a bicycle at least saves public transport fares or may even constitute a means of production (for hire), expenses for education are human capital formation and even food can be considered as reproducing manpower. Furthermore, expenditures on subsistence of the family may reproduce the labour force. Ghate (1988) introduced a useful distinction between productive loans, consumption loans and productive consumption loans.

The recent study of the Asian Development Bank (Ghate 1992: 106) fell back on the 'standard' classification. It counted an average of 24 percent production loans, 65 percent consumption loans (including expenditures on housing construction and repairs, which together formed about 37 percent of total informal credit, and 57 percent of consumption credit), and 11 percent payment of past debts.

From the perspective of a borrower, such classifications make even less sense because he or she does not distinguish between such purposes. Another often neglected fact is that borrowers tend to combine different types of formal and informal loans in order to maximise their credit volume or maintain different credit lines. Borrowers

> tend to build around themselves protective networks of security, stretching from relatives and friends to patron and landlord, trader, shopkeeper, priest, fellow artisan. Such networks are necessary for sheer survival. In the context of these networks much community-based credit has social undertones and is generated on a basis of reciprocity (Bouman 1989: 92-3).

Traders and crop merchants lend in cash or kind. They usually do not take collateral and may discriminate against some customers because of high demand. Harriss (1983) reported that the loan amounts are medium scale, interest rates remarkably consistent and not much above the legal ceiling (which was 12 percent at that time in Tamil Nadu). Repayment is normally in kind and takes place after the harvest. A delay in repayment for more than one month after the harvest (20 percent of the sample) gives rise to an increase in the interest rate.

A large number of traders and crop merchants can survive in the market only by providing credit to small farmers at low interest, and this is generally explained by the securement of agricultural produce.

Pawn brokerage is very common in India and practised by every lender who takes physical or legal possession of movable property. Whether a financial agent is a moneylender, a trader-cum-lender or a pawnbroker is very often a matter of definition, and the declaration of a business as a pawnshop only a legal distinction.

Pawn brokerage has continued to flourish in India, probably as a result of the steep rise in gold prices, and is very often combined with goldsmithery, gold refining and jewellery. Lending on pledged valuables was part and parcel of the ancient profession of moneylenders. Pawnbrokers provide smaller loans than moneylenders and the latter do not even tend to lend such small sums. According to Harriss (1981: 166, quoted by Bouman 1989: 76ff), until 1965 pawn brokerage/moneylending in North Arcot (Tamil Nadu) was primarily in the hands of Marwaris. Thereupon many newcomers from Tamil Nadu entered the business. These are mostly part-time lenders with a regular salary from their primary professions, such as officials, teachers, and clerks. Better-off farmers also tend to operate pawnshops. The increase in non-professional moneylending and pawn brokerage is, according to Harriss, a reaction to an increasing need for small agricultural loans. In Harriss' (1983) sample from Tamil Nadu, pawnbrokers charged an interest rate of up to 25 percent which was higher than bank interest charges. Sivakumar (1978: 847f) reported of Marwari pawnshops that interest rates vary according to the pawn.[8]

Overall the number of licensed and unlicensed pawnbrokers in India increased during the past decades. Bouman (1989) took a particular look at informal pawn brokerage in Sangli District of Maharashtra, where this increase was stopped by the Debt Relief Act in Maharashtra State from 1976. Various moneylenders and pawnbrokers closed their shops or concealed lending activities behind a commercial front. This dried up a credit supply for poorer people.

8 For gold, the rate was 2.5 to 3 percent per month; for silver, 4 percent; for brass and copper, 6 percent; for durable goods, such as watches or radios, up to 10 percent (quoted by Bouman 1989: 79).

The Reserve Bank of India fixed interest rates for licensed pawnbrokers. These rates, however, are unrealistic. Privileged borrowers, like farmers, will obtain preferential rates of nine percent only, while the pawnbroker has to pay 17 percent at the bank. To evade this act, the pawnbroker simply changed the profession of the borrower in his book and charged the maximum of 18 percent. In addition, many pawnbrokers make covert extra charges of two to three percent per month or even more for short-term loans (Bouman 1989: 91).

2.3 The Relation between Formal and Informal Rural Finance

Considering the relation between formal and informal rural finance, it is obvious that formal finance has not substituted the informal one to date. Scholars take controversial points of view of the relation of rural formal and informal finance. One study considers both formal and informal finance competitive. In her case study from Tamil Nadu, Harriss (1983) found active competition among all the informal institutions and lenders as well as formal ones, and Iqbal (1988) added that the existence of banks in villages reduces moneylenders' interest rates.

Another viewpoint considers both informal and formal finance as complementary since they finance different segments of society (for example, Jones 1994). Studies taking this position found that informal credit supply by friends and relatives, pawnbrokers and traders-cum-lenders becomes less important the bigger the size of farm. Pawnbrokers lend to the poorer section of society, while small farmers borrow from traders-cum-lenders. Full-time moneylenders, on the other hand, are increasingly concentrating in the towns, and lend to larger cultivators, traders and small producers.

Roth (1983) analysed rural credit markets in North India, and his sample survey produced quite different results from Harriss' (1983) rural financial market, that featured lively competition between formal and informal finance. In Roth's case the market was very inelastic. Most sample credit suppliers were large-scale farmers-cum-lenders. Moneylending is a very attractive form of investment for this category of lenders. They lend cash and in kind, and in many cases occupy key positions in the village administration. Typical interest rates charged for in kind loans were 50 percent of the amount for paddy consumption and 100 percent for seed paddy, to be repaid after the harvest (irrespective of the time of borrowing). 75 percent was taken for a mixed in kind loan for consumption paddy and seed paddy. The interest rates of the different moneylenders were generally the same. Factors, such as the bargaining power or land ownership of the debtor, had hardly any influence on the interest rate. Fluctuations in market prices for paddy did not affect the interest rates. Only cash loans were calculated on the basis of duration of credit and normally on a monthly basis. Cash loans as well as interest were principally repaid in cash. Cash loans in Roth's survey varied considerably from zero to 300 percent per year, depending on the supplier. General interest rates, here calculated on an annual basis, were 36, 60, 72, 75, 120, 150, 180 and 300 percent (ibid: 39ff.).

Roth (1983: 50ff) compared the contemporary interest rates of Bihar and West Bengal with those collected by British civil servants and missionaries in 1827. He concluded that there was no significant change in the conditions of traditional village credit. Neither market integration and formal credit competition, nor specific acts against usury (for example, the Bihar Moneylender's Act of 1938 with a legal maximum of 12 percent) had an impact upon the actual interest rates of moneylenders.

A challenging hypothesis was offered by Gregory (1988). With field work in Bastar District, Central India, this neo-Marxist scholar took the view that formal finance may even support the rise of moneylending and rural indebtedness. It is commonly assumed that World Bank medium-term and long-term productive loans will increase the efficiency of production and enable the agriculturalists to escape the clutches of traditional moneylenders. However, the operation of the World Bank-initiated Land Mortgage Bank produced just the opposite results. Instead of abolishing poverty through increased efficiency in production (from which the loans should be repaid), the bank caused an upsurge in village-based moneylending. Due to external effects and an unadjusted World Bank policy,[9] the borrowers are often unable to increase their productivity. For a timely repayment of the bank loan, they have to borrow from the moneylender.

Development agencies provide loans for productive purposes only. However, there is little demand in the village for such loans. Consequently, Gregory argued that such institutions have to create a demand. They sell their 'product' by raising unrealistic expectations among the villagers.[10] The inability to repay such unadjusted loans is one important reason for landlessness and poverty for Gregory, and this is not generally the outcome of moneylending business, in spite of land mortgages. The reason for this is that, in many cases, moneylending is not subject to the laws of the market, but rather embedded in social obligations.

Taking a look at the interest rates, Ghatak (1983) conducted a comparative analysis of rural interest rates of India in 1962-63, based on the data of the All India Debt and Investment Survey. He found much lower results than expected. The average interest rates in fourteen Indian states ranged from 8.65 to 29.19 percent only, a figure which was distorted by the high share of interest-free loans from friends and relatives (20-25 percent). Nevertheless, the proportion of loans above 40 percent was low.

Harriss (1992) summarised the findings of various scholars in various Indian regions which link certain production and exchange types to particular types of credit. Differences occur in the form of financial contract, in the market power of lender and borrower, in the segmentation of markets by locality group, crop and collateral, in class discrimination in the market, in unanticipated repercussions of policies, in production forms and in the commodities loaned and repaid.

9 The World Bank, Gregory (1988) argued, applies unadjusted theories which regard capital in technical relation to production only and misinterpret socio-economic conditions and processes. Recent neo-Marxist anthropology (e.g. Seddon 1978), however, interprets capital in the context of social relationships.

10 Indeed, I see a parallel to the assumption of British colonial policy that the peasant has to be educated to escape the 'vicious cycle of poverty'.

2.4 Cost Components

Considering the composition of interest, four cost components have been discussed in the literature: (1) transaction costs; (2) opportunity costs; (3) risk costs; and (4) the degree of market imperfection or monopoly profit.

(1) Transaction costs

Both lenders and borrowers have to take transaction costs into consideration, whereby I shall restrict my discussion to the former, because I believe that most borrowers are probably not aware of the transaction costs. Lender transaction costs consist of: cost of information (which are often zero because the lender generally has a fixed clientele and hence experience of former transactions or obtains information by living in the neighbourhood, while he is also informed of interest rates in other markets), administration, monitoring and the enforcement of loans. Administration costs are increased by the taking of collateral (safekeeping, documentation, etc.), which in turn reduces the costs of enforcement and the risk premium. Repayment takes place either automatically by a crop sale to the lender, by labour provision, instalments, and so on, or collateral or social pressure make repayment probable. To sum up, the transaction costs of informal lenders are relatively small (Roth 1983; Ghate 1992). Mathematically considered transaction costs as a percentage of loan size decrease with the size of loans. The same relation probably exists between interest rate and loan duration because of the fixed cost nature of transaction costs.

(2) Opportunity costs

Generally considered, opportunity costs are the loss of returns from an alternative action compared with the chosen action. For moneylending, this concept means that in a rural setting the interest of moneylending has to be compared with other investment opportunities, such as in land, the maintenance of a savings account, and so on. Since lenders have different opportunities, their opportunity costs vary considerably. Singh (1968), for example, estimated these differences in a village to account for 70 percent.

(3) The Risk Premium

The theory of finance maintains that, in the same way as insurance companies, a lender charges a risk premium for every borrower to be compensated for any defaults. According to Ghate (1992: 146), in India the risk premium is generally low, which does not apply in other countries. It depends on the default rate, which in turn is related to risk-reducing mechanisms like information, credit rationing (excluding risky borrowers), the taking of collateral, and social or physical pressure. A mechanism which significantly reduces the risk is social pressure applied by informal lenders, such as the threat to villagers that they lose social prestige or caste disapproval, pressure by the village *panchayats*, fear of borrowers to lose their credit source, and so on (Balamohandas et al. 1991: 3). Even physical pressure is reported in different case studies of India.

Other lending strategies to reduce the risk premium are to make smaller and shorter-term loans and lend for purposes which increase the ability to repay, such as income-generating activities. For example, Iqbal (1988) found that farmers residing in areas using the Green Revolution technology are charged lower interest rates by moneylenders, because agricultural development seems to lower the margin of risk in general.

Contrary to high default and low recovery rates among formal institutions, the defaulting of informal borrowers is comparatively low,[11] while the recovery rates of informal lenders are less high because they often prefer a long period of interest payment to the quick recovery of the principal sum. The default rates of low-income borrowers are not necessarily higher (Iqbal 1988).

(4) Monopoly profits

While the concept of opportunity costs includes a certain 'reasonable' profit margin between chosen and second-best alternative, any profit exceeding the sum of transaction costs, opportunity costs and risk premium is an extra profit called 'monopoly profit'. Generally speaking, monopoly profit depends on the market situation. In highly competitive markets it tends to be low, while under monopolistic or oligopolistic conditions it may be higher.

Scholars' assessments of monopoly profit vary considerably. Results are mainly based on their assumptions. Bottomley (1983), Harriss (1983) and Singh (1983), for example, maintained that monopoly profit is quite low. Singh provided a micro-economic analysis with a case study from North India, showing that the high interest rates of moneylenders are largely a function of opportunity costs and risk costs. On his sample he calculated annual interest rates as ranging from 134 to 159 percent (average 143 percent), irrespective of any moneylenders' acts. The marginal value productivity of capital on the sampled Indian farms was very high, which engendered a high share of opportunity costs averaging 77 percent. The average costs of distribution constituted 21 percent of the principal. The risk costs amounted to an average of 36 percent. The average monopoly profit was thus 9 percent only. I ask myself how far such calculations make sense from the point of view of borrowers and lenders. From another point of view, the interest rates in less productive regions are nearly as high, but the opportunity costs in particular are considerably smaller. Here the main share is probably the monopoly profit.

On the other hand, Tun Wai (1953), Nisbet (1967) and Lipton (1976), by making somewhat different assumptions about default rates and reasonable rates of return, concluded that monopoly profit plays a substantial role in rural lending. Roth (1983) took up the same view. He considered the rural informal credit market as segmented into smaller, regionally limited markets in which each village moneylender has, socio-economically speaking, a monopoly-like position. Co-operatives, which are usually assumed to be an instrument to combat moneylending, provide no real competition since the richer farmers-cum-moneylenders hold key positions in these institutions.

The fragmentation into small credit markets of limited extent is useful for the lender to minimise risk by personal knowledge of and the possibility to exert pressure on

11 The reason is that borrowers use to combine formal and informal credit. As the interest rates of the latter use to be higher, the rationale of the borrowers is to first repay the informal loans.

the customer. From the borrower's point of view the credit market is also fragmented. He can only obtain personal credit from moneylenders who know him. If he provides a mortgage title, only moneylenders in the neighbourhood who can make use of the right to cultivate the borrower's land would offer credit.

Roth (1983) came to conclude that the high interest rates in his study can only be explained with a high monopoly profit. However, the motive of lending of most farmers-cum-moneylenders is not only a high return per invested capital, but also to create social obligations in the form of mortgages and underpaid or unpaid labour of the debtors. Voluntary credit relations are based on mutual trust and the possibility of the borrower to obtain credit whenever needed. Involuntary commitments are debt liabilities which reduce the freedom and income opportunities of the debtor. Often "an initially voluntary agreement can turn into a personal liability, which obliges the debtor to pay off his old debts and arrears of interest by manual labour on the farm of the creditor" (Roth 1983: 36). Sometimes the third generation after the initial borrower has to work on the fields of the creditor and has no chance of freeing himself from debt bondage.

The Asian Development Bank (Ghate 1992: 149ff.) distinguished between a competitive and a transparent part of informal-sector finance and the non-competitive, non-transparent part. The former functions relatively impersonally and is not interested in the personal attributes of borrowers since it relies on collateral as a substitute for information. It consists of moneylenders lending on a collateralised basis, pawnshops, finance companies, etc. The latter part of informal finance is based more upon personal information than on collateral. Under such conditions every lender has a non-overlapping, quasi-monopolistic position in which demand reacts very inelastically to interest rate changes because the customers rely on their moneylender for future loans. The market for non-collateral based borrowing seems to have a cellular structure with the cells centred around each lender, and each cell contains the number of potential borrowers on which the lender possesses information. Among the borrowers of each lender is a core group for whom switching to another lender is too costly (e.g. long-standing tenants or employees), surrounded by a fringe of borrowers who have potential access to another lender.

2.5 Structural Change in Rural Finance

Bose (1986) analysed change in rural finance from the colonial to the post-independence period. For the latter period he argued that:

- Between 1945 and 1960, specialised lenders regained some importance, due to legislative measures after independence preventing landlords and traders to lend.
- From the 1970s onward, a diversification of lenders has been observed: moneylenders and pawnbrokers, rich cultivators, input entrepreneurs, cash crop brokers and traders. The relative importance of specialised lenders, which have been increasingly controlled by the government, has decreased, while that of linked credit-transactions (such as between cash-crop merchants and cultivators) increased.

This analysis of change in rural finance shows that, although the number of specialised informal financial agents decreased with the enforcement of usury legislation, it works counter to the intended aim, in that it raises the risk premium and interest rates and restricts wider access to credit. Furthermore usury laws force lenders and borrowers to work secretly, which further fragmentised sub-markets. The report of the Asian Development Bank (Ghate 1992: 161ff.) therefore recommended the abolition of usury laws, while it was proposed that the registration and licensing for purposes other than deposit taking be voluntary. It argued that instead of the categories legal/authorised and illegal/unauthorised, a distinction should be made between registered/licensed and unregistered/unlicensed intermediaries, and the public should be aware of the costs and benefits involved in dealing with each category.

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