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SEMINAR ON INFORMAL FINANCIAL MARKETS IN DEVELOPMENT

THE INHERENT STRENGTH OF INFORMAL FINANCIAL INSTITUTIONS

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ABSTRACT

Four major types of informal finance in India are described and their strengths identified. Author then argues that informal finance is often conducted more effeciently than is formal finance in terms of loan processing, being able to make small and short-term loans, and also regarding loan recovery.

THE INHERENT STRENGTH OF INFORMAL FINANCIAL INSTITUTIONS

by

C.P.S. Nayar

In spite of the phenomenal expansion of a variety of modern financial institutions in the formal sector which, inter alia is supposed to replace the "outmoded and exploitation-infested" financial agencies in the informal sector, the latter's popularity as reflected in the demand for its services is on the rise in India. Is it solely due to the operational weaknesses or constraints of the formal sector or due to the inherent strength of the informal sector? To get an answer one has to examine the working, especially the loan related operations of both the sectors.

At the very outset it may be remembered that the Indian informal financial sector is highly institutionalized and is thus much broader in coverage than its counterparts in other developing countries. With an organizational structure, covering institutions both in corporate and non-corporate forms, the informal credit market in India is fairly well organized. As Chart I shows, there are several financial institutions in the formal and the informal sectors in India. Due to constraint on space, we confine our study to the major ones in them, namely commercial banks in the formal sector and chit funds (ROSCAs), nidhis, hire-purchase finance institutions and finance corporations in the informal sector. Data on banks made use of in this paper are from the published reports of Reserve Bank of India (RBI), Government of India and an unpublished evaluation study by an individual researcher. Data on informal sector financial institutions are from published and unpublished research works of individual researchers. However, when the operational details of the two sectors are compared, one should keep in mind the fact that the operations of commercial banks, including interest rate fixation for both deposits and loans, liquidity requirements and credit-deposit ratio are controlled by the Central Banking Authority of the country, i.e., the R.B.I. while those of the informal sector institutions are generally free from any such control, though most of them are covered under different Acts of Government and Rules of RBI. Before examining the loan related operations of the informal sector financial institutions, it is useful to have a look at the working of the four institutions mentioned above.

CHIT FUNDS (ROSCAS)

Chit funds are conducted by companies, partnerships and sole proprietorships. Of late the accent is on company form of organization. The salient features of a chit fund, also known as kuri, or chitty or chit may be summarized as follows. A promoter (foreman) of a chit fund collects a specific periodical (usually monthly) subscription from each of a specified number of subscriber members for a specified period. In each monthly installment, the total monthly subscriptions of all members, called the capital of the chit fund, minus a commission of 5 per cent of it to the foreman, is given out as the prize amount to one of the members selected either by lot or auction. All members will have to contribute the periodical subscription till the end of the specified period. As the number of periodical subscriptions (installments) and the number of members are equal, and one member can take the prize amount only once during the chit period, each member gets a chance to receive the prize amount (For details of working of chit funds, see Nayar (1973, 1984, 1986 and 1989; Radhakrishnan and others 1975).

Distinguishing Features:

Certain aspects of chit funds make this institution different from other financial institutions in financial intermediation. A few may be noted:

a. Savings Mobilization: Traditionally, a chit fund was viewed as a common (economically poor) man's institution for accumulation of savings. Savings by people who have more income than expenditure are a natural phenomenon but savings by those who lead a hand to month existence are exceptional. The merit of a chit fund is that it encourages the poor households to spare something out of their daily bread for a rainy day. The investment of accumulated bits of savings in gold jewelry or household utensils or in a goat or a cow by one household through a chit scheme is a sufficient inducement for a nearby household to join a chit. This is particularly so in the case of women who manage the household affairs and the low income category of people who cannot think of acquiring assets through other means. An unique feature of savings in a chit fund is that there is a sort of compulsion in effecting savings. Savings in a bank or post office or other institutions are voluntary. After opening an account in any of them, the account holder is not bound to make savings regularly even in a recurring account. A recurring deposit can be discontinued before the stipulated period at the will of the depositor who will get back the amount in his account at the time of closure. But the position in a chit fund is different. Once a person becomes a member of a chit fund, he has to subscribe the stipulated amount regularly and compulsorily during the entire period of chit. If he discontinues after a few installments, he will not get the amount subscribed before the end of the chit period (previously, before the enactment of any legislation he used to lose it altogether). The obligation to pay the subscriptions is so strong that, at times, a subscriber may postpone or even cancel other routine expenditures. Sometimes he may borrow to pay the subscription in time and repay the debts afterwards. Thus there is a self imposed obligation on the part of the subscribers of chit funds to make savings.

One major attraction of a chit fund is that it allows the subscribers to take the total subscriptions, partly paid and partly yet to be paid, in advance. More than anything else, it is this facility for immediate realization of future savings in a lump sum that induces many people to subscribe to chit funds.

b. Lending through Auction: In an auction or business chit, the eligible (non-prized) members meet at every auction date to take the prize amount if the competition in bidding is relatively small or to raise the discount if the competition is stiff. In either case a competitive discount (or interest) rate is arrived at. The competition is, however, limited to the members. No outside party or outside action is involved in either boosting the rate or depressing it. The chit fund foreman is neutral in interest rate fixation. It is the borrower who fixes the rate of interest on the loan! What distinguishes a chit fund from other financial arrangements is that it is the only financial institution which gives freedom to a borrower to fix the rate of interest for credit.

NIDHIS

An indigenous financial institution commonly seen in South India is a nidhi, often called as a mutual benefit fund or permanent fund. Nidhis are public limited companies registered under the companies Act 1956 and its earlier version. Their objects are to promote the habit of thrift among the members and to provide loans to them at reasonable rates of interest against the security of gold jewelry and house or landed property. The services are extended only to the shareholder members. Considering the unique nature of their organization, namely, restriction of business to shareholders only, they are governed by special provisions under section 620 A of the Companies Act. Devised to cater to some specific requirements of people in the middle and low income categories, they generally keep the face value of their shares very small, often one rupee.

Nidhis are managed by a Board of Directors elected by the shareholders at the annual general body meeting under the principle of one man one vote. After the initial issue of block or bulk shares to the promoters and their relatives and friends, generally not more than one share is issued to a person.

Source of funds

As the face value of shares of nidhis is very small, share capital does not represent an important source of their funds. The shares are not offered to the public through public issue. A person takes a share of a nidhi when he wants to transact business with it, either as a depositor or borrower. With one share he can effect any number of transactions. He can also transfer his share to another person. Thus even when there are thousands of shareholder members in a nidhi, the total share capital remains a relatively small sum.

The major source of funds of nidhis is deposits from members. The deposits include savings, recurring, fixed and cumulative (cash certificate). Generally, fixed deposits form a major part of total deposits. According to a survey of 12 nidhi companies in South India in 1985-86, their deposits mix consisted of fixed deposits (67%), recurring deposits (13%), cumulative and cash certificates (14%), and savings deposits (6%) (Das-Gupta, Nayar and Associates, 1989). Members are not permitted to have current account deposits with nidhis. Most nidhis transfer a major part of net profit to reserves year after year.

Uses of funds

Loans occupy the major item in the use of funds of nidhis. The borrowers of nidhis are mostly middle and lower middle income group people and consist of 1) housewives 25%, b) salaried class 20%, c) businessmen 15%, d) pensioners 25%, and e) others 15% (Das-Gupta, Nayar and Associates, 1989). The purposes of borrowings are personal consumption, renovation/expansion of buildings, purchase of fats, house or plots, investment in business, repayment of other costlier debts, etc.

Interest rates

For various categories of deposits, nidhis offer about 3 to 8 percentage points higher interest rates than the prevailing interest rates in commercial banks. The interest charges on loans of nidhis vary in general from 18 per cent for jewelry loan to 23 per cent per annum for landed property loan. the calculation is on simple interest basis and only on outstandings. The effective jewel loan rate of nidhis is slightly lower than the jewel loan rate of commercial banks under private ownership. There can be no comparison with the banks for landed property loan because the banks do not extend loan against such security.

HIRE-PURCHASE FINANCE INSTITUTION

These institutions are everywhere in the industrialized and non-industrialized world. The common form of organization is a company which extends finance for the purchase of goods and vehicles and then recovers the principal and interest in installments over a period of time. The companies have systematized their operations including the calculation of hire charges which are generally on a flat rate basis. In India, the Hire Purchase Finance (HPF) Companies finance mainly the purchase of commercial and other vehicles of not older than three to five years. Banks also extend finance for new vehicles, but not on a hire-purchase basis. They extend loans on the security of the vehicle which will be hypothecated to them.

There is another category of hire-purchase finance institutions in India. These are either partnerships or proprietary concerns. They specialize in financing the purchase of old vehicles with low price per unit. They are known in different parts of the country as auto finance corporations. Their sources of funds are own funds, deposits from friends, relatives and public and, to a small extent, refinance from banks. They pay interest to their depositors at 18-21 per cent per annum, almost double the rate paid by banks. However, they invest their own funds in the business, in a significant way.

The hire charges of these institutions are about three to six percentage points higher than those of HPF companies. This is because of the high risk involved in financing very old vehicles which are prone to frequent break-downs. The present hire charges vary from 15 per cent to 20 per cent flat rate, giving an effective interest rate of 30 per cent to 40 per cent per annum, depending on the condition of the vehicle and the reputation of the hirer. As these institutions finance vehicles with no standard quality and low resale value, there is no uniformity in hire charges between different institutions or between different transactions of the same institution.

Aid to Weaker Sections

One distinguishing feature of lending of these auto finance corporations is that the bulk of their finance flows to the poor category of borrowers among transport operators. The well-off category transport operators who can afford to invest a sizeable sum of their own, seek credit for the purchase of new vehicles from banks/HPF companies. Their credit requirement per vehicle comes to about Rs.150,000 or more. Against this, the average credit requirement of a used vehicle comes to about Rs.30,000, i.e., about one-fifth of the requirement of a new vehicle. Again, in the case of a well-off category, the demand may sometimes be for more than one vehicle at a time. Thus the lender's resources are used by a few relatively rich borrowers. On the contrary, as the per borrower finance of the auto-finance corporations does not exceed Rs.30,000 to Rs.40,000, they are able to serve about 5 times more borrowers with the same magnitude of funds.

Empirical data show that 90 auto finance corporations in a relatively small town called Namakkal in the State of Tamil Nadu in India had financed 1,080 vehicles involving an amount of Rs.32.4 million in 1986. The organized sector comprising banks and HPF companies which also operate in the area was nowhere in the picture, having financed only 30 transactions (vehicles). By their operations, the auto finance corporations supply a mode of transport for goods mostly in the country side, provide a means of livelihood for thousands of drivers, helpers and cleaners, help to create productive assets by self employed drivers, activate the used vehicle trade and its continued use till it becomes near junk and help themselves with a business to make money. In a capital scarce economy, their contributions cannot be considered small.

FINANCE CORPORATIONS

A finance corporation is a financial intermediary set up for making profit from the business of lending money raised by way of deposits or borrowing (Nayar 1982). It may be a proprietary concern, a partnership firm or a limited company. The most common form, however, is a partnership firm registered under the Indian Partnership act, 1932. The initial funds for the operation of a corporation are contributed as share capital by the partners who may or may not be related to each other. Besides this contribution they may also deposit their money with it and also solicit deposits from relatives, friends and the general public.

In deposit mobilization the corporations offer stiff competition to the organized banking sector, notably the commercial banks. They accept current, savings, recurring and term deposits and pay interest at rates almost double, sometimes even triple, the rates paid by banks. The corporations' policy in this regard is governed solely by the supply of and demand for funds.

It is in lending business that the corporations move ahead of banks through their innovations. Against the stereo-typed pattern of lending of banks, the corporations have introduced novel schemes such as 100-day loan, daily loan, very short period (1-7 days) loan with interest liability only for the actual days of loan, besides loans against very old used vehicles.

Innovative Loans

The 100-day loan which is the best seller among the variety of loans of finance corporations operates with the following conditions: (1) interest will be collected in advance; (2) loan period will be 100 days; (3) the loan amount will be repaid in 100 installments at the rate of 1 per cent per day, the first installment falling on the 2nd day and the last on the 101st day when the loan will be closed.

The corporations currently charge a rate of interest of 10 per cent. This is for 100 days and the effective rate on a principal of say Rs.900 (Rs.1,000 loan minus advance interest of Rs.100) will work out to 40.56 per cent per annum. But the repayment of loan in equal installments reduces the effective loan period to half or doubles the rate of interest. Under such a situation, the rate of interest in the example cited comes to 81.12 per cent per annum. One more point to note is that under this scheme of lending the corporations effect many loan transactions with a given deposit amount, by raising funds out of loan repayments in installments. In a cycle of 100 days, the sum raised through installments of loan made out of an initial deposit of Rs.1,000, amounts to Rs.1,692 and including the initial deposit, the total loan transacted comes to Rs.2,692. If there are 3 cycles in a year, the total loan transactions amounts to (2,692x3) Rs.8,076, eight times the size of initial deposit (Nayar 1982).

Another loan which is popular is a very short period loan extending from one day to a week in which the calculation of interest is on a daily basis. The ruling rate is 10 paise per Rs.100 per day (i.e., 300 paise or Rs.3 per Rs.3 per Rs.100 per month = 36 per cent per annum). Interest for 5 days on a loan of say Rs.5000 comes to Rs.25. If the same loan were from a commercial bank, the rate of interest would be much lower, say 15 per cent per annum. But the bank would charge interest for a minimum period of 15 days. The interest works out to Rs.31.25 for 15 days. Had the borrower who wanted the loan only for 5 days borrowed from a bank, he would have thus paid Rs.6.25 (31.25 - 25.0) more, in spite of the fact that the corporation charged interest at 36 per cent per annum and the bank at 15 per cent per annum. One good effect of charging interest on the exact days of loan is that the borrower will return the loan amount without keeping it idle even for a day. If it were a bank loan, he may keep it idle or put it to less productive use for 10 more days, because his cost is the same up to 15 days. In effect, he blocks the loan from flowing to the most efficient use for 10 days.

There is also a daily loan system in which small sums up to Rs.1,000/- are lent in the morning and recovered in the evening. These loans are taken by vegetable vendors, fish mongers, flower selling women and others and are usually lent on market days which may be one or two days in a week. The current rate of interest is Rs.2 to Rs.5 per Rs.100 per day, which will work out to 720% to 1,800% per annum. Still the borrowers take the loan because the interest cost of Rs.100 is only Rs.2 to Rs.5 while the return on the investment of Rs.100 will be much higher. From the lenders' point of view such loans are risky and involve high recovery cost. Banks do not extend such loans.

EFFICIENCY IN FINANCIAL INTERMEDIATION

In this section we may examine the growth of major informal financial institutions and see if there is any slackening in their activities as a result of large scale expansion of the formal sector represented by commercial banks. We may also examine the efficiency including cost of intermediation of the two sectors.

In Table I is presented data on four major informal financial institutions which mobilize deposits from the household sector for their operations. Data on chit fund companies, mutual benefit fund companies and HPF companies are given in RBI surveys. RBI data also include housing finance companies, loan companies and investment companies in the category of non-banking companies. We have excluded these three because housing finance companies and loan companies are mostly operated with Government funds with little involvement of household savings. Investment companies operate in the formal sector confining their activities in trading and investment of shares, though a few of them raise deposits from the household sector.

The growth of deposits of the four major informal institutions does not show much of a slackening during the 10 year period from 1976. These institutions almost keep pace with the growth of the formal sector as can be seen in columns 7 and 8 of Table I. It must be noted that bank branches rose from 18,730 in 1975 to 52,936 in 1986 (183% increase), bank deposits from Rs.120,340 million in 1975 to Rs.878,870 million in 1986 (650% increase) and bank loans from Rs.73,630 million in 1975 to Rs.549,080 million in 1986 (646% increase). It is all the more important to note that a major part of all these expansions took place in the rural and semi-urban areas where the informal financial institutions were active. Yet, as the figures in Table I prove, the banks are not able to dislodge informal finance from their business. In other words, people still want their services as much as they were getting earlier. Now, what is it that fastens the customers to these informal financial institutions?

Efficiency in Intermediation

Generally, the efficiency of operations of a financial intermediary is judged, among other things, by (1) the speed with which it transacts business, (2) distribution of credit to the borrowers in such a way as to cover many borrowers rather than a few, (3) the rate of return offered on borrowed funds, (4) the rate of interest charged on loans, (5) the intermediation cost, (6) the rate of recovery of the amounts lent, (7) the promptness with which the borrowed funds are returned, and (8) the package of services offered to the clients.

If empirical evidence is any guide, the informal financial institutions are more efficient than the banks in respects of 1, 2, 3, 6 and 8 mentioned above, as efficient as the banks in respects of 4 and 5 and a little less efficient in respect of 7 (7 is only in the case of finance corporations).

The major attraction of all informal financial institutions is their speed in transacting business including disbursal of loans. Scrutiny of loan application, evaluation of property, verification of title deeds, etc. will be completed normally within a week in respect of immovable property and the loan will be released immediately thereafter. The loan against fixed deposit receipts and other movable property will be completed within minutes. The banks, on the other hand, may take about three months to process the application for a loan to buy a vehicle for which immovable property is offered as additional security. A borrower will be lucky if he gets even a jewel loan within hours of submission of application to the bank.

Loan Size

Field data on the size of loan show that the average loan amounts were as low as Rs.12,750 in the case of finance corporations, Rs.20,000 in the case of nidhis and Rs.12,197 (chit amount per chit) in the case of chit funds. Only in the case of HPF companies, was the amount financed higher, at an average rate of about Rs. One lakh. Here again, the finance per vehicle of the noncompany sector was low at around Rs.40,000. The evidence clearly shows that these institutions help small business and small borrowers and depositors (Das-Gupta, Nayar and Associates, 1989).

Table 2 presents data on interest rates paid on borrowed funds and charges on loans by the informal and formal sectors at three points of time. There does not appear to be any strong empirical evidence to suggest that the spread between the lending and the deposit rates is higher in the informal sector than in the formal sector. Taking spread as a crude measure of financial intermediation, it appears that the informal financial agencies are at least as efficient as the formal sector financial institutions (Madhur and Nayar, 1987).

Analyzing the earnings and expenses of finance corporations, one of the informal financial institutions, and commercial banks, another study (Nayar 1982) states: (1) Administrative expenses form only 1.94 per cent of deposits of finance corporations, while they are 3.51 per cent of deposits for banks, (2) Finance corporations spend as much as 2.15 per cent of their deposits on fund raising (whereas the banks get deposits without incurring much financial cost, often through direct and indirect Governmental support, (3) profit as per cent of earnings is significantly lower for finance corporations (5.32%) than the banks (9.28%). This is because a larger part of earnings of finance corporations is given as interest to the savers. The interest paid to deposits and borrowings as per cent of earnings of finance corporations was 74.80 per cent against the corresponding percentage of 60.12

for commercial banks. Broadly, these findings suggest that the informal financial institutions are more "cost effective" in financial intermediation, i.e., in raising and deployment of funds, than commercial banks.

Loan Overdues

It is in respect to recovery of amounts lent that the informal financial institutions show their superiority over the formal financial institutions. While almost all informal financial institutions have a very high rate of recovery of loans, the banks are faced with the problem of mounting overdues, especially in respect to small loans. A recent study on District Credit Plans (Nayar 1987) which covers the overdue position of commercial banks in four selected districts of Tamil Nadu and Kerala highlights this point. "Without exception, all the four districts showed very high overdue percentages (i.e., overdues as per cent of principal and interest dues) in each of the four years under review. Among the public sector bank branches in 1985, ten out of 19 branches in Coimbatore District, five out of 8 branches in Pudukottai District, five out of 10 branches in Palghat District and 8 out of 11 branches in Trivandrum District had overdue percentages above 50 percent."

Against this huge overdues position of a representative sample of bank branches in South India, it is interesting to compare the overdues position of the informal financial sector. For chit funds, field data show that "bad debts formed about 7 per cent of total chit transactions. However, 25 per cent of the institutions did not report any bad debts, although there were overdues in some cases" (Das-Gupta, Nayar and Associates, 1989). For nidhis overdues were practically nil (Nayar 1982, 1984, Ramani 1986). "None of the selected nidhis has reported any bad debt" (Das-Gupta, Nayar and Associates 1989). The same source comments on finance corporations. "Data on defaults in repayments by borrowers show that 23 out of 42 corporations had problems of defaults. However, overdues were small and loans taken to courts for recovery were nil. Debts which were written off as completely non-recoverable were negligible". In the case of HPF institutions, because of the many safeguards provided in the HP agreement and the financier's right to repossess the asset financed in case of default in payment of installments, bad debts are very small in H.P. transactions. There may be some overdues at any point of time; but the arrears are generally collected during the currency of the HP agreement (Das-Gupta, Nayar and Associates, 1989). Thus, on the whole, the recovery performance of the informal financial institutions is far better than that of the formal sector.

Recovery procedures

Now the question that arises is how the informal financial institutions with less manpower, often with traditional accounting practices and low levels of education, no mechanized installations such as computer, and an indifferent attitude on the part of Governmental agencies even when approached for help, recover most of their dues when the formal sector banks with modern facilities and highly qualified manpower fail to do so? The answer is that the informal financial institutions adopt two major safeguards: First a proper scrutiny of loan application and collaterals in respect of tangible security and, more importantly, a personal assessment regarding the real worth (not necessarily in financial terms) of the borrower before the release of loan, and second, timely follow up action, again through personal contact, till the loan is repaid. As a loan is granted not mainly on the strength of documents but on the personal assessment by the lender regarding the social standing and integrity (reputation to meet commitments) of the borrower, backing out of repayment obligations, or seeking evasive measures to circumvent loan contracts by the borrower is much less than in a situation in which the loan is based entirely on documents and the lender's knowledge of the borrower is through documents (Nayar 1982). In other words, the informal sector binds the borrowers with personal and legal obligations while the banks do so with legal obligations only. Often the borrowers take legal obligations lightly and are sometimes happy to be dragged into a court of law by the lender because in that case he can delay the repayment, plead the court to grant him facility of small installment repayments, and even prove that he deserves special consideration in respect of interest rates etc.

Another reason why borrowers attach a low priority to repayment of a bank loan is that a bank loan is generally cheaper compared to the cost of loans from informal sector. Therefore it is advantageous to the borrowers to pay the least cost loan last.

The second safeguard adopted by the informal sector, namely, follow up action is neglected by the banks. An interview with 69 branch managers of commercial banks in 1987 corroborates this view when they opined that "if some follow up action is taken by the branch staff or some kind of monitoring is done occasionally to see whether the borrower is actually using the loan amount for the purpose for which it was sanctioned, the overdues can be reduced, if not eliminated" (Nayar 1987). What emerged from the same interview was that the bank staffs do not attach as much importance to recovery of loan dues as they do to the release of loan. In the context of India where about 95 per cent of the commercial banks in terms of number and volume of business are under Government ownership, this may be due to the fact that the sanction of small loans, in many cases, is based on a quota system fixed for the bank/branch by the Government/RBI. When a bank/branch does not reach a target fixed for it, the staff may be pulled up. The attitude appears to be not so strict with respect of recovery of loans.

Again, in the context of India, the lender-borrower relationship in banks has, of late, become mechanical, due mainly to the abnormal expansion of each bank, resulting in lack of "personal touch" between the banker and the clients. At least in this respect we may say "small is beautiful".

STRENGTH OF INFORMAL SECTOR

The reason why many forms of informal finance continue to thrive despite the penetration of commercial banks even in the rural areas in India is mainly due to the inherent strength of the former in financial intermediation. The demand for the services of informal sector is two types. One is direct demand from both business and households and the other is indirect demand emanating from the unsatisfied clients of the formal sector. The direct demand comes from borrowers who have little access to the formal sector due to reasons such as failure to offer acceptable collateral and inability to conform to the stipulations in respect to credit use. These borrowers also may be at the bottom of the list of priorities in a system of credit rationing by the formal sector. The indirect demand for informal sector credit comes from borrowers who are not able to get sufficient credit at the required time from the formal sector. In a period of contractionary credit policy by the Government, these borrowers turn to the informal sector to supplement their funds from formal sector. Of the two types of demands mentioned above, the direct demand is due to the inherent strength of the informal sector financial institutions, while the indirect demand is due to the constraints (resulting from the adherence to Government policies) and weaknesses (arising from procedural delays, conservative and cautious approach and rigid norms) of the formal sector.

Take the case of chit funds. The compulsory nature of savings, the right of the borrower to fix the discount (interest) rate for a loan, the automatic clearing of a loan at the end of chit period, a reasonable return on savings with the additional benefit (rather a consolation) that at any time from the payment of first installment one can have a cushion against planned or unplanned expenditure, and a low transaction cost limited to a fixed (5 per cent of capital) commission to the intermediary enabling the members to share the gains among themselves are facilities available only in chit funds and are their inherent strengths.

The main strength of a nidhi is the extension of a loan at a relatively moderate rate of interest to its members on the security of building and landed property. Banks do not extend loans for these purposes and against such securities.

The strength of non-company HPF institutions which specialize in financing used vehicles lies in the extension of H.P. credit to those borrowers who have been shunned by other financial institutions.

Finance corporations can claim to have the strong points mainly in their innovative lending practices. Such lending practices are not available in banks.

The preceding paragraphs establish the fact that people patronize certain informal financial institutions because of the particular type of services available with them. Besides these services, there are the attractions of informality and flexibility in operations.

<u>Lessons for Formal Sector</u>

The major lesson that the formal sector can learn from the informal sector is the promptness with which the latter recovers the amount, however small it may be, lent by them. It is useful for the formal sector to examine the methods used by the informal sector for recovery of loan dues. Another point of interest to the formal sector banks should be the popular loans extended by the informal sector. Some of them such as the 100-day loan can be tried by the banks. The major beneficiary of such a measure will be the borrowers who, presently paying an interest rate of about 81 per cent per annum for their loans, will get them at 17 per cent per annum (present general lending rate) from banks.

Policy Aspects

In one respect, the lending operations of the informal financial institutions act counter to the official monetary policy, i.e., when their loans are deployed in purposes not favored by official credit policy. But the impact of credit flows from the informal sector on the official credit policy is not likely to cause any major distortion because only a part of credit of some informal financial agencies flows to such purposes.

But it is established by various studies that the informal sector is both better at serving the sectors neglected by banks and the borrowers like small business-men and traders, poor transport operators, handloom weavers, small agriculturists, self employed and housewives, and also in recovering advances from the borrowers. Therefore, the formal sector banks should adopt a policy of encouraging the informal sector, with refinance wherever possible (e.g., chit funds, H.P.F. institutions and nidhis). In respect of nidhis which extend loans only against tangible security, deposit insurance over by the Deposit Insurance Corporation of India might be extended. With such refinance and liberal credit facilities to the deserving informal financial institutions, the banks will be helping the poor indirectly without undertaking a direct risk of default.

Concluding Remarks

Informal financial institutions function on commercial lines, and under competitive conditions. They raise funds locally without any Government support or tax concessions and lend the same to those who really require credit even at a fairly high rate of interest. Through this intermediation, the informal financial agencies not only fill a gap left by the formal banking sector but also quicken development.

TABLE I
GROWTH OF DEPOSITS WITH SELECTED INFORMAL FINANCIAL INSTITUTIONS

Year (Month end)	Chit Fund Companies (Chit subscription)	Mutual Benefit Fund Companies (Nidhis)	Hire Purchase Finance Companies.	Finance Corporations (non-Companies)	Total of 2 to 5	Annual growth of deposits with informal sector (% p.a.)	Annual growth of deposits with formal sector (% p.a.)
1	2	3	4	5	6	7	8
						(Rs. Million)	
1975	330	199	401	2908	3838	--	--
1976	308	200	452	3417	4377	14.7	21.6
1977	376	198	532	4017	5123	17.1	24.4
1978	352	217	605	4721	5895	15.1	26.2
1979	373	246	700	5549	6868	16.5	21.7
1980	1463	281	911	6522	9177	33.6	17.6
1981	1564	315	1113	7495	10487	14.3	19.4
1982	2081	311	1333	8613	12338	17.6	15.1
1983	2271	356	1579	9898	14104	14.3	17.3
1984	3807	396	1538	11373	17114	21.3	18.0
1985	4392	604	2803	13072	20871	22.0	19.3
1986	6883	735	2793	15022	25433	21.9	17.9

Sources: 1) Columns 2, 3 and 4 from growth of Deposits with Non-Banking Companies, RBI Bulletin various issues.
2) Column 5, (a) C.P.S. Nayar, Finance Corporations, Institute for Financial Management and Research (IFMR), Madras, 1982. (b) C.P.S. Nayar, A Study on Non-Banking Financial Intermediaries, IFMR, Madras 1984. (c) Prior to 1979 and from 1984 figures are derived using the growth rate given in (a)
3) Column 8 (all scheduled banks data) from Report on Currency and Finance, RBI, various issues.

Note: The annual turnover in chit funds should be 12 times higher the figures shown in column 2 because what is given is the stock figure at the end of March.

TABLE 2
DIFFERENCE IN AVERAGE LENDING RATES AND AVERAGE DEPOSIT RATES OF INFORMAL AND FORMAL SECTORS

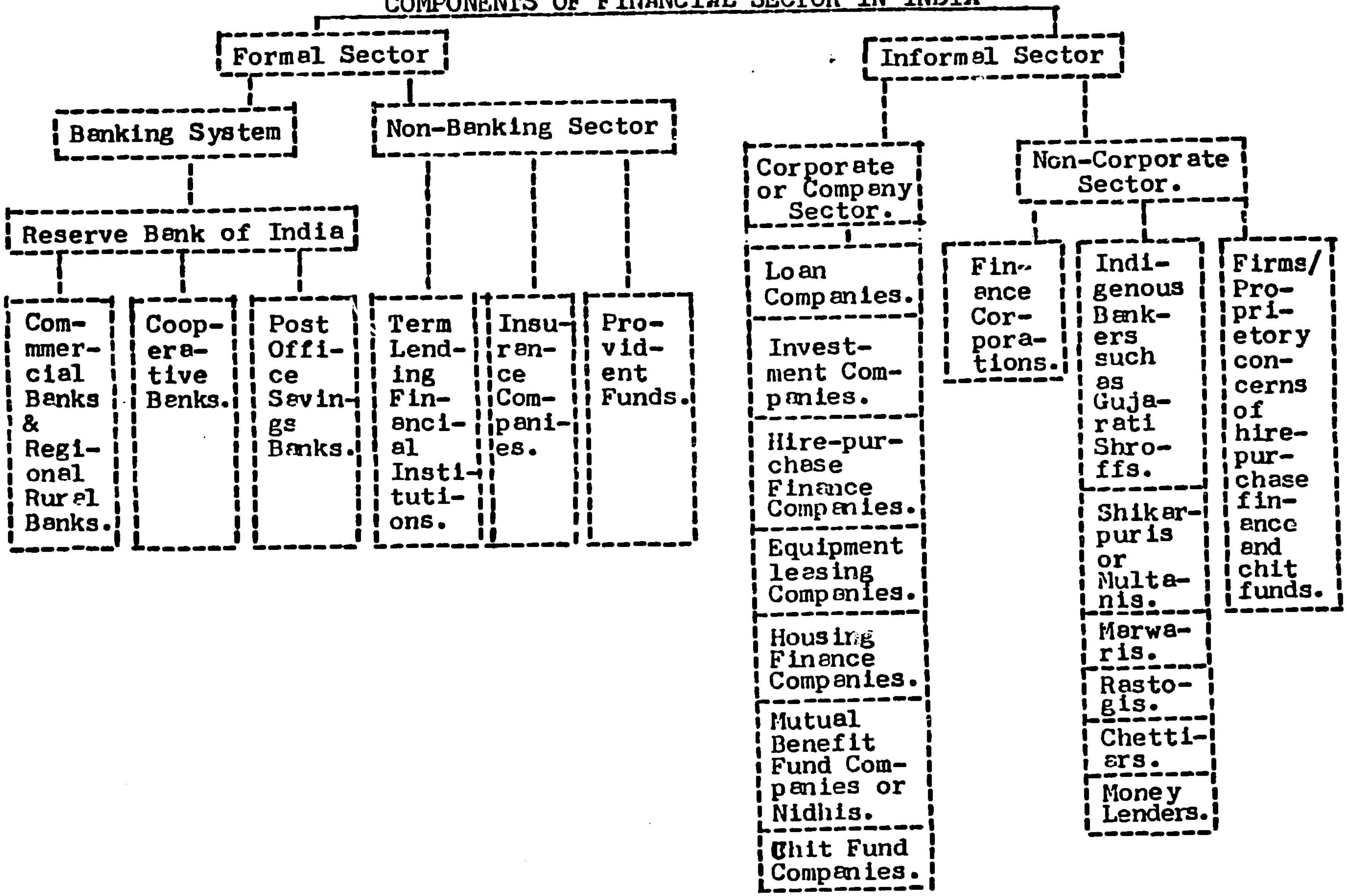
Sector	Year		
	1971	1979-80	1984-85
	(percent per annum)		
Informal Sector*			
Average lending rate	14.1	23.4	25.3
Average deposit rate	10.2	13.7	15.5
Difference between lending and deposit rates (Spread)	3.9	9.7	9.8
Formal Sector (All Scheduled Banks)			
Average lending rate	9.8	16.5	18.0
Average deposit rate	6.3	7.3	9.5
Difference between lending and deposit rates (Spread)	3.5	9.2	8.5

*Informal Sector includes finance corporations, nidhis, chit funds and indigenous bankers such as Shikarpuris, Chettiars, Rastogis, Gujaratis and Marwaris but excludes HPF Companies.

Sources: 1) Informal Sector: Gathered from diverse sources by S. Madhur and C.P.S. Nayar (1987).
2) Formal Sector: RBI, Report on currency and Finance, various issues.

CHART - I

COMPONENTS OF FINANCIAL SECTOR IN INDIA



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