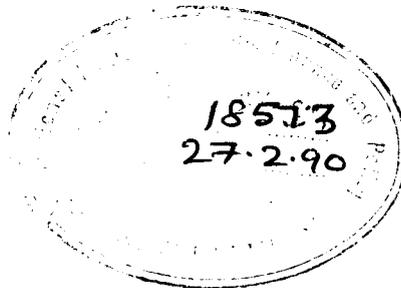




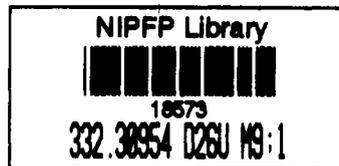
URBAN INFORMAL CREDIT MARKETS
IN INDIA

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SEPTEMBER 1989



NATIONAL INSTITUTE OF PUBLIC FINANCE AND POLICY
NEW DELHI

PREFACE

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

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

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

1. C.P.S. Nayar : Chapters 18 to 21, 22 (except the Delhi case study), 23 (except the note on community chits) and 26 (with S.Radhakrishnan).
2. Krishnamurthy Maya : The Delhi case study in Chapter 22.
3. Sadhna Marwaha: Chapter 33 and the Appendix to Chapter 2.
4. Hiranya Mukhopadhyay : Chapters 24 and 31.
5. J.K. Pandey : Chapters 27 and 28.

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

The focus of the study is on the operation of Informal Credit Market (ICM) in India and its role and impact from the angles of efficiency in resource use, social justice and efficacy of monetary control. The authors have made painstaking effort to provide an idea of the working of the ICM in India, based on a

survey of selected sectors. Secondary data have also been used wherever found relevant and useful. An attempt has also been made to estimate the size of the ICM, though very tentatively. The study brings out several aspects of the operation of the ICM which were relatively neglected in previous studies on the subject such as the possible significance of unaccounted incomes in funding the ICM and the importance of the market structure. It also brings to light the sources and uses of funds in a number of sectors not covered in past researches. An important finding of the study is that even after the rapid expansion of banking services in the country after nationalisation of the major banks in 1969, the ICM continues to finance trade and business activities in a big way, and not merely in the unorganised sector. Some of the case studies documented here also reveal that existing regulations governing the functioning of the ICMs leave much to be desired.

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

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

New Delhi
September, 1989

Amaresh Bagchi
Director, NIPFP

ACKNOWLEDGEMENTS

In carrying out this study of urban informal credit markets, the project team has profited greatly from the help and advice of a number of persons and institutions whom it is my pleasant duty to acknowledge.

The NIPFP team wishes to thank Amaresh Bagchi for going through drafts of several chapters and offering valuable suggestions. Special thanks are due to T.N. Srinivasan, the referee of this report at the final workshop on informal credit markets held in Manila in March, 1989, for his detailed comments on the draft report. Also, the NIPFP project team would like to thank S. Radhakrishnan for his association and for providing data on nidhis. Thanks are also due to other participants at the workshop, to Srinivasa Madhur the former project coordinator, and to Sudipto Mundle, Mihir Rakshit, Shovan Ray, Amal Sanyal and participants of seminars at the East-West Centre, Harvard Institute for International Development, Rutgers University and the NIPFP for helpful comments and suggestions.

We also take this opportunity to thank Prabhu Ghatge of the ADB for his encouragement and patience.

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

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

The NIPFP project team is also grateful to the staff of the NIPFP Computer Centre for assistance with data processing, to Shahana Ghosh for proofreading assistance, to K. Subramanian for secretarial assistance and to N. Natatajan for taking care of photocopying and binding of the report.

Finally, the NIPFP project team is immensely grateful to Promila Rajvanshi who coordinated correspondence, word processing of the report/questionnaires and report production work from the inception of the project with efficiency and cheerfulness.

A. DAS-GUPTA
Project Coordinator

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SECTION I

ASPECTS OF URBAN INFORMAL CREDIT IN INDIA

PART A

Overview

CHAPTER 1

OVERVIEW

1.1 Objectives

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

- i. To examine informal credit market structure and operations and the impact of government regulation on informal credit markets,
- ii. to derive estimates of the size and importance of informal credit,
- iii. to examine the impact of informal credit on allocation, distribution, growth and the effectiveness of short run macro policy and
- iv. to make policy suggestions as to regulation of informal credit markets and formal sector credit operations.

1.2 Definition of informal credit adopted

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

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

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

1.3 Coverage

1.3.1 A total of 6 credit using sectors, 9 intermediary sectors, 1 integrated credit market, 3 cases of regulatory efforts by the government and 3 Reserve Bank of India Surveys of households and firms are covered in this study. The credit using sectors were chosen on the basis of where earlier work or discussions suggested the prevalence of informal credit. However, at least one sector, garment exports, was chosen to examine conditions in a sector

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

1.4 Analysis

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

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

in the chapters dealing with RBI surveys. This is, of course, a limitation of our work which may be seen to have breadth of coverage rather than great depth in view of the comprehensive terms of reference and the limited time at our disposal.

1.5 Main findings

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

- a. Informal deposit interest rates generally exceed formal sector rates as do loan rates of informal intermediaries. However, given the importance of credit from friends and relatives, the average cost of borrowing for informal credit users in the productive sectors studied in this report is lower than the average for all units taken together (Chapters 3 and 5).
- b. Though credit is fungible, making it difficult to determine the extent to which loans for a given purpose are actually used for that purpose, informal credit is largely used for productive activities (rather than consumption) and, inclusive of trade credit, is the dominant source of credit for all productive sectors studied (including in the RBI surveys). That loans from intermediaries are of importance to such sectors as transport operators and handloom weavers emerged in the course of studies of intermediaries. Furthermore, even for credit from informal intermediaries, loans are largely for production or trade (Chapter 4).
- c. Monopoly profits are not an important component of informal lending rates for the major types of informal intermediaries in urban India (Chapter 6).
- d. Informal credit markets are generally at the competitive end of the spectrum of market types. Fragmentation, defined to be a situation where interest rate differentials for similar loans to similar borrowers persist is present due largely to informational obstacles (Chapter 7).
- e. Aggregate informal credit forms about 73% of gross bank credit (at a conservative estimate) though operations of informal intermediaries are much less important (Chapter 8).
- f. The evidence suggests that, in some cases, informal credit

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

- g. That informal credit is, by and large, complementary to bank finance, given current banking practice, finds support from the data from case studies, though not from the RBI surveys of firms. Informal credit is said to complement bank credit when they serve different groups of borrowers or are used for different purposes so that the two sectors are not in competition for the same custom. It is possible that informal credit lowers short run monetary policy effectiveness, though there is less reason to believe that it renders it totally impotent (Chapters 12 and 13).
- h. The hypothesis of financial repression finds some support from the evidence (Chapter 14).

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

- a. Informal loans show greater diversity and readier adaptability to borrower convenience than formal loans.
- b. The average and maximum duration of informal loans are less than formal loans (though not necessarily commercial bank loans).
- c. Informal credit assessment and loan sanctioning procedures are speedier than formal procedures.
- d. The range of activities financed by the informal sector is greater than the range financed by the formal sector.
- e. To the majority of households and unorganised enterprises, informal loans are the main source of borrowed funds.
- f. Informal credit is more important for working capital and capital maintenance finance than for financing the purchase of capital goods.
- g. Informal credit agencies have an absolute and comparative advantage in the provision of credit to small activities.
- h. Due to informational disadvantages and extant technologies for making payments for goods and services, modern banking may not be able to replace informal credit in the medium term even with complete financial liberalisation.

- i. Optimal policy for formal agencies requires them to confine their direct activities to deposit taking and lending only where they have an advantage. Methods of refinancing informal credit agencies should be devised in order to ensure efficient credit delivery to other activities.
- j. Regulation of urban informal credit should be directed at:
 - (i) Ensuring improved information about informal credit and informal intermediaries.
 - (ii) Ensuring the financial probity of informal intermediaries. Such measures should be designed separately for relatively homogenous groups of intermediaries and should err, if at all, on the side of non-interference with the efficient functioning of informal financial markets.
- k. When required, monetary control can be exercised by the central bank by varying the rate at which refinance is available.

1.6 Organisation

1.6.1 The report is divided into 7 additional parts. Part B contains short chapters which describe salient features of urban informal credit including, in the Appendix to Chapter 2, a review of earlier literature. Part C contains chapters in which findings on the economic impact of urban informal credit are discussed. Policy suggestions are in Part D. The second section of the report is divided into 4 parts containing various types of sectoral and case studies. Analysis of RBI surveys of households, small scale industry, traders and transport operators is in Part E. Part F contains case studies of selected intermediaries. Part G contains case studies of informal finance in various productive sectors while Part H documents attempts by the government to regulate informal finance.

TABLE 1.1

Sample Characteristics for Sectors Studied

Sector	Secondary data source for financial data				Field data	
	Name	Year	Location	Sample size	Location	Sample size
Intermediary Sectors						
1. <u>Finance corporations</u>	Nayar(1984)	1982	All India	450	South India	42 companies 31 users
2. <u>Chit funds</u>	RBI(1)		See note(1)	1066	South India	37 chit funds 42 members
3. <u>Hire purchase (1)</u>	RBI(1) FIHPA(2)	1986	See note(1) Madras city & surrounding areas	481 1110	South India and Delhi	30 BPF 12 borrowers
4. <u>Midhis</u>	RBI(1)	1986	See note	65	Tamil Nadu & & Andhra Pradesh	12
5. <u>Auto financiers</u>	(2)Rawani(1985) Local Ass. of finance corporations	1986	South India	1344	Namakkal (T.N)	10
6. <u>Handloom Financiers</u>	-	-	-	-	Karur / Bangalore	10
7. <u>Shroffs of Western India</u>	Bombay Shroffs Association	1986	Western India	N.A.	-	-
8. <u>Intercorporate funds market</u>	-	-	-	-	Metro Cities	60
Credit Using Sectors						
1. <u>Road construction</u>	-	-	-	-	Delhi and Western U.P.	35
2. <u>Garment exporters</u>	-	-	-	-	Delhi	19
3. <u>Film finance</u>	-	-	-	-	Madras	-
4. <u>Powerloom units</u>	-	-	-	-	Surat(Gujarat)	18
5. <u>Textile wholesale trade</u>	Jain et.al.(1982)	1979	All India	950	Bombay	37
6. <u>Housing finance of households</u>	V.D. Lall(1984)	1984	All India	720	-	-
RBI Surveys						
1. <u>Households</u>	RBI	1981-82	All India	31014	-	-
2. <u>Small Scale Industry</u>	RBI	1976-77	All India	12356	-	-
3. <u>Traders</u>	RBI	1979-80	All India	12057	-	-
4. <u>Transport operators</u>	RBI	1979-80	All India	6129	-	-
TOTAL						415

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

PART B

**Description of Indian Informal Credit
and Informal Credit Markets**

CHAPTER 2

URBAN INFORMAL CREDIT AND INFORMAL INTERMEDIARIES

2.1 Introduction

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

2.2 Trade credit

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

2.3 Informal credit instruments

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

2.4 Informal intermediaries and lenders

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2.5 Regional informal markets

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

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

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

CHAPTER 3

DEPOSIT MOBILISATION AND SOURCES OF FUNDS

3.1 Sources of funds of intermediaries

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

3.2 Pattern of deposits with intermediaries

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

lenders for arranging borrowers exist, has been pointed out earlier (Aiyar, 1979 and Timberg and Aiyar, 1980).

3.3 Deposit ceilings

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

3.4 Deposit interest rates

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

3.5 Growth of deposits

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

TABLE 3.1

Sources of funds of surveyed sectors

(percentage of total liabilities)

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

TABLE 3.2

Interest Rates in the Informal Sector

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

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

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

CHAPTER 4

DEPLOYMENT OF INFORMAL CREDIT

4.1 Sectoral deployment of funds of intermediaries

4.1.1 The experience here is quite varied.

- a. Hire purchase firms provide finance primarily for new and used commercial vehicles through one to four year hire purchase agreements. Hire purchase firms also finance consumer durables and non-commercial vehicles.
- b. Handloom financiers, of course, provide working capital finance for production by handloom weavers in the unorganised sector.
- c. Finance from Nidhis is available mainly to households, though small business is also financed. The bulk of loans goes to finance the construction, renovation and repair of houses and other buildings. Loans may be for as long as seven years.
- d. Peerless invests much of its deposits in government securities and term deposits with nationalised banks.
- e. Intercorporate loans average three to six months for private sector corporations and six to twelve months for public sector corporations.
- f. Chit funds mainly finance trade, self employed persons, agriculturalists and, to a limited degree, consumption.
- g. Shroffs in western India largely finance domestic trade through 'hundis', though they also finance exports and industry.

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

4.2 Bad debts and overdues

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

4.3 Importance of informal credit to productive sectors studied

4.3.1 One sector, film finance in Madras, is almost wholly dependent on informal finance. Trade credit proved to be the most important external source of finance for the productive sectors studied, especially for the smaller firms (where a small/large categorisation was feasible). However, owners' capital is the dominant source of finance in road construction. In textile distribution, trading agents (wholesalers) rely more on own funds than non trading agents (brokers and commission agents). While it was learnt that finance from professional financiers is the main source of finance for road construction contractors in Kerala, pure informal intermediaries played next to no role in any productive sector studied. Informal credit from friends, relatives and other associates was, however, of importance, being more important than bank finance in road construction and textile distribution. Whether such funds really reflect informal finance or represent illegal funds is not ascertainable for individual firms but are, in all probability, largely illegal funds in the aggregate given that we estimate such funds to exceed net household sector dues receivable as estimated by the RBI (1987). However, that infor-

mal finance plays a dominant role in the finance of handloom weavers and used truck operators was ascertained from studies of intermediaries. That bank finance is not the main source of finance even to garment exporters, despite various export incentives and concessions, is revealing. Formal credit is more important only for households (including for house construction) and perhaps for transport operators.¹ Details are in Table 4.2.

4.4 Inequality of credit distribution

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

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

4.5 Flow of funds between formal and informal financial sectors

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

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

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

4.6 Overall credit position of credit using sectors

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

- a. Garment exporters, particularly the larger firms, are net receivers of credit and are able to generate large internal surpluses due to the combined operation of three factors: Cheap bank credit to finance exports, export tax concessions and the manner in which the quotas under the Multi Fibre Agreement are allocated between competing firms.
- b. Road construction contractors are net providers of credit to the monopsony buyer of their services, the government, due to the need to provide security deposits and due to delayed receipts of dues.
- c. Textile distribution intermediaries in the middle of the distribution chain are net providers of credit, the beneficiaries being retailers.
- d. Powerloom units reloan about half their borrowed fund as trade credit.
- e. Bhole (1985) reports that large, and after 1970, small companies were net receivers of trade credit basing this conclusion on data for 1956 to 1978. On average, firms in the RBI surveys are net receivers of credit, though for wholesale traders the net credit receipts are marginal.

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

TABLE 4.1

Sectoral Deployment of Funds of Intermediaries

Inter- mediary	Trade	Agri- culture	Const- ruction	Trans- port	Indus- try	Consump- tion	Other
Finance Corporations	35	10	9	4	6	12	24
Chit funds	45	8	Nil	Nil	Nil	37 ¹	10
Hire Purchase	Nil	Nil	Nil	Bulk	-	Minor	-
Nidhis	Housewives: 25 %, Businessmen 25%, others 50 % largely for house construction and repair						
Shroffs	50	NA	NA	NA	10	Neg	40

Note: 1. Including self-employed.

TABLE 4.2

Sources of Funds of Using Sectors

(in percentage)

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

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

CHAPTER 5

LOAN TERMS AND CREDIT APPRAISAL METHODS

5.1 Interest rates

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

5.2 Loan duration

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

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

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

5.3 Collateral

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

5.4 Credit assessment

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

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

TABLE 5.1

Cost of Informal Credit

(in percentage)

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

CHAPTER 6

COST OF INTERMEDIATION

6.1 The decomposition of interest rates

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

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

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

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

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

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

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

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

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

and R is the economic rent.

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

6.1.4 The main interest in such a decomposition is in order to ascertain the extent of monopoly rent and in order to compare across institutions. However the latter objective requires that

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

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

6.2 Estimates

6.2.1 Estimates were computed using average figures across all firms, ignoring inter-firm heterogeneity.⁴ In consequence the figures reflect the average position of firms. Our estimates are given in Table 6.1 for 6 intermediary sectors. These estimates assume an opportunity cost of own funds of 18 per cent for all sectors except shroffs for whom an opportunity cost of 14 per cent⁵ is assumed. The estimates show that there is reason to suspect "monopoly power" only among auto-financiers in Namakkal. However, the second hand auto-finance business is growing rapidly and it is more likely that the rent estimate captures an element of disequilibrium profits. For shroffs, analysis for 1979 revealed a rent element of 35 per cent. The decline in the use of darshani hundis and the sarafi system as a whole due to the impact of recent repressive legislation may explain this, given that shroffs were the sole suppliers of this instrument. The position for the

-
3. I am indebted to T.N. Srinivasan for pointing out the problems with intermediary comparisons based on average values.
 4. When firm-wise data were available. Otherwise other approximations are used.
 5. 14% is assumed on the basis of discussions with respondents in the field survey.

inter-corporate funds market, for risk adjusted interest rates, similarly appears to indicate lack of monopoly pricing, though given the 'joint producer' nature of corporate lenders no estimate were made. Thus the evidence does not support the hypothesis of monopolistic intermediaries in the sectors studied.

6.2.2 The high establishment costs reported in this table appear to contradict the presumption of informal lenders being efficient purveyors of credit. In fact commercial bank costs contributed about 27 to 38 per cent of the interest rate on loans (assumed at 16.5 per cent) in 1984 and 1985. Though the caveat in paragraph 3 should be kept in view and though it should be kept in mind that banks could probably not replace informal intermediaries in the credit sub-markets served by them, these figures do tend to suggest that all informal intermediaries are not efficient suppliers of credit compared to banks in the sense of having low transaction costs. This finding is at variance with earlier studies, such as Timberg and Aiyar (1980). They, however, do not attempt an explicit decomposition. From what is reported in the popular press, and from the little evidence available, informal intermediaries have substantially lower risk costs than banks, a finding which is reflected in the Table. Before leaving this chapter, we briefly summarise findings on informal credit to using sectors. Details of computations for banks are given in Tables 6.2 and 6.3.

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

6.3.1 While most loans were found to be for working capital purposes and were thereby short term loans or even loans on call, the mean effective loan duration was greater than that for formal sector credit in road construction. Furthermore, while the cost of informal finance for film making was between 67 per cent and 99 per cent per annum, the average informal interest rate was estimated to be lower than the cost of bank finance in the other sectors, though the median rate was higher and the dispersion was large in road construction. The main reason for this is that low,

often zero, interest rate loans from friends and relatives are often used by firms. Furthermore, a regression, using inter-State data on the pooled samples from the RBI surveys of firms, of interest cost on the ratio of formal to informal finance showed no significant link between the two.

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

TABLE 6.1

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

(in percentage)

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

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

TABLE 6.2a

Basic Data on Indian Scheduled Commercial Banks

(Rs lakh)

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

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

TABLE 6.2b

Basic Data on Indian Scheduled Commercial Banks

(Rs lakh)

Item	1984	1985
From special returns to the RBI on Forms A1 & A2 (Total Business)		
Paid up capital	30,665	65,020
Reserves	74,434	118,451
Deposits	8,349,820	9,864,917
Cash	1,315,167	1,595,285
Investments	2,489,412	3,102,261
Money at call	186,659	332,399
Loans and advances	4,733,334	5,411,078
Bill business	610,992	611,299
Profit (balance sheet)	4,452	5,872
EARNINGS		
Inland bills	52,199.1	61,337.6
Loans and advances	547,067.5	660,127.6
Investment: government	109,319.7	139,037.6
Investment: trustee	48,267.9	69,332.5
Investment: other	40,747.3	5,855.1
Deposits with RBI	54,759.3	75,323.2
Deposits with banks	11,159.9	18,247.3
Total oper. earnings	949,279.2	1,123,404.1
Total earnings	970,979.1	1,145,832.1
EXPENDITURES		
Interest: deposits	513,563.2	607,641.9
Interest: borrowings	55,590.6	64,210.1
Rediscounts	10,393.1	13,199.6
Other business	10,210.7	11,576.4
Establishment cost	204,173.2	235,938.5
Taxes on operations	1,468.1	1,655.0
Interest tax	13,458.8	4,016.8
Total oper. expense	872,896.0	1,014,407.4
Total expense	891,248.2	1,053,390.5
PRE TAX PROFIT	79,330.9	92,441.6

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

TABLE 6.3

Consolidated Data on Indian Scheduled Banks

(in percentage)

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

TABLE 6.3(CONTD.)

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

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

Source: As for Table 6.2.

CHAPTER 7

STRUCTURE OF INFORMAL CREDIT MARKETS

7.1 Introduction

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

7.2 Intermediary sub-markets

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

presented in Table 7.1.

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

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

7.3 Fragmentation

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

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

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

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

7.4 Conclusions

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

TABLE 7.1

Industrial Organisation of Informal Sub-Markets

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

TABLE 7.1 CONTD.

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

TABLE 7.2

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

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

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

B. Estimated Correlation Matrix of Variables

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

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

CHAPTER 8

SIZE AND TRENDS IN SIZE

8.1 Preliminaries

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

8.2 Methodological issues

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

funds intermediated is of interest. Thus, figures on both deposits and advances by them are of interest. Similarly total informal credit to all sectors is of interest and is accordingly estimated.

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

8.2.3 Thus for most financial institutions, who may be assumed to have a constant level of outstandings throughout the year, or a

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1. Even this is open to objections. A more appropriate measure would, for example, weight loans of different duration differently. Other considerations may also be brought to bear.
 2. The idea in this paragraph arose as a result of discussion with C.P.S Nayar and Srinivasa Madhur regarding the measurement of deposits with chit funds.

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

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

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

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

fact, even if there were transient idle balances, these would have to be deducted. Likewise, as the second part of the example shows, credit which is on-lent (sub-intermediated) should be counted only once.

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

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

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

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

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

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

- a. Ratios of informal credit to formal credit and of informal credit to value added⁴ were based on Reserve Bank of India

4. Value of production in the case of small

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

- b. Even though a statistical test failed to reject the hypothesis of a unitary elasticity of informal credit per firm with respect to income, using cross sectional data and state domestic product as the income variable, the preferred estimate uses an average of two estimates, one using bank credit (the low estimate except for transport operators) and the other using value added.⁵
- c. Though the test reported is for informal credit per firm yet no attempt was made to correct for growth in the number of firms.
- d. Only selected sectors were used in compiling aggregate estimates whereas the bank credit figure used for comparison is for all (urban and rural) sectors.
- e. When aggregate estimates were not available for the most recent year (1986-87), no attempt was made to project these figures. In contrast, the bank credit figure is the most recent available.
- f. A large portion of informal credit was subtracted from the gross total obtained as possibly consisting of black money.

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

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

8.3 Estimates of size

8.3.1 The estimates of informal credit to receiving sectors is

scale industry and a weighted average of credit per vehicle of different types for transport operations.

5. See the previous footnote.

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

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

8.3.3 Informal credit estimates for specific sectors from field surveys which are included but not reported separately in Table 8.1 are in Table 8.3. As mentioned, the basis of computations is in the Appendix. A problem with the inter-corporate funds estimate is that it cannot be reconciled with the estimate of informal credit to public limited companies in Table 8.1. Though the two estimates are based on different aggregate firm populations, there is a large overlap. This suggests that corporate reliance on informal credit is much higher than is reported in Table 8.1 or that our estimate of inter-corporate funds is seriously biased.⁷ The latter may be ruled out since even the total intercorporate

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

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

credit in the sample exceeds the relevant RBI figure. No attempt was made to adjust the Table 8.1 figure upwards in keeping with our general approach.

8.4 Trends in size of intermediaries

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

- i. Hire Purchase : Growth of deposits faster than bank deposits.
- ii. Finance Corporations: Declining.
- iii. Chit Funds: Growth of credit/deposits faster than banks. Growth in popularity outside South India, its traditional stronghold.
- iv. Nidhis: Growth faster than bank credit (from a small base).
- v. Indigenous Bankers (Based on estimates provided by the Bombay Shroffs Association): Declining sharply.

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

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

TABLE 8.1

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

(Rs Crore)

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

Notes: 1. P: Provisional

2. Years/dates given are for aggregate figures used to inflate sample estimates. Stock credit figures may be taken to prevail at the mid point of periods in cases where flow aggregate figures were used.

3. For the basis of estimates see the Appendix.

TABLE 8.2

**Aggregate Estimates of Credit and Deposits Activity
of Informal Intermediaries**

(Rs. crore)

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

Note: See Appendix for basis of estimates.

TABLE 8.3

Sectoral Estimates of Informal Credit Based
on Field Data

(Rs. Crore)

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

CHAPTER 9

REGULATION OF INFORMAL INTERMEDIARIES

9.1 The current regulatory environment

9.1.1 Regulations governing informal intermediaries have been briefly alluded to in Chapter 7 and described in more detail in the case studies. Earlier legislation is described in the Appendix to this chapter.

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

- i. The Non-Banking Financial Companies (Reserve Bank) Directions, 1977 (as amended upto 1984). (abbreviated Nbfd)
- ii. The Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1977 (as amended upto 1984). (MNDB)
- iii. The Residuary Non-Banking Companies (Reserve Bank) Directions, 1987. (RNBD)
- iv. Chapter IIIB of the Reserve Bank of India Act, 1934 (which came into force in 1963).
- v. Chapter IIIC of the Reserve Bank of India Act, 1934 (which came into force in 1983).
- vi. Chapter V of the RBI Act, 1934.

9.1.3 In addition, ineffectively enforced moneylenders acts impose interest rate ceilings, registration and record keeping requirements in various states in India. Further details are in the Appendix to this chapter.

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

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

- i. Issuing advertisements and other promotional material
- ii. Information it is empowered to call for
- iii. Directions it may issue
- iv. Inspection and
- v. Soliciting of deposits by such institutions.

Under the Act, companies and partnerships are included in non-banking institutions, provided partners' capital exceeds Rs. 1 lakh in the latter case. Non-banking institutions include 'financial institutions', which includes non-banking institutions which finance trade, industry, commerce or agriculture, which invest in shares, stock, bonds or government securities and hire purchase firms

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

9.1.7 The three sets of Directions apply to different groups of informal intermediaries. All of them, however, apply only to companies as defined in section 45I(a) of the RBI Act, 1934 and not to other unincorporated firms. All three sets of directions place limitations on the duration for which deposits can be

accepted. In addition, both Directions of the year 1977 lay down ceilings on the ratio of net owned funds to deposits. Deposit interest rate ceilings applicable to most firms are laid down in Nbfd and MNDB and a cash "reserve ratio" for certain firms is also laid down in Nbfd. As discussed earlier, RNBD, which applies to Peerless, lays down stringent requirements for the loan portfolio allowed.

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

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

9.1.10 A Hire Purchase Act has been on the statute books since 1972 though it is yet unenforced.

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

9.1.12 In the light of our discussion currently in the previous paragraphs it is easy to see that, if enforced properly, the major laws governing informal credit intermediaries will stifle the healthy development of informal financial markets. Directions for information returns and for advertisements and also the powers of the RBI under Chapter IIIB appear, however, to be adequate for the formulation of suitable monitoring schemes. Also, as the case studies show, the current corpus of regulations does not in any way prevent questionable firms from winning the approval of the

RBI or from indulging in counterproductive activities. It should be clear, without further discussion, that a drastic overhaul of the regulatory corpus and also its enforcement machinery is called for.

9.2 Self regulation:

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

9.3 Government regulation at work:

9.3.1 Four cases of government regulation are discussed in the report. The first case study documents the progressive stifling of shroffs of Western India by regulations such as Chapter IIIC and requirements under the Income Tax Act that payments above a certain size be made by cheques rather than, say, hundis. The second case study concerns the government's attempts to regulate the intermediary firm Sanchaita Investments. Due to a weakly made out case, the Supreme Court quashed legal proceedings against Sanchaita, even while acknowledging that it paid interest on deposits out of fresh deposits and had a questionable loan portfolio. The third case, that against the 50 years old Peerless General Finance and Investment Company was also thrown out of the courts since the Reserve Bank tried to classify the firm as a banned 'prized chit/money circulation scheme'. This classification is difficult to accept. In fact, though Peerless' activities were in some cases arguably sharp, it was by and large an innovative and dynamic financial intermediary. Thus the wisdom of attempts by the Reserve Bank to suppress it completely can be questioned. The fourth case relates to the RBI's action against finance corporations known as 'blade companies' in Kerala. These

companies had expanded greatly in the wake of the sharp increase in remittances from Indian workers in the Persian Gulf. Many more clearly unsound and 'fly-by-night' firms took advantage of gullible depositors and secured borrowers alike. While the RBI succeeded in identifying and bringing action against a number of unsavoury firms, their action caused runs by depositors on a large number of finance corporations. In the process, several corporations, which were not fly-by-nighters, failed due to runs on them by depositors. It is not clear that the RBI's action in this case was misguided, but the fact remains it that did have partially negative consequences.

PART C

Analysis of Economic Impact of Informal Credit Markets

CHAPTER 10

INFORMAL CREDIT AND THE EFFICIENCY OF RESOURCE ALLOCATION

10.1 Concepts of efficiency for financial markets

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

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

- a. **Information arbitrage efficiency:** which is the degree of gain possible by the use of commonly available information. Efficiency is inversely related to the gain.
- b. **Fundamental valuation efficiency:** The extent to which the present discounted benefits stream from an asset are reflected in its price.
- c. **Full insurance efficiency:** The extent of hedging possible against future contingencies.
- d. **Functional efficiency:** This is reflected in the transactions cost of borrowers and lenders combined (lower transactions costs reflect more functionally efficient the market). An extended discussion of this concept is in Fry (1988).

10.1.3 Implicitly, these concepts reflect the impact of credit markets on the efficiency of resource allocation. However, while information arbitrage efficiency and functional efficiency are certainly concepts which can be used in judging the relative efficiency of different components of a financial markets, the other two concepts are more difficult to apply. Valuation efficiency is

certainly lowered by a credit market segment which is subject to quantitative controls and administered prices. However, freely functioning markets may ration credit and keep loan rates of interest below their market clearing level in a world in which there is asymmetric information and incomplete contingent markets, implying some degree of inefficiency by the full insurance criterion (see Stiglitz and Weiss, 1981 and Santomero, 1984).

10.1.4 However, while accepting that actual credit markets will depart from full efficiency, it is still possible to examine the relative efficiency of resource allocation facilitated by different market participants if a set of criteria can be laid down to judge efficiency. A crude set of criteria that can be used to judge the impact of formal and informal credit on the efficiency of factor use in the Indian situation are the relative magnitudes of three ratios by firms primarily supported by formal/informal credit. The ratios are the capital-output ratio, the labour-output ratio and the capital labour ratio.¹ The rationale is as follows. In the Indian situation, the formal sector keeps rates of interest below their market clearing levels and rations credit through selective credit controls. Consequently, it can be expected that firms with access to formal credit will have an overly capital intensive choice of techniques, which detracts from the efficiency of factor use. Furthermore, due to less than perfect credit rationing, inefficient firms may receive finance while efficient firms are rationed out of the market. Inefficient choice of techniques are reflected in the capital-output ratio while relatively inefficient factor use is reflected in the factor ratios for firms within the same industry. It should be pointed out that low factor use ratios are neither sufficient nor necessary as proof of inefficiency. Furthermore, unless there are constant returns to scale, a higher capital output ratio for a firm

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

may simply reflect a different scale of operations compared to another firm.² Likewise, capital labour ratios may reflect non-homotheticity. The measures are therefore crude. Thus, whenever it is possible to supplement the evidence of the ratios with direct evidence this is done.

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

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

10.2 Impact on the efficiency of resource use

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

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

Thus no firm global conclusion can be drawn.

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

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

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

10.3 Impact on the efficiency of sectoral resource allocation

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

necessarily in the social interest at all times.

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

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

10.4 Information arbitrage efficiency

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

10.5 Functional efficiency

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

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

10.5.3 One remaining puzzle about informal credit costs needs to be addressed. It has been argued that the main component of informal sector interest on loans is the deposit interest rate and opportunity cost of own funds. But, why is this so with respect to deposits costs? Put another way, how can commercial banks, which have high inconvenience costs to depositors and also low

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

deposit interest rates attract deposits despite the fact that informal intermediaries offer higher deposit rates and, for example in the case of nidhis, an equally large array of deposit schemes? Is it the case that these interest rate differentials between formal and informal sector reflect hidden risk costs of deposits with informal depository institutions?

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

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

10.6 Conclusions

10.6.1 While no global conclusions can be drawn, it is clear

that in some, though not all, respects informal credit does contribute to more efficient resource utilisation particularly from the point of view of functional efficiency. However, it is difficult, given current research, to come to an unambiguous ranking of the formal and informal sectors.

TABLE 10.1

Efficiency Ratios for Productive Sectors

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

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

CHAPTER 11

EQUITY IMPACT OF INFORMAL FINANCE

11.1 Evaluation criteria

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

11.2 Cause and effect

11.2.1 Are weaker sections weak because of exploitative informal finance or despite it? At one level, the answer to this question does not matter: if borrowers can be taken to reveal their preferences for some informal finance to none, then informal finance is clearly welfare improving. However, if it is exploitative then this alone is insufficient and informal credit should be supplanted by non-exploitative sources of credit if possible. The direct evidence of borrowers in studies of intermediaries and in credit using sectors referred to earlier

leads us to reject the hypothesis of universally exploitative informal credit, though in some relatively minor sectors this is the case with urban informal finance. This is despite the evidence, albeit not global, of higher informal sector interest rates.

11.3 Summary of disaggregated findings

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

11.4 Conclusions

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

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

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

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

TABLE 11.1

Percentage of Total Borrowings from Informal Sector

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

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

CHAPTER 12

ARE INFORMAL AND FORMAL FINANCE COMPLEMENTS OR SUBSTITUTES ?

12.1 Three types of situations need to be distinguished here.

- i. The first type of situation is where banks do not enter or are unable to enter a particular market segment or when informal finance cannot substitute for bank finance. In such cases, formal and informal finance are clearly complementary. Most case studies in this report found this type of situation prevailing due to banks being unable or unwilling to compete with informal lenders and also (especially) trade credit. In one case study of a credit using sector (road construction), informal financial instruments were not acceptable as a substitute for bank guarantees.
- ii. The second situation is when banks provide credit but up to a ceiling amount. In such cases, informal finance complements the credit flows to a particular section of credit constrained borrowers or the credit flow for particular uses. The inter-corporate funds market, field studies of productive and trade sectors, chit fund operations, loans against jewellery by nidhis and to a partial extent, hire purchase fall into this category.
- iii. The third situation is when banks and informal intermediaries are in active competition. This does not appear to be the case in any loan market, though it is largely the case for the mobilisation of deposits by some, though not all informal intermediaries. One area in which informal and formal sectors are in competition, to the latter's disadvantage, is in the transfer of funds between geographical centres. Informal couriers, known as 'angadias' are seen as superior to banks by many businessmen.

12.2 A second finding relevant to the discussion here is the opinion of borrowers of the two sources of credit. In all field studies of credit using sectors and of borrowers from particular intermediaries, informal credit was, broadly speaking, viewed positively due usually to the expected speed and informality (and

in some cases, low cost) of informal credit while bank credit was viewed negatively. Dockyard financiers in Calcutta and some finance corporations were the exceptions.

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

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

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

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

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

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

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

CHAPTER 13

INFORMAL CREDIT AND MONETARY POLICY

13.1 Prior evidence and issues

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

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

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

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

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

- i. Does lower money supply (including bank credit) necessarily lead to a fall in total credit availability (or can informal credit counteract this sufficiently)?
- ii. A related point, do movements in the bank loan interest rates lead to general movements in informal loan interest rates or credit in the same direction?
- iii. Is the opposite of (ii) true for bank deposit rates?
- iv. Can selective credit controls, which are used in India, be effectively imposed in the face of informal credit?
- v. Even if all four questions are answered in the affirmative, is the credit multiplier the same as it would be in the absence of informal credit (or is it lower or less predictable)?

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

13.2 Evidence

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

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

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

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

13.3 Towards a short run macro-model with informal credit markets

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

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

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

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

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

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

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

TABLE 13.1

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

(Per cent per annum)

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

Note: Negative figures
in parentheses.

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

TABLE 13.2

Interest Rates of Banks and Informal Intermediaries

(Per cent per annum)

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

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

CHAPTER 14

TWO ISSUES: THE COMPLEMENTARITY HYPOTHESIS AND LINKS WITH THE BLACK ECONOMY

14.1 The McKinnon (1973) complementarity hypothesis¹

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

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

14.2 Links with the black economy

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

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

- a. Black transactions take place through both formal and informal credit markets. Informal markets do not have any necessary link with the black economy and all submarkets do not facilitate black transactions.
- b. The film industry, construction, hotel industry and transport sector rely heavily on black funds.
- c. The main service of informal intermediaries is to facilitate payments for illegal goods through bank sight drafts while allowing transacting parties to retain their anonymity. The annual volume of such remittances in 1979 is estimated at Rs 450 crore in Bombay alone and Rs 750

crore for the whole of India.

- d. The provision of brokerage services, by specialised brokers for the placement of black funds. Loan defaults for black money loans were almost unheard of even if white debts were defaulted. The interest rate on such loans was from 12 per cent to 15 per cent in 1979.
- e. Records of black transactions or instructions for disposal of black funds were usually on scraps of paper and in innovative and oft changing codes.
- f. The provision of bogus receipts or book entries allowing the laundering of black funds or the concealment of incomes by recording fake expenditure - both for a fee. An agent for these transactions is known as an Havala.
- g. The facilitating of 'kite flying' operations by taking advantage of bank cheque discounting and delays in bank collection of outstation cheques. This service is reported to be provided by finance corporations in Kerala. Road receipts and letters of credit are similarly used.
- h. Remittances of cash through Angadias.
- i. Evasion of foreign exchange restrictions through overseas correspondents and arranging private remittances (the agent in India accepts rupees for remittance and pays out rupees remitted while the correspondent does the same in foreign currency. No actual funds flows take place).

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

TABLE 14.1

Loans and Advances versus Borrowed Funds of
Credit Using Sectors

(In percentage of total assets)

Sector	Road constr- uction	Garment expor- ters	Power- loom	Aratiyas (textile trade)	Textile wholesale traders
Loans and advances	43	39	26	72	57
Borrowed funds	38	70	59	82	37

PART D

Policy Prescriptions

CHAPTER 15

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

15.1 Lessons for formal banking

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

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

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

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

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

15.2 Fraud, information and the regulation of informal intermediaries

15.2.1 One way of ensuring that no fraudulent organisation has access to deposit money is by banning informal intermediation altogether. The consideration of this possibility, while not being suggested as a serious policy measure, has the merit of throwing the consequences of overly restrictive regulation into sharp focus. If such an alternative was enforceable, then those with financial saving would be restricted to formal sector saving institutions and equity markets. However, it is likely that informal intermediaries can tap large reservoirs of public saving even after substitution between formal and informal saving instruments is accounted for. High interest, personalised service, deposit soliciting agents and informality of dealings and innovative saving schemes all make this likely. Further, deposits so mobilised, amounting to a sizeable amount in absolute terms, find their way into the formal sector, particularly the government sector. Thus, development of the financial sector and, in particular, the substitution of financial for non financial saving would suffer if informal intermediaries are banned. The point here is that certain informal intermediaries have an absolute advantage in mobilizing deposits from particular segments of the saving public. Secondly, certain informal intermediaries have an absolute advantage in ensuring the recovery of loans made to particular segments of investors. Banning all informal intermediaries will thus result in financial constraints being

faced by a section of firms or, if they get formal accommodation, will result in raising the aggregate risk of formal sector loan portfolios. The efficiency of financial intermediation will be affected in either case. Thus, regulations which put (partial or total) quantitative restrictions on the deposits which an informal intermediary can mobilise should be made only after carefully weighing the costs and benefits. This may be taken inter alia as a criticism of the Prize Chit (Banning) Act of 1978. In fact, that money circulation schemes or prize chits, even if they have no loan portfolio, should be banned is open to debate.¹ What is not at issue is that fraudulent intermediaries such as a section of blade companies or as described in the Raj Committee Report (1975) should be wound up.

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

15.2.3 While the measures outlined in the previous paragraph would, if properly implemented, ensure that fraud and parallel market transactions are curbed, depositors may still be misled by aggressive and inaccurate promotion campaigns. In a largely

1. A social security scheme such as in most developed countries, whereby the young are taxed in order to make transfer payments to retired persons, has, given that the younger generation receives transfer payments in their turn when they retire, much in common with a money circulation scheme.

rural and relatively backward economy like India's, the efficacy of any measures to prevent such practices is bound to be limited. Still, efforts can be made to inform savers as to the attractiveness of different saving schemes by instituting a method for rating different saving schemes. The rating can be based on scheme details, the intermediary's loan portfolio and its past performance. These ratings can then be given wide publicity. Armed with a rating chart and a list of licensed intermediaries, even a person with limited training or sophistication could serve as a competent financial adviser. Additionally, firms may be compulsorily required to supply certain items of information to depositors at periodic intervals. Similar rules could also be laid down for advertisements by financial firms. Loan schemes and lending practices should be subject to similar vetting as has been suggested for deposit schemes.

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

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

environment.² Accordingly, the remedy proposed deals almost entirely with improved information flows.

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

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

2. Which, of course, has been made much of in the recent theoretical literature of financial economics.

SECTION II

SECTORAL AND CASE STUDIES

PART E

Analysis of Reserve Bank of India Surveys

CHAPTER 16

INFORMAL CREDIT AND HOUSEHOLD DEBT

16.1 Introduction

16.1.1 A common presumption about informal credit in India is that it contributes to indebtedness among the poor. Furthermore, such debt is seen to be socially undesirable in that informal lenders use their monopoly power to drive poor households to perpetual subsistence, in the process depriving households of their meagre assets especially land holdings. While this presumption is seen more as a feature of rural areas, urban areas are not seen to be totally free of the evil of 'loan sharks' and their ilk.

16.1.2 The Reserve Bank of India has been conducting decennial national surveys of assets and debts of rural households since 1951-52. The fourth such survey, for 1981-82, includes a sample of urban households for the first time.¹ Thus an analysis of the relation between debt of urban households and informal credit for the entire nation has become possible for the first time.

16.1.3 This chapter presents some inferences on household debt and informal credit based on an analysis of the data in the survey.

16.1.4 The chapter contains 5 more sections. In the next section, the sample design of and information in the RBI survey are briefly described. Section 3 contains an analysis of debt of

1. Reserve Bank of India (1987), All India Debt and Investment Survey 1981-82; Department of Statistical Analysis and Computer Services, Reserve Bank of India, Bombay. Their 1970-71 survey also covered urban households, but urban data were not generally released due to sampling problems.

households grouped by asset category. Various characteristics of household debt and credit and also the distribution of credit to households from the formal and informal sectors are examined². Section 4 looks at inter-State variations in debt and its correlates and indicates where inferences run counter to findings in the previous section. In section 5, information from sections 3 and 4 is used along with additional information to arrive at tentative conclusions as to characteristics of informal credit to households in India. The final section contains some concluding remarks and all-India estimates for formal and informal credit to the household sector.

16.1.5 Analysis is limited to four samples of households out of 7 that were available. The samples are: all households, all urban households, urban self-employed households and all rural households. The last named category is included for comparison.³ Urban self-employed households had, on average, a much higher debt level (at Rs 8708 compared with an all urban household average of Rs 5930 and a rural household average of Rs 3311). This feature led us to include them as a separate sample in the analysis.

16.2 The All India Debt and Investment Survey, 1981-82: Data and Sampling

16.2.1 The volume of the survey released gives details of assets and liabilities of households as on the 30th June 1981. Data are provided for household debt and assets with households broken up into 8 asset groups⁴ or 18 regional groups.⁵ Data are provided

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2. All data used are from the RBI survey with the exception of State domestic product per capita in 1981-82 which is from Central Statistics Organisation estimates.
 3. Further details of informal credit to rural households are provided in the companion report on rural informal credit by the Centre for Development Studies, Trivandrum.
 4. <1000, 1000 to 5000, 5000 to 10000, 10000 to 20000, 20000 to 50000, 50000 to 1 lakh, 1 lakh to 5 lakh, 5 lakh and above (in rupees per household).

on average assets; inequality in asset ownership; proportions of different asset types; average debt per indebted household and proportion of households with debt; proportions of debt by credit agency, purpose, security, interest rate range and size of debt per household; and the debt asset ratio. Debt data pertained to cash debt since about 1 per cent of debt of rural households was in kind and almost no urban debt was in kind. A total of 61,774 rural households from 7718 sample villages (8 households per village) and 31,014 urban households from 5169 sample urban blocks (6 households per block) were sampled, blocks being drawn randomly from all states in India.

16.2.2 Two visits were made to each household, the reference period being July 1981 to June 1982. Only the first volume of survey results has so far been released. Household flow debt and investment figures are, as yet, unreleased.

16.3 Sources of household credit and household debt: Analysis of aggregate data and data by asset ownership

16.3.1 All India averages: Average household debt per borrowing household was Rs 3791. Urban households were more indebted on average at Rs 5930, while urban self-employed households had an average debt of Rs 8708. However, the percentage of indebted households was 19.10, 17.36 and 16.89 respectively. Of this debt, debt to informal agencies was 39.4 per cent, 40.1 per cent and 42.3 per cent respectively.⁶ Informal debt includes loans from friends and relatives, money owed to shopkeepers and traders and so on in addition to chit funds, finance companies, etc. By subtracting gross household dues receivable from gross household

5. 17 major States and all India figures, the latter including minor States and Union territories.

6. 'Informal' in this note corresponds to 'non-institutional' in the RBI survey and 'formal' to 'institutional'. The language used here is in keeping with the rest of this report.

debt, an estimate of net household debt to agencies other than households within the group can be arrived at. Inter-household debt, in the process, gets netted out.⁷ Net debt per household (not per borrowing household) to other agencies is estimated at Rs 691 for all households, Rs 635 per rural household, Rs 867 per urban household and Rs 1098 per urban self employed household. These figures are substantial in view of the per capita net domestic product of Rs 1557 in the year of the survey (1981-82).

16.3.2 Gross informal debt per household to agencies other than friends and relatives can be estimated at Rs 205, Rs 195, Rs 256 and Rs 413 respectively. These figures are summarised in Table 16.1.

16.3.3 Correlation design: Variation across asset groups is substantial as indicated by the coefficients of variation in Table 16.2. Formal credit is the predominant source of funds for all household samples.⁸ Of informal credit, friends and relatives are relatively more important in urban areas though for all groups they form the least important credit source. For asset poor households, almost all debt is informal. Correspondingly, unsecured debt, while less important for asset poor urban households compared to rural households, forms the bulk of debt for asset poor households. A similar pattern is to be found for consumption debt. For wealthy urban households, informal credit other than from friends and relatives is substantially more important than for rural households with this being reflected in the unsecured debt figures as well. Consumption debt is, of course, unimportant for wealthy households. As would be expected, the proportion of high interest (20 per cent per annum or more) debt is greatest for rural households among the asset poor and urban households among the wealthy, though wealthy urban households have less high inter-

7. Subject to the data being for a sample and not the population. All estimates given by us are subject to error due to rounding in the published data used.

8. Table 16.5 contains all India averages.

est debt than asset poor urban households. The low relative proportion of indebted asset poor rural households and the low debt equity ratio is in accordance with the belief that borrowing constraints are most severe in rural areas especially for the asset poor.

16.3.4 This information can be seen in another way by examining the correlation coefficients in Table 16.3. From here we can conclude that households with relatively large consumption debt are likely to have a high proportion of informal borrowing, low formal borrowing, a large proportion of unsecured debt, a high debt-asset ratio and are likely to be asset poor. The link between consumption debt and both informal borrowing other than from friends and relatives and the debt asset ratio is less pronounced in urban areas. The correlates of unsecured debt and high interest debt are similar. Turning to informal debt of households, it can be seen that a typical household with a large informal debt of either type shown, is likely to have unsecured and high interest debt mainly for consumption. Furthermore both types of informal debt and little formal debt is likely to be found with such households.

16.3.5 Distribution of informal credit: The distribution of informal debt by household group, has so far been looked at. The distribution of total formal and informal **credit** to households of different types is of equal interest. To study this, the percentage of loans from a given agency going to different asset groups has been computed and used to calculate inequality measures. These are given in Table 16.4.

16.3.6 According to either inequality index computed (the coefficient of variation and the gini index), formal credit is less equally distributed than informal credit. However, largely due to the fact that a disproportionately large share of formal credit goes to the second highest household asset group (asset between Rs 1 lakh and Rs 5 lakh), Lorenz curves for formal credit intersect those for either informal credit source. Inequality indices disagree in most cases about the relative inequality rank of the

sources of informal credit. In the case of urban self-employed households, the distribution of credit from friends and relatives Lorenz dominates that from other informal sources, the only case of non intersecting Lorenz curves. However, if households are grouped into three groups which are as equal as possible (data limitations do not allow for exactly equal groups), Lorenz curves for formal credit are dominated by the other two Lorenz curves in all cases. Credit from friends and relatives is more equally distributed than other informal credit among urban self employed households. At the all-India level, informal credit is most equally distributed by both inequality indices and Lorenz curves based on three groups. These data, while of interest, have little bearing on the effect of credit by source on asset or income inequality or on welfare.

16.3.7 Equity impact: Much more interesting is that asset poor households get a greater share per rupee of informal credit than the corresponding share of formal credit for well past the half way mark of the households when they are ranked by assets. Equally interesting is the fact that the share of informal credit going to the wealthiest class exceeds the corresponding share of formal credit, the difference being particularly marked for urban areas. Thus, urban "lower middle to middle class" households, especially among non self-employed, who would typically fall into the asset class between Rs 20,000 and Rs 5 lakh, are least dependant on informal credit.

16.3.8 The data presented in Tables 16.1 to 16.5, especially that summarised in para 16.3.7, lend support to the hypothesis that informal credit is welfare augmenting especially for the poorest classes. Of course, this positive 'equity' impact does not rule out the hypothesis that informal credit is usurious and leads to a perpetuation of poverty but neither is the negation of this proposition ruled out. What is very clear is that formal credit has failed to supplant informal credit for the poorest households. We conclude tentatively that informal credit to households is equity improving while not ruling out the pos-

sibility that it is socially undesirable.⁹ However, remarks in the RBI survey volume and also field studies of borrowers from selected groups of informal intermediaries tend to suggest the social desirability of urban informal credit, at least for the sectors studied.

16.4 Inter-state variation

16.4.1 Table 16.5 shows that inter-state variations in household debt are fairly substantial when this is measured by the coefficient of variation. Interestingly, the least variable statistic given is the proportion of formal debt. An examination of correlation coefficients (Table 16.6) also reveals interesting patterns in the debt structure. The main patterns revealed are the following:

1. Financial development, as measured by the proportion of financial assets, is only weakly associated with all variables of interest. Interestingly, the associations with consumption and unsecured debt are positive while that with other informal debt is negative.
2. Asset inequality, as measured by the association with asset shares of the top and bottom 25 per cent taken together, is positively associated with urban formal credit and negatively with rural formal credit and both types of informal credit in urban areas. However, the association is weak. Surprisingly, consumption debt is negatively associated with inequality in rural areas but positively with urban inequality though the latter effect is weak.
3. While per capita state domestic product has a weak association with all variables, associations tend to be stronger in rural areas. The association with informal credit from others, consumption debt and unsecured debt is negative while that with formal debt is positive. Thus informal credit, may be taken to be somewhat more important in poor states while the opposite

9. Even if we allow for the fact that data for this chapter are as on June 30, 1981 the aggregate figure of household debt from friends and relatives will not exceed, say, 3 times this figure, which is still small.

is true for formal credit.

4. Informal credit from others has a strong negative association with formal credit as does credit from friends and relatives.
5. Conflicting signs between asset-wise and statewise samples were obtained for the following correlations: (a) consumption debt and unsecured debt in urban areas; (b) credit from relatives and friends and high interest debt; (c) urban other informal debt and debt to relatives and friends; (d) the debt-asset ratio and rural consumption debt, urban unsecured debt, debt from friends and relatives and urban formal debt. However, statewise correlations are weak.

16.5 Informal credit and the household sector: some inferences

16.5.1 Pooling together the results of the previous sections we draw the following inferences.

- a. Households having a high proportion of informal debt from all sources (i.e., a low proportion of formal debt) are more likely to have high consumption debt as would be expected.
- b. Households with a high proportion of unsecured debt are likely to have a low proportion of formal debt and a high proportion of debt to friends and relatives.
- c. Informal debt other than from friends and relatives is likely to have higher than average interest cost, but this is by no means certain.
- d. Informal credit other than from friends and relatives complements formal credit to households in that a high proportion of one is strongly associated with a low proportion of the other.
- e. Informal credit is associated with lower urban asset inequality but higher rural asset inequality.
- f. Informal credit in urban areas is more evenly distributed among asset groups than formal credit.
- g. Informal credit is almost certainly welfare improving for asset poor households, who are largely excluded from formal credit markets. This does not imply that such credit cannot be supplanted by even better institutional arrangements (given the suspected high cost of informal credit to households). However, formal credit has yet to make major inroads into credit markets serving the poor.

16.6 Aggregate estimates and concluding comments

16.6.1 The figures given in Table 16.1 can be used to compile crude estimates of aggregate informal credit. According to the Census of India, 1981, the aggregate number of households in India in 1981 was:

All India	:	119,772,545	households
Rural	:	90,886,596	households
Urban	:	28,905,949	households.

Using these figures, we can get estimates of total household debt by directly inflating figures in Table 16.1. These figures are in Table 16.7.

16.6.2 These figures are small relative to the total size of credit markets in India. Thus, it can be concluded that informal credit is not primarily directed at the household sector. A corollary of this is that only a very small fraction of informal credit finances consumption debt.

16.6.3 Perhaps the most surprising finding of the analysis in this chapter is the small size of informal credit to the household sector. It is nevertheless clearly of importance to the poorest households. That a large portion of informal credit, being inter-household loans from friends and relatives, is low interest debt and that the evidence for other informal debt having high interest cost is not unambiguous are also of great interest. Finally, since much informal credit to business firms is claimed to be from 'friends and relatives' and since the total size of such debt is less than Rs 1000 crore (the size of household dues receivable is even smaller), it is likely that much of the credit of this type reported by firms is actually unaccounted funds. This is discussed further elsewhere.

TABLE 16.1

Household Debt : Selected All India Averages

(in Rupees)

Variable	Group of households			
	All	All rural	All urban	Urban self-employed
1. Average debt per indebted household	3791	3111	5930	8708
2. Percentage of indebted households	19.10	19.97	17.36	16.89
3. Debt to informal agencies (%)	39.4	38.8	40.1	42.3
3a. of which friends and relatives (%)	11.1	9.0	15.2	14.2
4. Net debt per household	691	635	867	1098
5. Gross informal debt (other than from friends and relatives) per household	250	195	256	413

Notes: 1. Rows (4) and (5) and the first figure in row (1) are computed from survey and census of India (1981) data. Other figures are as in the survey.

TABLE 16.2

**Variations in Debt Characteristics Across
Asset Groups**

Variable	STAT- ISTIC	Group of households			
		All	All rural	All urban	Urban self-employed
Percentage					
Debt from friends and relatives	C	49.5	41.8	51.0	51.4
	L	24.6	10.9	33.0	33.6
	H	2.6	1.9	3.9	4.1
Debt from other informal sources	C	51.1	60.6	42.8	33.9
	L	69.6	80.0	61.5	58.9
	H	12.4	3.1	29.2	32.8
Debt from formal sources	C	53.6	54.9	50.3	55.7
	L	5.8	11.3	5.5	7.5
	H	85.0	95.0	66.9	63.9
Unsecured debt	C	46.7	54.2	40.7	47.5
	L	82.9	90.4	78.9	87.5
	H	9.1	6.9	13.3	14.4
Consumption debt	C	65.1	72.9	54.5	84.6
	L	81.2	79.1	81.3	81.5
	H	2.7	2.0	3.7	0.1
Financial assets plus dues receivable	C	28.2	27.5	44.4	25.8
	L	2.7	2.0	4.1	2.2
	H	4.0	1.0	8.5	5.4
Debt at 20% p.a. or more interest	C	52.8	62.0	47.3	51.4
	L	42.0	57.7	33.0	32.6
	H	7.0	1.8	16.8	19.9
Proportion of indebted households	C	36.89	35.61	45.54	40.40
	L	7.8	5.7	14.5	9.9
	H	0.5	0.3	0.7	1.2
Debt asset ratio	C	106.4	88.1	115.6	131.6
	L	16.3	11.3	24.7	32.4
	H	2.0	2.2	1.7	2.5

Notes: 1. C: Unweighted coefficient of variation across groups (%).

L: Households with assets less than Rs 1000.

H: Households with assets more than Rs 5 lakh.

2. Total number of asset groups: 8.

TABLE 16.3

Selected Correlation Coefficients: Household Data by Asset Groups

(Correlation Coefficients in Percentage)

Proportion of		Proportion of					
		CONS	UNSEC	INT20	RF	INF	FOR
Consumption debt (CONS)	R	100.0	98.2	99.0	(91.4)	98.9	(97.4)
	U	100.0	96.8	80.2	(96.7)	74.7	(89.30)
Debt from friends and relatives(RF)	R	66.8	75.4	73.0	100.0	74.0	(80.5)
	U	96.7	97.8	78.6	100.0	75.7	(91.4)
Debt from others informal sources (INF)	R	98.9	99.6	99.3	74.0	100.0	(99.5)
	U	74.7	66.8	90.1	75.7	100.0	(95.7)
Formal sector debt (FOR)	R	(97.4)	(99.3)	(98.7)	(80.5)	(99.5)	100.0
	U	(89.3)	(84.9)	(90.9)	(91.4)	(95.7)	100.0
Debt to assets	R	88.9	81.3	82.8	28.0	84.0	(78.4)
	U	69.7	63.3	71.0	70.8	92.6	(88.7)
Average assets of the groups (Rs.)	R	(65.8)	(78.3)	(74.2)	(87.2)	(74.3)	78.8
	U	(80.9)	(87.2)	(35.6)	(77.5)	(28.0)	51.8

- Notes: 1. CONS : Consumption debt.
 2. UNSEC : Unsecured debt.
 3. INT20 : Debt at interest of 20% or more per annum.
 4. R : Rural households.
 5. U : Urban households.
 6. Negative figures in parentheses.

TABLE 16.4

Inequality Indicators for Credit Distribution Across Households

Variable	Group of households			
	All	All rural	All urban	Urban self-employed
A. Credit from friends & relatives				
COEFF of VAR (%)	70.3	74.6	70.1	73.6
GINI Index (%)	33.9	35.8	33.4	32.4
Share of households (%):				
Assets < Rs 1000	1.64	0.57	2.77	2.33
Assets < Rs 20000	32.66	32.13	33.25	36.43
Assets > Rs 5 lakh	2.49	1.60	2.17	4.89
B. Credit from other informal sources				
COEFF of VAR (%)	63.5	75.0	57.3	72.2
GINI Index (%)	31.9	27.7	40.2	49.3
Share of households (%):				
Assets < Rs 1000	1.83	1.28	3.21	2.08
Assets < Rs 20000	34.60	36.25	31.90	19.17
Assets > Rs 5 lakh	4.67	0.79	10.06	19.44
C. formal credit				
COEFF of VAR (%)	108.9	116.3	107.0	157.8
GINI Index (%)	46.4	43.4	55.1	61.9
Share of household (%):				
Assets < Rs 1000	0.05	0.03	0.16	0.11
Assets < Rs 20000	19.44	20.05	17.08	6.81
Assets > Rs 5 lakh	0.64	0.29	0.53	1.96
D. Dominant Lorenz partial ordering				
(A) versus (B)	- (B)	- (B)	-	A
(A) versus (C)	- (A)	-	- (A)	- (A)
(B) versus (C)	- (A)	- (B)	- (B)	- (B)
E. Percentage of indebted households in different asset groups				
< Rs 1000	7.8	5.7	14.4	9.0
< Rs 20000	57.9	57.2	60.3	51.2
> Rs 5 lakh	0.5	0.3	0.6	1.2

Notes: 1. Based on 8 asset groups of unequal size.

2. Lorenz crossings occur at most once (A dash indicates crossing curves)

3. Letters in parentheses (item D) indicate Lorenz dominant group when groups are aggregated to three almost equal groups. Exactly equal groups cannot be made due to data limitations.

TABLE 16.5

All India Averages and Interstate Variation

Variable	Group of households			
	All	All rural	All urban	Urban self-employed
Percentage of				
Debt from friends & relatives	11.1 (41.57)	9.0 (69.67)	15.2 (41.36)	14.2 (97.05)
Debt from other informal sources	28.3 (49.75)	29.8 (54.10)	24.9 (69.93)	28.1 (62.68)
Debt from formal sources	60.6 (23.59)	61.2 (27.32)	59.9 (22.33)	57.7 (28.85)
Unsecured debt	41.8 (26.15)	39.5 (34.27)	46.3 (29.61)	34.2 (47.49)
Debt for consumption	27.5 (31.18)	23.4 (40.13)	36.4 (41.19)	14.4 (62.91)
Indebted households	17.7 (36.89)	19.97 (35.61)	17.36 (45.54)	16.89 (40.40)
Financial assets plus dues receivable	3.9 (48.87)	1.3 (39.72)	11.0 (42.04)	5.9 (33.46)
Proportion of indebted households	19.10 (36.89)	19.97 (35.61)	17.36 (45.54)	16.89 (40.40)
Debt at interest of 20% or more	19.5 (36.89)	21.7 (35.61)	15.0 (45.54)	16.7 (40.40)
GINI coefficient of asset ownership (%)	65.42	63.54	70.40	68.20
Average assets (Rs)	37160 (48.94)	36090 (65.17)	40573 (46.67)	55320 (42.62)
Debt asset ratio (Rs)	2.0 (60.61)	1.8 (69.28)	2.5 (50.16)	2.7 (61.41)

Note: Figures in parentheses are interstate coefficients of variation computed using unweighted data.

TABLE 16.6

**Selected Correlation Coefficients: Household Data by States
(Correlation Coefficients in Percentage)**

Proportion	Proportion of						
	CONS	UNSEC	INT20	RF	INF	FOR	
Consumption	R	100.0	59.5	(1.5)	79.0	44.1	(69.7)
debt (CONS)	U	100.0	(7.4)	38.4	10.9	19.4	
Debt from	R	79.0	29.5	(24.9)	100.0	22.7	(61.4)
friends and	U	10.9	36.4	(7.3)	100.0	(26.5)	(19.5)
relatives(FR)							
Debt from others	R	44.1	89.3	68.9	22.7	100.0	(90.8)
informal sources	U	19.4	14.5	(45.1)	26.5	100.0	(89.4)
(INF)							
Formal sector	R	(69.7)	(85.1)	(45.1)	(61.4)	(90.8)	100.0
debt (FOR)	U	(24.8)	(31.7)	(24.8)	(19.5)	(89.4)	100.0
Debt to assets	R	(41.9)	0.35	39.4	(37.1)	17.6	1.7
	U	36.8	(37.6)	44.0	(17.6)	36.6	(29.1)
Financial assets	R	20.8	3.9	9.1	23.3	(23.9)	(16.4)
	U	50.8	24.7	(17.2)	(13.8)	(8.2)	14.7
Assets with top	R	(59.40)	(18.4)	39.8	(46.0)	(2.6)	21.9
25%	U	35.0	2.3	35	48.3	47.3	(25.0)
Assets with	R	57.3	(35.8)	(29.3)	(27.13)	(15.6)	(24.3)
bottom 25%	U	(44.4)	(15.5)	(44.4)	(49.5)	(39.2)	24.6
State domestic	R	(45.3)	(43.4)	(37.3)	(20.2)	(54.3)	52.7
product per	U	(16.3)	12.9	(15.3)	28.3	(19.5)	6.7
capita							

- Notes: 1. See Table 16.3 for variable definitions.
 2. Negative figures in parentheses.
 3. Correlation coefficients above 50 per cent are in bold type.

TABLE 16.7**Aggregate Estimates of Credit to the Household Sector
(June 30, 1981)**

(Rs crore)

Variable	Group of households		
	All	Rural	Urban
1. Gross formal debt	5458	3676	1782
2. Gross informal debt	3523	2330	1193
a. Friends and relatives	992	540	452
b. Others	2531	1790	741
3. Total net cash debt of the household sector	8277	5771	2506

Note: Figures for rural households in Rows 1 and 2 are taken from the companion CDS report.

CHAPTER 17

INFORMAL CREDIT FOR SMALL SCALE INDUSTRY, TRADERS AND TRANSPORT OPERATORS

17.1 Introduction

17.1.1 As yet, the only relatively recent data on small scale industry (SSI), traders and transport operators (TO), which comprise the bulk of productive activities financed by urban informal credit, are from the Reserve Bank of India's survey of small scale industrial units in 1977 and their survey of traders and transport operators in 1979-80.

17.1.2 These surveys sampled a total of 12,356 small scale industrial units, 3269 wholesale traders (WT), 8788 retail traders (RT) and 6129 transport operators. In all cases, surveys were limited to units assisted by commercial banks so that data are biased against informal credit. The bias is particularly serious for TO as vehicle finance is the chief reason for their borrowing. Clearly, those receiving formal credit for the purchase of vehicles, at margins not exceeding 30 per cent, will have little need for additional informal credit. As the surveys of hire purchase and auto financiers elsewhere in the report shows, many transport operators, particularly of used vehicles, receive no formal finance. The bias is not serious for SSI since most units have access to formal credit. Trade represents an intermediate case. Nevertheless, the surveys, even with the bias against informal credit reveal enough about informal credit to be of interest. Unfortunately, the summary reports released by the Reserve Bank do not contain information by different categories of informal lenders, though such data were collected.¹ Information

1. Attempts were made by us to obtain the detailed data tapes from the RBI. Though tapes were obtained, difficulties with the documentation of tapes have yet to be resolved. The data is, therefore, still unusable.

on the cost of informal credit and its terms and conditions was also unavailable in the published volumes. From the data which is available, the following information of interest could be derived and is reported here:

1. The relative importance of formal and informal credit² for units classified by output (small scale industry), sales (trade) or gross earnings (transport operators).
2. The relative importance of credit by source for SSI and T0 units classified by assets.
3. The relative importance of credit by source for SSI units classified by persons employed.
4. The relative importance of credit by source for units classified by type of organisation.
5. The relative importance of credit by source in different activities.
6. The net credit position of units and inter-state variations.
7. Duration of trade credit given and received by traders.
8. The total cost of credit in relation to the importance of different sources.
9. The relation between credit sources and the capital output ratio.

17.2 The relative importance of formal and informal credit

17.2.1 Table 17.1 gives details of units classified by the value of output, sales or gross earnings and the ratio of formal to informal credit. The ratio increases with the value of gross output for SSI, but fluctuates for other sectors. However, informal credit to SSI, WT and RT Lorenz dominates formal credit when units are classified by output or sales, as in the table. For T0, formal credit is more equally distributed. However, as discussed, the bias in the data are particularly serious for T0.

2. 'Formal' corresponds to 'institutional' in the survey and 'informal' to 'non-institutional'. The language here is consistent with the rest of the report.

This means, that, out of every rupee of informal credit, a greater percentage goes to small units regardless of where (below 100 per cent) the dividing line between small and large is drawn as compared to formal credit, except possibly for transport operators.

17.2.2 Data on market value of fixed assets is used to classify SSI and TO units. As can be seen (Table 17.2) for SSI, informal credit per rupee of assets and the formal/informal credit ratio show that informal credit favours smaller units both absolutely and relatively. For TO, no particular trend is discernible, though it is clear that informal credit is important both absolutely and relatively for the smallest and largest units.

17.2.3 Table 17.3 contains details of firms classified by persons employed. While it is clear that informal credit favours small firms by this criterion as well, it is also true that large SSI units in the sample have the highest employment (70.78 per cent of the sample total) but receive only 54.1 per cent of informal credit as compared to 61.9 per cent of formal credit. Furthermore, and unexpectedly, the employment to capital ratios are found to increase with employment possibly due to the existence of minimum capital requirements for viable operation. Consequently, we may conclude that informal credit is negatively associated with employment in SSI. This must be weighed against the labour intensive nature of trade when drawing overall conclusions.

17.2.4 Table 17.4 shows that proprietary concerns are better served by informal credit except in TO. Formal credit favours private limited companies. If incorporation is associated more with educated and relatively sophisticated entrepreneurs, then this points to an additional desirable feature of informal credit when coupled with the lack of exploitation of small firms found in field studies.

17.2.5 Table 17.5 shows the relative dependance of subgroups of SSI, trade and TO on different sources of credit. As would be expected, SSI units engaged in job work are most highly dependant on informal credit, though all groups receive more informal than formal credit. For trade, all groups depend more on informal credit than formal credit but this is especially true of the textile trade. Retail trade is most poorly served by formal credit. TO is better served by formal credit in general but motor passenger transport is relatively most dependant on informal credit.

17.2.6 Inter-state variations in the formal/informal credit ratio are substantial, with the States least served by formal credit having ratios of 48.8 per cent for SSI (West Bengal), 12.5 per cent for WT (Tamil Nadu), 23.1 per cent for RT (Madhya Pradesh) and 91.1 for TO (Andhra Pradesh). For TO only one State had a ratio below unity. Rank correlations of state domestic product and the formal to informal credit ratio are given in Table 17.6. As can be seen correlations are small for all sectors except SSI, where it is negative at 43.4 per cent. Thus the credit mix bears no relation to regional development except perhaps for small scale industry, where formal credit is found to be associated with backwardness.

17.3 Net credit position of units

17.3.1 A final set of figures on sampled units is their net credit position (credit received less credit given). Relative to own funds, SSI is the least credit constrained and trade is most dependant on own funds. Thus dependance on informal credit is seen to be associated with the most credit constrained sectors given our earlier finding that informal credit is most important for trade.

17.3.2 Table 17.7 provides details on the duration of trade credit received and given in RT and WT and the net trade credit position of units. Retailers received credit for longer periods

but also gave more days of credit than wholesalers in 1978-79, a situation that appears to have changed in the 80's³ in favour of retailers. Wholesalers were net givers of trade credit and retailers were net receivers of trade credit, a situation that appears to have continued into the 80's.

17.4 Cost of credit

17.4.1 The costs of informal credit relative to formal credit was studied by regressing the ratio of interest paid to total borrowing on the formal to informal credit ratio. The pooled sample of SSI, trade and T0 was used (68 observations) using data for 17 States and one union territory (only 13 states and the union territory were available for SSI). Ordinary least squares on level variables was the only specification attempted. From the regression (in the appendix to this chapter), the credit ratio is insignificant.⁴ The dummy variables however show that trade had the highest interest cost of 17 per cent to 19 per cent and that T0 had the lowest at about 13 per cent. This ties in well with field investigations. Note that the regression specification fails residual tests for normality and homoscedasticity. Addition of statewise dummy variables and/or state domestic product did not make any difference to the size or significance of the coefficient nor to specification diagnostics.

17.5 Informal credit and allocative efficiency

17.5.1 The allocative efficiency impact of informal credit was studied by regressing the capital output ratio⁵ on the formal informal credit ratio using the data set and specification

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3. See the chapter on the textile wholesale trade.
 4. Addition of dummy variables for States worsened the specification diagnostics and did not improve the significance.
 5. The ratio was proxied by: net sales to net fixed assets for SSI; net sales to net assets for trade; and gross earnings to gross fixed assets for T0.

discussed in the previous paragraph. Here too, no association of the formal/informal credit ratio with efficiency of capital use was found. Though specification diagnostics of this regression are also poor, neither the coefficient diagnostics nor regression significance were improved with the deletion of statewise dummy variables. We thus conclude that the credit mix has little association with the efficiency of capital use, with the caveat that this is subject to further testing.

17.6 Aggregate estimates

17.6.1 Aggregate estimates of informal credit in the four sectors were computed in two ways. The first estimate used the ratio of formal to informal credit in the sample and scheduled commercial bank advances to the sectors on the last Friday of June 1985.⁶ The second estimate employed some aggregate statistic available in both the sample and published data. Full details are provided in the second part of Table 17.8. No attempt was made to correct for the bias against informal credit in the sample in order to obtain lower bound estimates of informal credit. To these estimates, figures on estimated informal credit derived from Reserve Bank data on 1800 Public Limited Companies⁷ is added for comparison between formal, large scale manufacturing.⁸ Even the lower of the two estimates gives a figure of Rs 46,437 crore for informal credit (Table 17.8). This is extremely large given that gross bank credit to all sectors according to provisional RBI estimates was about Rs 62,500 crore in March 1987. However, as has been pointed out elsewhere in the report,⁹ bank credit to

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6. 1985 was the most recent year available. Since, in some of our estimates, flow figures are used to compute informal credit estimates, mid points of periods may be taken as the date for the stock estimates.
 7. Less than 1% of sampled firms would fall into this category, if any. See the last column of Table 17.4.
 8. The extent of informal credit, almost entirely trade credit, to such companies is itself of interest.
 9. See the chapter on Shroffs of Western India.

these sectors has stagnated relative to output - a fact these aggregate estimates reflect.

17.6.2 The upper estimate of aggregate credit demand would be valid if there was, roughly¹⁰ speaking, a unitary income elasticity or output elasticity of credit demand. A double log regression of average credit per unit on state domestic product for the years in which the survey was conducted yielded an elasticity estimate not significantly different from unity (the value was 0.8205 and the standard error was 0.1886). Thus estimate 2 finds support from cross sectional evidence, to the extent that such evidence is valid. As a measure of abundant caution, we take as our preferred estimate the average of the two estimates which is Rs 69,000 crore.¹¹

17.7 Conclusions

17.7.1 Informal credit has been found to be the main source of credit for SSI and trade in the late 70's, a situation that is likely to continue to prevail if our field studies are anything to go by. Transport operators, especially of old vehicles, are also dependant on informal credit, though units receiving bank finance do not appear to have great need for informal credit. There is more than adequate support for the hypothesis that informal credit is welfare improving for smaller units who, it appears, do not receive adequate bank finance. The hypothesis that informal credit promotes employment finds no support from survey data and the mix of informal and formal credit appears to have no bearing on the efficiency of capital use of surveyed units. Mild support is found for the proposition that informal credit is more costly than formal credit. Among the groups surveyed, WT appear to be net informal lenders, a finding corroborated by field work in the

10. This is valid only approximately since the same variables were not used to inflate sample figures in all samples.

11. The regression is reported in the Appendix to this chapter. See also the correlations in Table 17.6.

textile sector. In interpreting these findings, the aggregate nature of data used should be kept in view, especially where no supporting field evidence is available.

TABLE 17.1

Dependance on Formal and Informal Credit by Value of Gross Output/Sales/Earnings

A. Small Scale Industry (Value of Gross Output)

	Upto 1	1 to 5	5 to 10	10 to 50	Above 50
Percentage of units	63.75	21.28	6.12	7.41	1.44
Ratio of formal to informal credit (%)	105.77	131.03	136.94	144.67	148.95

Gini Index of Credit Distribution (%) : Formal Credit: 68.76;
Informal Credit: 64.62. Lorenz Domination By : Informal Credit

B. Wholesale Trade (Value of Sales)

	Upto 1	1 to 5	5 to 10	10 to 50	50 to 100	Above 100
Percentage of units	2.84	19.40	15.16	44.78	10.12	7.7
Ratio of formal to informal credit (%)	38.92	37.79	51.75	40.38	54.03	86.80

Gini Index of Credit Distribution (%): Formal Credit: 44.14;
Informal Credit: 33.71. Lorenz Domination By : Informal Credit

C. Retail Trade (Value of Sales)

	Upto 1	1 to 5	5 to 10	Above 10
Percentage of units	74.44	18.76	3.62	3.18
Ratio of formal to informal credit (%)	50.26	46.87	47.60	53.70

Gini Index of Credit Distribution (%) : Formal Credit: 59.03;
Informal Credit: 58.57. Lorenz Domination By : Informal Credit

D. Transport Operators (Gross Earnings)

	Upto 1	1 to 2	Above 2
Percentage of units	83.51	13.50	2.99
Ratio of formal to informal credit (%)	241.69	252.62	103.19

Gini Index of Credit Distribution (%): Formal Credit: 35.36
Informal Credit: 45.71. Lorenz Domination By : Formal Credit

TABLE 17.2

**Dependence on Formal and Informal Credit for
Units Classified by Market Value of Assets**

(Rs '0000)

	Market value of fixed assets/transport equipment owned					
	Upto 2	2 to 5	5 to 10	10 to 20	20 to 50	Above 50
A. Small Scale Industry						
Percent. of units	57.1	14.0	10.0	7.3	7.3	4.4
Ratio of formal to informal credit (%)	41.43	77.56	94.94	113.57	141.99	169.25
Ratio of informal credit to market value of fixed assets (%)	3.06	1.06	0.76	0.75	0.49	0.37
B. Transport Operators						
Percentage of units	64.2	9.1	10.4	13.4	2.6 ¹	
Ratio of formal to informal credit (%)	149.82	263.44	207.70	291.34	127.21 ¹	
Ratio of informal credit to market value of trans- port equipment owned (%)	0.37	0.18	0.22	0.15	0.23 ¹	

¹ Above 2,00,000.

TABLE 17.3

**Dependance on Informal Credit of Small Scale Industrial
Units Classified by Employment**

No. of persons employed	All units	Upto 5	6 to 10	11 to 15	16 to 20	Above 20
Percentage of units	100	60.91	16.58	7.04	3.66	11.80
Ratio of formal to informal credit (%)	73.66	72.82	115.08	116.87	118.58	142.31
Cumulative employment (%)	100.0	6.82	16.93	24.11	29.22	100.0
Cumulative formal credit (%)	100.0	8.1	22.2	31.3	38.1	100.0
Cumulative informal credit (%)	100.0	13.8	29.1	38.7	45.9	100.0
Ratio of employment to market value of fixed assets (upto 5 group=100)		100	106.6	116.6	126.8	221.7

TABLE 17.4

Dependance on Formal and Informal Credit by Type of Organisation

Sector	Type of organisation			
	Proprie- tary	Partner- ship	Private limited company	Other
Small Scale Industry				
Percentage of units	68.23	27.74	3.15	0.85
Ratio of formal to informal credit (%)	73.14	101.87	194.13	215.28
Wholesale trade				
Percentage of units	22.67	75.11	1.57	0.66
Ratio of formal to informal credit (%)	37.88	47.02	220.96	133.94
Retail trade				
Percentage of units	87.20	12.54	-	0.26
Ratio of formal to informal credit (%)	27.38	40.75	-	48.07
Transport operators				
Percentage of units	96.81	2.88	-	0.31
Ratio of formal to informal credit (%)	153.52	94.05	-	83.66

TABLE 17.5

**Dependance on Formal and Informal Credit by
Nature of Activity**

		Percentage of units	Ratio of for- mal to infor- mal credit(%)
A.	Small Scale Industry	100.00	65.28
	Manufacturing	85.59	75.56
	Job work	10.24	64.61
	Other	4.16	99.49
B.	Wholesale Trade	100.00	52.12
	Food and Beverages	29.40	44.94
	Textile Trade	23.76	36.83
	Other	46.84	71.03
C.	Retail Trade	100.00	28.91
	Food and Beverages	42.83	23.31
	Textiles & Ready-Made Garments	12.78	28.84
	Other	44.39	30.67
D.	Transport Operators ¹	92.84	188.57
	Motor Passenger Transport	27.82	148.75
	Motor Freight Transport	24.98	210.68
	Animal/Animal Vehicle/Hand Transport	40.04	205.67

1 Omitted groups of transport operators: Water transport.

TABLE 17.6

**Net Credit and Variations in Formal and Informal
Credit Across States**

Item	Sector			
	Small scale industry	Whole- sale trade	Retail trade	Transport operators
1. Rank correlations (%): Formal/informal Credit ratio and per capita state domestic product (relevant years)	-43.4	0.98	-25.4	-9.07
2. Total credit to GDP (%)	59.8	46.1	58.6	22.8
3. Net credit as a percent- age of own funds	136.05	71.30	70.81	87.46

- Notes: 1. Rank correlations based on 13 States for SSI and 17 States for others.
2. Net credit: Total liabilities/assets less own funds less loans and advances (given).
3. Own funds: Capital plus reserves plus provisions.

TABLE 17.7

Average Duration of Trade Credit Given and Received

Sector	Sundry creditors		Sundry debtors	
	Days	% to total	Days	% to total
<u>Retail Trade</u>				
Producers	49.7	33.5	-	-
Wholesale and other retail traders	46.6	60.8	45.1	24.5
Consumers	-	-	69.8	66.4
Total	46.4	100.0	64.3	100.0
Ratio of credit received to credit given: 113.8%				
<u>Wholesale Trade</u>				
Producers	39.4	59.1	-	-
Other wholesale traders	40.9	33.0	41.9	43.0
Retail traders	-	-	53.9	34.9
Consumers	-	-	62.3	12.9
Total	41.3	100.0	53.4	100.0
Ratio of credit received to credit given : 80.76%				

- Notes: 1. Mid points of intervals taken. Open interval taken to have average of 210 days.
 2. Intervals available: upto 1 month; 1 to 3 months; 3 to 6 months; more than 6 months.

TABLE 17.8

Aggregate Estimates of Informal Credit for Small Scale
Industries, Traders and Transport Operators

(Rs Crore)

Sector	Estimate 1	Estimate 2
1. Small scale industry	5840	12066 (86-87)
2. Wholesale trade	27313	
3. Retail trade	9446	51673 (84-85)
4. Transport operators	1423	1040 (86-87)
5. Public limited companies (1984-85)	11871	
Agriculture and allied activities	209	
Mining and quarrying	54	
Processing and manufacturing	9849	
Other industries	1759	

Sources: See the Appendix to Chapter 8.

PART F

Case Studies of Selected Intermediaries

CHAPTER 18

AUTO FINANCIERS IN NAMAKKAL

18.1 Introduction

18.1.1 There are several towns in India, particularly South India, where finance for the purchase and operations of used vehicles is provided by partnership firms styling themselves as "auto finance corporations". The term "used vehicle" includes vehicles registered as far back as 1942. Given the great risk in financing such old vehicles no hire purchase finance company or commercial bank comes forward to extend credit for such vehicles.

18.2 Geographical dispersion

18.2.1 Hindupur in Ananthapur district of Andhra Pradesh and Namakkal in Salem District of Tamil Nadu are two major towns which specialise in this line of hire purchase credit in South India. Within a half a kilometer or so we counted 60 auto finance corporations at Hindupur and 90 at Namakkal. Firms often have offices in the same building. The pattern of financing is the same in both the towns, although hire charges are not identical. Other towns which have concentrations of auto finance corporations (at least a dozen each) are Madras, Coimbatore, Salem, Trichy (Tiruchirapalli), Madurai, Nagercoil, (in Tamil Nadu), Trichur,

Ernakulam, Kottayam, Trivandrum, Quilon, Calicut (in Kerala), Bangalore, Mysore, Mangalore, Tumkur, Belgaum, (all in Karnataka), and Hyderabad, Vijayawada, Madanapalli, Chittur, Kurnool, and Ananthapur (in Andhra Pradesh). We selected Namakkal for this case study given its relative importance as an auto finance centre.

18.3 Description of area surveyed

18.3.1 Namakkal is reached by road from Salem and is situated between Salem and Trichy. It is a small town surrounded by rural countryside. No industry worth the name is located here but, of late, a few medium and large size poultry farms have been established. Its growth as an auto finance centre is explained by its location between Salem, noted for Salem Silk, trading in agricultural produce, stone crushing, etc., and Trichy, a fast growing banana and commercial crop exporting district with a dominant cotton handloom production and trading centre at Karur. A lot of construction activity also takes place in these two districts as also in nearby Coimbatore district. Goods such as textiles, bananas and eggs are carried to distant markets located in neighbouring States. Other items such as construction materials and goods for inter-city markets are transported short distances. While the long-distance transport is handled by fleet owners and individuals owning new vehicles purchased on credit from banks and H.P. finance companies, short distance transport is operated by individuals or contractors owning three or four old vehicles who turn to auto finance corporations for credit.

18.3.2 Auto finance corporations usually keep away from big cities to keep their establishment costs low and retain proximity to their mainly small town clients. Above all, these corporations

feel that the business is safer in small towns where it is easier to trace defaulters.

18.3.3 Sample size and business: We randomly selected 10 of the 90 identified auto finance corporations for this study. All of them were established in the 1970's and all were partnership firms with five to ten partners. The stock on hire with the 10 firms at the end of 1985 was Rs. 223.00 lakh and Rs. 250.35 lakh at the end of 1986 (Table 18.1). According to the managing partners of these firms, the average price of a good truck fitted with a Perkins diesel engine and 6 good (retreaded) tyres was about Rs. 30,000 for a pre-1950 model, Rs. 40,000 for a pre-1960 model with an original but reconditioned diesel engine, Rs. 50,000 for a pre-1970 model and between Rs. 50,000 and Rs. 1 lakh for a pre-1980 model. The majority of business handled by these corporations was for pre-1960 trucks. Hence the requirement of finance for a truck averaged Rs. 40,000. On average, 75 per cent of the cost of the truck would be borne by the firm, the rest being the buyers share. If the loan was for a two year period at an interest of 20 per cent (flat) per annum¹, the buyer's installment amounts per month would be $Rs. 30,000 + (30,000 \times 2 \times 20 / 100) / 24 = Rs. 1,750$. Besides an initial investment of Rs. 10,000, the buyer would thus have to repay Rs. 1,750 every month for 24 months and then own the vehicle. A vehicle can be transferred to another person under certain conditions, if the purchaser agrees to pay the remaining instalments.

1. Flat rates for periods of upto three years are close to double the annual compound rates. See the case study on hire purchase for details.

18.4 Sources of funds

18.4.1 Deposits from the public account for the lion's share of funds of these firms. The capital and reserves of the ten auto-finance corporations at Namakkal amounted to Rs. 23.50 lakh at the end of 1986 as against Rs. 69.25 lakh raised by way of deposits from the public. In other words, own funds formed about one-fourth of total funds.

18.4.2 Borrowed funds were raised by 9 corporations (one did not accept deposits) from the public, at 18 per cent per annum for a one year deposit, 19 per cent per annum for a two year deposit and 21 per cent per annum for a 3 year deposit. One year deposits formed about 80 per cent of the total deposits and two year deposits were negligible. Therefore, the average cost of funds borrowed from the public was around 19 per cent per annum. This is much higher than deposit costs incurred by banks. Besides deposits, some corporations received "cash credit" from private sector commercial banks at 17 per cent per annum, secured by the assets of partners. But this source was minor. A major source of working capital was monthly repayments made by hirers.

18.4.3 The interest rate of 18 per cent per annum for a one year deposit was about 10 per cent higher than the rate offered by commercial banks. Moreover, while corporations offered higher rates for longer terms, commercial banks offered only 10 per cent (now 11 per cent) per annum for any period above 3 years. During the last three years there appeared to be no fluctuation either in the average period of deposits or in the cost of funds of corporations.

18.5 Uses of funds

18.5.1 The borrowers of these corporations consist mostly of transport operators who operate used vehicles including trucks, light commercial vehicles, tourist and other taxis and auto-rickshaws. Being operators of very old vehicles, they do not get credit from banks and hire purchase finance companies who extend credit only to new or upto five years old vehicles. As mentioned, the bulk of finance of corporations studied went for pre-1960 trucks, the oldest being a 1942 Ford fitted with a Perkins diesel engine.

18.5.2 Financial requirements for these old vehicles ranged between Rs. 25,000 and Rs. 40,000 per vehicle. The average finance per vehicle in our sample was Rs. 30,000 and the period varied between one year and three years. Corporations were in favour of short loans because the longer the period the greater is the chance for breakdown and consequent default in repayment. The period is related to the age and condition of the vehicle. Usually, very old vehicles do not get credit for more than a year.

18.5.3 Hire charges for most corporations moved up from 19 per cent per annum (flat) in 1984 to 20 per cent in 1985 and 21 per cent in 1986 though some corporations charged only 20 per cent per annum in 1986. These are rough averages. The model and condition of the vehicle are usually taken into account in fixing hire charges.

18.5.4 Hirers are usually required to contribute 30 per cent to 50 per cent of the price of the vehicle as their investment in the venture. In comparison, for a new vehicle, the hirer's contribu-

tion in a hire purchase transaction with a H.P. company is 25 per cent. Higher investment is stipulated by auto finance corporations because of the greater uncertainty as to the resale value of a used vehicle.

18.5.5 On the whole, non recoverable debts were found to be very small. One reason for this is the timely action taken by corporations. According to the H.P. agreement, the corporation has the right to repossess the vehicle if payments are defaulted. The hirer gets what is left after settling the dues of the corporation if the vehicle of defaulters is repossessed. In practice, repossession of vehicles does not exceed 5 per cent of HP transactions. Before repossession, negotiations are held with the hirer, and sometimes with third parties, for settlement of dues.

18.5.6 Credit-worthiness assessment is limited in this business, because first, the hirer himself invests a part of the price of the vehicle, and secondly because the vehicle is given on hire purchase and belongs to the financing firm until the last instalment is paid. Repossession is possible even if only the last instalment remains unpaid.

18.5.7 Since commercial banks (and even hire purchase companies) do not finance very old vehicles, finance from auto finance corporations clearly complements formal finance.

18.6 Cost of intermediation

18.6.1 Details of income and expenditure were not furnished by the corporations. However some corporations interviewed replied orally that administrative expenses average 5 per cent of their operating income which, in turn, can be estimated at around 27 per

cent of stock on hire (corresponding to a flat rate on loaned funds of about 20 per cent per annum and contribution by the company of about two-thirds of the value of stock on hire). Thus, in 1986, given a stock on hire of Rs 250.35 lakh, operating income would be Rs 66.76 lakh. Of this 12.52 lakh is administrative expense. Given deposits of Rs 69.25 lakh and taking 19 per cent to be the average deposit rate, deposit cost works out to be Rs 13.16 lakh. Likewise opportunity cost of own funds at 18 per cent of Rs 23.50 lakh is Rs 4.23 lakh. Assuming two managing partners per firm and a monthly opportunity wage of Rs 2000 per partner, the imputed wages of managing partners work out to be 4.8 lakh. Finally, extraordinary expenses associated with repossession proceedings at, say, 2 per cent of stock on hire, work out to be Rs 2.50 lakh. Thus, economic rent works out to be Rs 29.95 lakh. The implied return on capital is 145.95 per cent. However, these high profit levels can be hypothesised to be largely due to the growing market rather than to outright monopoly power given the relatively easy entry conditions. The percentage break up and spread is as follows:

Lending rate	40%
Deposit rate	19%
Spread	21%
Deposit & opportunity cost	26.05%
Default cost	7.30%
Establishment cost	25.94%
Economic rent	44.86%

18.7 Regulatory environment

18.7.1 As most corporations are registered under the Indian Partnership Act 1932, they are not covered under the deposit ac-

ceptance rules of the Reserve Bank of India. The Non-Banking Financial Companies (Reserve Bank) Directions, 1977. Auto finance corporations are covered under the Banking Laws (Amendment) Act, 1983 according to which they can accept deposits from 25 depositors per partner or from a maximum of 250 depositors for 10 partners apart from deposits from relatives, irrespective of the amount of deposit per depositor. Therefore, in deposit acceptance, these corporations are at a disadvantage compared to hire-purchase companies. No other special legislation covers their operations.

18.8 Market structure

18.8.1 No marked concentration of business in the hands of few firms was observed at Namakkal. The maximum stock on hire of sampled firms was Rs. 60 lakh while the minimum was Rs. 13.50 lakh. The growth rate in stock on hire of these corporations between 1981 and 1986, presented in Table 18.2, also showed that some small and medium size corporations had higher growth than larger corporations. There was also little evidence of price dispersion (the observed differential being 1 per cent (flat) for some firms in each of 1984, 1985 and 1986). Price dispersion showed no link with the age or size of corporations. Finally, besides availability of start up capital, no major entry barriers appear to exist. Thus, together with the fact that most firms are located close to each other as described earlier, a more or less competitive market structure can be inferred. Excess profits may therefore be ascribed more to short run demand growth rather than to monopoly power as mentioned earlier.

18.8.2 One interesting feature of auto finance markets is the specialisation of different agencies, that is banks, HP firms and auto financiers in different segments of auto finance markets.

18.9 Estimate of size

18.9.1 A precise estimate of the number of auto finance corporations and the volume of business handled by them even for one year would be impossible because there is no source which lists the number of such corporations.

18.9.2 We may, however, make a guesstimate with the limited data that we have collected from the field. In each State, there are some towns with specialisation in auto finance. Besides Namakkal and Hindupur, we have also identified a number of towns (listed State-wise in the Appendix to this chapter) where auto finance corporations are active. Based on these observations an estimate of the number of auto finance corporations and their stock on hire in South India for the year 1986 is about 1200 auto finance corporations with a stock on hire for about Rs. 200 crore in South India which, roughly, accounts for about one-fourth of the total number of such corporations in India. Thus the figures for the entire country are 4800 corporations with a stock on hire of Rs. 800 crore. The high growth rate of sampled firms would imply that a significantly larger market can be forecast for the near term.

18.10 Influence of formal sector lending rate or availability of formal sector finance

18.10.1 The formal sector, represented by commercial banks, does not finance the type of activity financed by the auto finance corporations. Nor is there any evidence of any effect of formal sec-

tor lending rates on loan interest rates in auto finance. While indirect effects may be present, this is not discernible from the evidence available.

18.11 Distributional impact

18.11.1 One distinguishing feature of lending by auto finance corporations is that the bulk of their finance flows to the poorer transport operators. Well off transport operators, who can afford to raise the required margin for new vehicles, seek credit from banks and hire purchase finance companies. Furthermore, besides financing old vehicles, customers of auto finance companies seldom own more than one or two vehicles. Large fleet owners are normally also new vehicle owners. Thus, at a rough estimate, auto finance corporations serve about 5 times as many borrowers per rupee of funds as compared to HP companies. Thus their activities should definitely result in reducing the inequality in credit availability and aiding weaker sections.

18.12 Impact on savings mobilisation & investment

18.12.1 Auto finance corporations offer high rates of interest on deposits relative to banks. That corporations sampled have been in existence for 10 to 15 years is also indirect evidence of the lack of excessive risk of default for depositors. However, they serve limited clientele in the non-metro areas in which they are located. Overall, to the extent that higher interest rates contribute to additive saving, some additive saving is to be expected though no evidence is available. Secondly indirect saving generation through their impact on income on hirers surely occurs.

18.12.2 A case study: If we examine the profile of a borrower before and after the purchase of a vehicle, the role of the auto finance corporations in promoting investment and raising the income level of the borrowers will be clearer. Mr. R. Kannan, aged 40, is a resident of Chinna Agraharam at Rasipuram in Salem District of Tamil Nadu. His family consists of four members besides himself, that is his wife, who is employed as a sweeper in a panchayat office, and three sons aged between 6 and 14. For 15 years he was a lorry driver for a contractor. It was his long cherished desire to become the owner of a truck. With this goal in mind he started saving and eventually managed to save Rs. 7,000. But this amount was so small that he almost lost hope of owning a vehicle. At last he found a 1960 truck owner who was interested in selling his vehicle for Rs. 40,000. He approached several bank managers and hire purchase finance companies for hire purchase credit. They declined because the truck was very old. Ultimately, he went to an auto finance corporation at Namakkal which agreed to provide finance if he himself would invest Rs. 10,000. This left him with a shortage of Rs. 3,000. He got the consent of his wife to part with her gold chain to meet this deficit. He took the vehicle in 1984, by executing the hire-purchase agreement for Rs. 30,000, and agreeing to pay interest at 18 per cent per annum flat rate, for a period of 2 years. The instalment amount per month came to Rs. 1,700. He was so happy that he worked sometimes even on Sundays and at night. He could earn on an average about Rs. 250 to Rs. 300 gross a day. After meeting the running expenses on fuel and oil and the share of the helper/cleaner and himself, he earned about Rs. 100 to Rs. 150 per day including his labour charge. Within 25 days in a month, he could thus make Rs. 2,500 to Rs. 3,750 from which he could regularly pay the instalments. Fortunately for him, there was no major repairs for the truck and in 1987, he purchased another truck of 1970 model. This was also

with finance from the same finance corporation and Mr. Kannan, who is the proud owner of 2 vehicles now, is all praise for the corporation knowing that he has actually paid true interest at the rate of about 36 per cent per annum.

18.13 Overall assessment and distinguishing features

18.13.1 The automobile industry in India is small and protected. A few companies make almost the same models of cars year after year. As production and, to an extent, prices are controlled by the Government, for various reasons, including scarcity of inputs, supply falls short of demand and there is a premium on new vehicles. Because of this short supply position and the ever rising demand for transport of goods and persons, old - sometimes very old - vehicles are still in evidence on Indian roads.

18.13.2 In the absence of credit facilities for the purchase and use of used vehicles, many will remain idle or be sold as scrap. It is here that the auto finance corporations have come to play a role. The ten corporations we studied at Namakkal roughly financed the equivalent of 90 trucks in 1986. A crude estimate for the 90 corporations at Namakkal would be 9 times this or 820 vehicles. Even this is an underestimate according to a managing partner of one corporation.

18.13.3 The market for very old vehicles is maintained by these corporations. By their operations, they supply a mode of transport for goods mostly in the countryside, provide a means of livelihood for thousands of drivers and cleaners, help to maintain productive assets and enable continued use of scarce capital.

18.14 Recommendations for regulatory framework

18.14.1 Auto finance corporations are mostly partnership firms and proprietary concerns, not coming directly under any Governmental regulation and control. Only deposit acceptance is restricted under the Banking Laws (Amendment) Act 1983. Banks or any other refinancing agency do not at present give refinance facility to these corporations.

18.14.2 We recommend that the banks accept hire-purchase documents for refinance. By doing so, banks can indirectly help transport operations, a priority sector, without much risk and at low cost. As about one third of the capital of corporations is their own, the risk of default by them can be expected to be low. However, the RBI cannot exempt this category of corporations alone from the deposit acceptance provisions of the Banking Laws (Amendment) Act, 1983 because it is difficult to distinguish between an auto finance corporation and an ordinary finance corporation which also lends occasionally to transport operators.

18.15 Lessons for the formal sector

18.15.1 Banks charge about 17 per cent per annum on a reducing balance or annual compound basis for loans to transport operators. Auto finance corporations charge about 20 per cent per annum (flat) for a similar loan. The difference in the two rates is about 25 percentage points on an annual compound basis. A low cost loan is less burdensome than a high cost loan. Still, the cheap bank loan is often defaulted while the costly finance corporation loan is promptly repaid. This is because auto finance corporations keep a watch over hired goods, and timely follow-up action is taken to recover due amounts. In the case of banks,

there is limited machinery for follow-up action. Clearly, banks would benefit by studying the loan recovery procedures of auto finance corporations and by applying such procedures to their business. If this is infeasible, banks should consider ways of delegating HP finance to auto finance and HP companies, say through refinance facilities.

TABLE 18.1

**Consolidated Position of 10 Auto Finance
Corporations at Namakkal**

(Rs. lakh)

Year (December end)	Stock on hire	Variation over the previous year	Deposits outstand- ing	Variation over the previous year
(1)	(2)	(3)	(4)	(5)
1981	167.75	-	50.00	-
1982	182.05	14.30	58.35	8.35
1983	189.80	7.75	63.30	4.95
1984	207.80	18.00	68.05	4.75
1985	223.00	15.20	66.45	-1.60
1986	250.35	27.35	69.25	2.60

TABLE 18.2

Size Distribution and Growth Rates of
The Ten Corporations at Namakkal

Corporations	Stock on hire		Variation between 1981 and 1986 (Rs.lakh)	Growth rate between 1981 and 1986 (%)
	December end 1981 (Rs.lakh)	December end 1986 (Rs.lakh)		
(1)	(2)	(3)	(4)	(5)
1	9.00	13.50	4.50	50.00
2	16.00	25.00	9.00	56.25
3	49.00	60.00	11.00	22.45
4	8.50	17.30	8.80	103.53
5	12.00	18.50	6.50	54.17
6	15.00	20.50	5.50	36.67
7	20.00	30.50	10.50	52.50
8	7.75	17.50	9.75	125.81
9	17.50	26.75	9.25	52.86
10	13.00	20.80	7.80	60.00

CHAPTER 19

NIDHIS OF SOUTH INDIA

19.1 Introduction

19.1.1 A nidhi, (or mutual benefit fund or permanent fund), is an indigenous financial institution, commonly seen in Tamil Nadu. Its place of origin is the erstwhile Madras Presidency and it is one of the few financial institutions which are allergic to geographical expansion. Initially, it spread to neighbouring areas in the princely States of Travancore and Mysore but subsequently, its growth outside the Presidency dwindled. Presently, nidhis are found mainly in Tamil Nadu, particularly the city of Madras.

19.1.2 Nidhis arose to cater to specific requirements of middle income individuals. In the last century as also in the early part of the present century, indigenous bankers, pawn brokers and money lenders were the only sources of consumption credit for such persons. Families requiring money for social and religious purposes were charged usurious rates of interest by these financiers even for secured loans. Thus an institution called 'nidhi' was set up by some public spirited men drawn from different walks of life, including among them lawyers, teachers, engineers and administrators, with the following objects:

- i. To promote the habit of thrift among people.
- ii. to deal exclusively with shareholder members, and
- iii. to provide loans to members at reasonable rates of interest against jewellery and house property.

19.1.3 Nidhis are public limited companies registered under the Indian Companies Act, 1956, or its predecessors. In view of the unique nature of their organisation by which operations are con-

fined to shareholders, they are governed by special provisions under section 620A of the Act, if they satisfy criteria laid down in this section. The face value of their shares is small, often Re 1, and shares are not traded on the stock exchange.

19.1.4 Most nidhis only have these Re 1 shares. However, some nidhis have two types of shares - "A type" with face values varying between Rs 5 to Rs 50 and "B type" with a face value of Re 1. In such nidhis only "A type" shares, normally held by the directors, their relatives and close friends, have voting rights.

19.1.5 Nidhis are managed by a board of directors elected by shareholders usually under the principle of one man one vote since, generally, not more than one share is issued to a person.

19.1.6 Nidhis operate in specific locations and members are generally from the same area. Most nidhis are single office institutions without branches. Barring a few which carry the name of the community that patronises them (e.g., Madhva Siddanatha Fund and Catholic Permanent Fund), nidhis normally carry the names of the locality where they operate (e.g. Egmore Benefit Fund, Triplicane Permanent Fund and Abhiramapuram Permanent Fund).

19.1.7 As financial institutions, nidhis accept deposits from members and provide loans to them. Though their operations resemble those of banks in the organised sector, they do not come under the Banking Regulation Act 1949 and also are not permitted to issue cheques.

19.2 Geographical dispersion and numbers

19.2.1 The first official reference to nidhis is found in the Report of the Madras Provincial Banking Enquiry Committee (1930). According to the Report, there were 346 nidhis in Madras Presidency of which 288 were functioning in 1929. The Report of the study group on Non-Banking Financial Intermediaries (1971) set up by the Banking Commission states that there were 150 nidhis in

1966. A recent study of nidhis (Ramani 1985) which examined the number of companies registered with the Registrar of Companies, Madras put the number at 134 in 1985. About half of these were either dormant or were operating in a very limited way. The Department of Financial Companies of the RBI puts the number of reporting nidhis at the end of March 1986 as 65. Year-wise details are in Table 19.1 and State-wise details for 1981 are in Table 19.2. Table 19.1 shows that about half the companies registered under Section 620A of the Companies Act reported to the RBI. Table 19.2 shows that nearly 80 per cent of reporting nidhis are in Tamil Nadu.

19.3 Area surveyed and description of sample

19.3.1 To evaluate the contribution of this financial intermediary to the financial sector of India, a survey was conducted during 1986-87 with the help of a suitably framed questionnaire. This chapter is based mainly on the results of the survey.

19.3.2 A majority of nidhis which reported to the RBI in 1986 were old (Table 19.3). The Table shows that 83 per cent of the nidhis are more than 25 years old and 62 per cent are more than 50 years old. The reduction in the number of working nidhis from 288 in 1929 to 65 at the end of March 1986 is due to the merger of some of them with commercial banks, the failure of a few in the 1930's, voluntary winding up and stoppage of activity for various reasons.

19.3.3 Growth in deposits was slow during 1967 to 1982. Since then, upto 1986, deposits grew by 136 per cent although the number of nidhis rose only by 3. Even with this, total deposits with nidhis, at Rs 73.50 crore at the end of March 1986, were less than that of the smallest commercial bank in the country and formed an insignificant 0.09 per cent of commercial bank deposits.

19.3.4 For this survey, we selected a sample of 12 nidhis from Tamil Nadu and Andhra Pradesh - seven from the city of Madras and

one each from Karur, Nagapattinam, Adoni, Bellary and Nellore. The list of selected nidhis, their age and number of shareholders are shown in Table 19.4. The average age of the 12 nidhis is 79.5 years and the average number of shareholders is 15020. Selected nidhis had deposits of Rs 46.48 crore at the end of March, 1986, which formed about 63 per cent of deposits with all nidhis. They had high credit deposit ratios (95 per cent to 97 per cent) in the three years ending 1985-86.

19.4 Sources of funds

19.4.1 Share capital of nidhis does not represent an important source of funds. For the few nidhis that have two types of shares, the value of founders capital varies from Rs 2 to Rs 50 while the ordinary share value remains Re 1. Further, the shares are not offered to the public through public issues. A person takes a share of a nidhi when he wants to transact business with it, either as a depositor or borrower. Normally he is allowed to take only one share, which is transferable, and with it he can effect any number of transactions. Thus, although there are thousands of shareholders in a nidhi, the total share capital remains a small. In relation to their deposit liabilities, capital formed only 0.35 per cent in 1985-86 for the sampled firms (Table 19.5).

19.4.2 Reserves: Nidhis transfer a major portion of their profit to reserves. As a matter of policy, they limit dividends. Dividends are expected only by major shareholders who manage the affairs of nidhis. However, even so, as much as 85 per cent to 95 per cent of profits are transferred to reserves. Consolidated balance sheet figures of sampled firms for 3 years (Table 19.5) show that total reserves formed about 6.1 per cent of deposit liabilities in 1985-86. Thus, own funds (capital and reserves) as a percentage of deposit liabilities during 1983-84, 1984-85 and 1985-86 was 9.33 per cent, 7.38 per cent and 6.75 per cent, respectively.

19.4.3 The major source of funds of nidhis is deposits from members. The deposits variously include savings, recurring, fixed and cumulative deposits (cash certificates). In the deposit mix in 1985-86, fixed deposits constituted 67 per cent, recurring deposits 13 per cent, cumulative and cash certificate 14 per cent and savings deposits 6 per cent of total deposits. There is almost no borrowing from the formal sector.

19.4.4 Period of funds availability: About 94 per cent of deposits with Nidhis are from long term contracts. Fixed deposits (FD) ranged from one to nine years, although shorter periods of 3 years and less make up 80 per cent of FDs. Recurring deposits (RD) ranged from 12 months to 108 months and cash certificates from three years to seven years. Commercial bank deposits were normally for 5 years or less during this period. Premature withdrawals of FDs are not permitted in nidhis. If a depositor is in need of money, he is allowed a loan of upto 95 per cent against his FD. Funds availability for such long and fixed periods enables nidhis to extend loans for land improvement and building construction.

19.4.5 Cost of funds: Nidhis' deposit interest rates are higher than those prevailing in commercial banks. They are not covered by any deposit acceptance or interest fixation rules prescribed under the Non-banking Companies (Reserve Bank) Directions 1977 or by the Banking Laws (Amendment) Act 1983, because technically, they accept deposits from members only. Interest rates offered for different types of deposits and periods are as follows:

19.4.6 Savings deposits: Interest is paid at 6 per cent to 6.5 per cent per annum against 5 per cent in commercial banks.

19.4.7 Recurring deposits: Nidhis started RD as early as the 1880's, following a model given in a journal, the Scotsman which was received in Madras in 1882. The Mylapore Permanent Fund established in 1888 was the first to introduce the scheme. Other nidhis soon followed and later it was adopted by commercial and co-

operative banks (Radhakrishnan, 1979). Interest on RD paid by nidhis are almost double the rates paid by commercial banks for such deposits (Table 19.6). However, since interest rates are fixed on a simple interest basis, they have an erratic term structure.

19.4.8 Cumulative term deposits: Term deposits of nidhis range from three months upward. Interest rates are not the same for all nidhis. The average rates for different periods are at least four percentage points higher than those of commercial banks (Table 19.6).

19.4.9 The mode of interest payment differs from nidhi to nidhi. On savings deposits, some nidhis calculate interest for the minimum balance in the account between the 6th and the 26th while others do it for the minimum balance during the month. Some nidhis pay interest every month for fixed deposits, depending on the amount of deposits.

19.5 Uses of funds

19.5.1 Borrowers consist mainly of housewives, salary earners, businessmen, pensioners and professionals. Nidhis do not maintain data on the types of borrowers. The data furnished by some of the nidhis to our investigators give approximate percentages of each category in total borrowings. The classification is as follows:

a.	Housewives	25 per cent
b.	Salary earners	20 per cent
c.	Businessmen	15 per cent
d.	Pensioners	25 per cent
e.	Others (Unspecified)	15 per cent

19.5.2 Middle class housewives reportedly join nidhis primarily to save small amounts through recurring deposits and to borrow against jewellery. Salary earners deposit money in recurring or fixed deposits and later borrow to supplement their own funds at

the time of investment in housing. Businessmen are mostly small traders who borrow from nidhis on the security of property. Pensioners are the backbone of nidhis. They save with nidhis during their working lives and draw upon these funds after retirement. Other categories of borrowers such as professionals borrow on the security of property for setting up clinics, workshops, etc. Some borrowers borrow to repay old debts incurred at high interest cost.

19.5.3 Nidhis generally offer two types of loans, simple loans, and mortgage loans. A simple loan is granted against fixed or recurring deposits. Each nidhi fixes the maximum limit for such loans at 85 per cent to 95 per cent of the amount deposited.

19.5.4 Mortgage loans are of two kinds, ordinary and special. Ordinary mortgage loans are granted to members who offer as security immovable property within specified civil jurisdictions. These borrowers are asked to open RD accounts and deposit periodic instalments to liquidate the loan in five to seven years according to the agreement. Ceilings on ordinary mortgage loans are usually set between Rs. 15,000 and Rs. 25,000 on any single property. A few nidhis set the maximum limit at Rs. 3 lakh and even Rs. 5 lakh.

19.5.5 Special mortgage loans are also offered to members who offer movable or immovable property as security. In special mortgage loans, the minimum amount of loan against movable property found was Rs. 100 and the maximum was Rs. 20,000. Against immovable property, the usual range of loans was found to be between Rs. 10,000 and Rs. one lakh, the maximum going upto Rs. five lakh in rare cases. Furthermore, against property, the maximum loan is usually two-thirds of the market value, decided by a recognized property valuer.

19.5.6 Some nidhis invest in Unit Trust of India Certificates and Government of India bonds. But such investments form less than one per cent of the asset mix of nidhis.

19.5.7 Interest charges on loans: Interest on loans varies from 18 per cent to 23 per cent (Table 19.7). The two major categories of loans are those against jewellery and property. Though personal surety loans, produce loans and consumer credit loans are shown in the table, such loans are exceptions and are confined to one or two nidhis. In comparison, the maximum lending rate of commercial banks in the corresponding period was 16.5 per cent per annum.

19.5.8 Movable and immovable property accepted by nidhis as security are:

- a. Jewellery, gold and silver articles;
- b. Government Bonds; debentures of companies or corporations guaranteed by the Government of India or any State Government; securities recognised by the Indian Trust Act; and Insurance Policies;
- c. Property and title deeds of properties.

19.5.9 For all loans, borrowers have to execute a demand promissory note (DPN). Titles to property, after examination of property by nidhis are generally registered with the local Sub-Registrar. Only in special cases are title deeds deposited with nidhis. Loans against FDs and RDs are given on the depositor's discharging them and executing a DPN. Personal surety loans are rare. When they are made, the borrower has usually to furnish his salary certificate from his employer and produce two guarantors to stand as surety. Produce loans and consumer durable loans were found to have been extended by one nidhi only. In such loans, borrowers have to pledge the produce or hypothecate the consumer durable item to the nidhi, in addition to executing a DPN. Thus almost all loans of nidhis are secured.

19.5.10 Loan periods of nidhis are long as compared to loan periods of other informal financial institutions. As loans are given against collateral, the lender generally does not insist on a firm period for repayment. If the repayment is inordinately delayed, nidhis send reminders and notices. However, certain nidhis fix a maximum period of loan for jewel loans (two years) and

mortgage loans (three to seven years).

19.5.11 Bad debts and overdues: None of the nidhis studied reported any bad debt. The rate of recovery of loans was almost 100 per cent. When a pledged article or mortgaged property is not redeemed and hence disposed of through legal means after intimating the borrower, nidhis seldom suffer losses because sufficient margin is maintained between the loan amount and the expected sale value of the article/property.

19.5.12 Assessment procedures: When a loan is applied on the pledge of jewellery, jewellery appraisers of nidhis estimate the value and certify the genuineness of the article. For the valuation of immovable property, most nidhis appoint estimators, appraisers and surveyors certified by the Government of India. If nidhis are not satisfied with these valuations, they appoint any two directors for the purpose without any additional cost to the borrower. Annual verification of the property is usually done to take note of any depreciation that may take place in its value.

19.5.13 Margin: Some nidhis grant up to 75 per cent of the estimated value of most types of security offered while others grant only 50 per cent. For depreciable assets or properties, the margin is usually higher. For government or other approved paper securities, nidhis usually grant 85 per cent of the nominal value or 90 per cent of the market value whichever is lower.

19.5.14 Complementarity to formal sector: Loans by nidhis are either for consumption or for investment in real estate. The major purposes of loans are marriages; religious ceremonies; clearing of old debts; and construction, repair or renovation to buildings. Commercial banks generally do not extend finance for such purposes.

19.6 Cost of intermediation

19.6.1 In the deposit mix of nidhis in 1985-86, FDs accounted for 66.7 per cent of total deposits of which FDs of three years and less formed about 80 per cent. In raising funds, nidhis do not incur any expense on advertisement or brokerage. Nor do they incur floatation costs for issue of shares as they are not offered to the general public. Nidhis have low risk cost as advances are fully secured. A final advantage is the relatively low overheads as most directors provide services in an honorary capacity.

19.6.2 The consolidated profit and loss account of 12 nidhis (Table 19.8) shows that in all three years under reference, net profit was around 9 per cent of income. The low establishment expenses of nidhis relative to banks is also revealed. It is difficult to compare the performance of informal intermediaries with formal intermediaries for reasons discussed earlier (Chapter 6). However, on average, the performance of Nidhis may be worked out as has been done in Table 19.9. The spread between loan and deposit rates is seen to be 5 to 7 percentage points on average as compared to 6 to 10 points for scheduled commercial banks (Chapter 6). Even so, the major component of nidhi loan rates is the high deposit/opportunity cost of funds (79 per cent) in comparison with banks (at best 67 per cent). Establishment expenses account for all but 2 per cent of the remaining part of loan interest. In line with field interviews, default cost has been set to zero.

19.6.3 Nidhis have a credit deposit ratio of 95 per cent against the commercial bank ratio of 65 per cent (the latter is obviously partly due to reserve requirements), and a gross profit rate of about 11 per cent of income per annum. Nidhis earn these profits after paying higher interest to depositors than the commercial banks and charging only slightly higher interest on loans. The real reason for the high profitability rate is the significantly lower establishment expenses and the high credit deposit ratio.

19.7 Regulatory environment

19.7.1 Nidhis are registered under the Indian Companies Act, as amended from time to time. As mutual benefit funds, restricting activities to members only, they are exempt from many provisions of this Act and are governed by special provisions contained under Section 620-A. Some of the special provisions are:

- i. They are not required to furnish copies of their audited balance sheets to each of their shareholders but are required to publish the audited statement in an English and local language dailies besides displaying the same on their notice boards. Balance sheets are to be sent to members who hold shares worth Rs 100 or more.
- ii. They are not allowed to offer shares to existing share holders, but only to persons who wish to join them.
- iii. Section 87(i)(b) of the Companies Act provides that voting rights of shareholders in proportion to their equity holdings. Nidhis are exempted from this provision with the condition that no members shall exercise voting rights in excess of 5 per cent of the total paid up capital.
- iv. Nidhis are allowed to furnish a list of changed and added members to the Registrar of Companies once in five years as against once in two years for other companies under Section 159(i) of the Act.
- v. Nidhis are not required to send dividend warrants to members except when the dividend exceeds Rs 25. They may pay it in cash or deposit it in the members' accounts.
- vi. Section 295 of the Companies Act prohibits a company from lending to its directors without prior approval of the Central Government. This section is not applicable to nidhis except where the loan amount is Rs 2000 or more and where it exceeds 25 per cent of the value of collateral security.

19.7.2 Nidhis are exempt from the acceptance of deposit rules prescribed under the Non-Banking Companies (Reserve Bank) Directions, 1977. They are, however, required to submit returns to the RBI twice a year detailing the number of shareholders, types and amounts of deposits and advances.

19.7.3 Nidhis are also exempt from State moneylenders acts and debt relief acts.

19.7.4 These exemptions and the special treatment under the Companies Act give nidhis wide latitude in their business operations. They are free to raise any amount of deposits from members at whatever interest rates they think fit. They can similarly fix lending rates. Despite this freedom, official Commissions have recognised the useful role played by nidhis in the financial system.

19.7.5 The Banking Commission (Government of India, 1972), recognising the role of nidhis in the Indian financial system, pointed out that they were run on efficient lines and that their lending operations were marked by caution. It also recognised the role of nidhis in financing house construction and property improvement and in meeting the consumption needs of the lower middle and poorer classes of the community. While appreciating the useful service rendered by nidhis to their members, the Commission underlined the need for regulating them so that they could become "more dynamic and useful to the economy". In this context, it pointed out that though nidhis were akin to commercial banks in their working, they were not subjected to regulations applicable to banking companies except for periodical submission of returns to the RBI.

19.7.6 The Commission suggested the following measures of regulation:

- i. Nidhis accepting demand deposits should be regulated in the same way as other commercial banks. In regard to others, they should be licensed by the RBI or any other appropriate authority;
- ii. A minimum liquidity ratio, lower than that of commercial banks, should be prescribed for them;
- iii. They should be required to have minimum paid-up capital and reserves, with an added condition that a specified percentage of net profits should be transferred to the reserve fund every year;

- iv. There should be periodical inspection by the regulating authority; and
- v. Nidhis satisfying certain requirements should be classified as "approved institutions" to become eligible for refinance, guarantee of loans, insurance of deposits and even tax concessions available to banks.

19.7.7 The Commission also urged that links should be established between nidhis and commercial banks by making the former, with their intimate knowledge of the clients in their localities, agents for the latter in the matter of small loans.

19.7.8 The James Raj study group on Non-Banking Companies (1974) set up by the RBI recognised that nidhis were a notable exception to other non-banking financial companies in that their liabilities, like those of commercial banks, comprise both demand and time liabilities while their assets, unlike those of commercial banks, are more specialised, covering advances mostly against mortgages. It also drew a distinction between nidhis and other non-banking financial companies since the latter are run on commercial lines while the former are organised for the mutual benefit of their members. It came to the conclusion that the nature of controls on them need not be identical with those on other non-banking financial companies. However, the Study Group recommended that all non-banking financial companies, including nidhis, be required to transfer to reserve funds a sum equivalent to not less than 20 per cent of their annual net profits before declaring any dividend till such time as the amount in the reserve fund is equal to the paid up capital of the company. Most nidhis already meet this criterion.

19.7.9 According to the Report of the Committee to Review the working of the Monetary System (1985), nidhis are purely local institutions which accept deposits from members and restrict their lending to members. They work on sound principles of banking, and their operations are similar to those of unit banks although they do not issue cheque books to their clients.

19.8 Industry structure

19.8.1 As nidhis are largely single office institutions, their area of operation is demarcated and within their area they do not face competition. We have not observed any place where two nidhis or two offices of nidhis are located so as to compete for the same customers. Many nidhis may be located in a city but they are scattered at different places within it.

19.8.2 We have noted marginal interest rate difference among nidhis located within the city of Madras. Interest rate difference becomes possible because people generally prefer a nidhi within their locality to a distant one even if the latter offers a slightly higher rate of interest for deposits and a slightly lower rate on loans. Clearly, however, excessive rents cannot be earned.

19.8.3 Another factor which influences price fixation by nidhis is their age. Generally, the longer the age of a nidhi, the better its reputation and so the greater its position in attracting clients and fixing price. But this advantage has not been made use of by nidhis. Data on age-wise distribution of deposits presented in Table 19.10 shows that about 85 per cent of deposits of nidhis studied was accounted for by five nidhis above 100 years old. It is also seen that nidhis outside the city of Madras fared poorly in terms of deposits, suggesting that successful nidhis are an urban phenomenon.

19.8.4 Loan availability to a member of nidhi depends on its funds position. It is not uncommon for a nidhi with shortage of funds to recommend a member to another nidhi which intends to expand its loan portfolio.

19.8.5 Entry to the nidhi market and exit from it are permitted by the Indian Companies Act under certain conditions. Exemption under Section 620A of this Act is available only after a nidhi has enrolled 1000 members. The procedure for winding up of

companies is also given in the Companies Act. Thus entry and exit barriers, though not insuperable ones, result from the regulatory environment.

19.9 Estimate of overall size

19.9.1 There is no need to estimate the overall size of nidhis because the actual position is reflected in the RBI surveys on growth of deposits with non-banking companies apart from some non-functioning nidhis. These data, presented in Table 19.1, give the effective number of nidhis in March 1986 as 65 with a total deposits of Rs 73.50 crore. If we apply the growth rate between 1985 and 1986 (21.69 per cent), their deposits in March 1987 would be of the order of Rs 89.44 crore.

19.10 Influence of formal sector lending rate/loan availability

19.10.1 Prima facie, formal sector lending rates have little influence on the lending rates of nidhis even for gold loans which are sanctioned by both nidhis and banks. Banks lend to a limited extent against the security of gold jewellery. Here, if the loan is for agricultural purposes, they charge a lower rate of interest as applicable to agricultural loans. If it is for other purposes, they charge the maximum lending rate, currently at 16.5 per cent per annum. They charge their normal rate, currently at 18 to 20 per cent per annum, for all gold loans. The lending rates of banks fluctuate according to the guidelines of the RBI.

19.10.2 Even though the maximum lending rate of banks is about 1.5 to 3.5 percentage points lower than that of nidhis, many borrowers against gold turn to nidhis because (a) banks limit the amount of loan to unreasonably low levels, (b) the total loan per borrower is limited to a maximum of Rs 3000 by commercial banks and Rs 10,000 by cooperative banks in some States, (c) loans are not sanctioned on all working days in a week, (d) the loan is subject to a ceiling prescribed for gold loans in each bank branch and (e) there is delay in releasing the loan.

19.10.3 Banks do not extend loans against mortgage of landed property, even though they take such property as additional security for other loans. They do not give any accommodation or refinance to nidhis against the latter's mortgage loan. Therefore, the interest rates of banks have no direct influence over the interest rate for mortgage loans of nidhis.

19.10.4 The availability of funds for loan operations of nidhis is limited to their own and borrowed funds. There is no refinance facility from the organised banking sector, even though such a measure was mooted by the Banking Commission in 1972.

19.10.5 All nidhis maintain current accounts with banks and all payments except small gold loans are made by bank cheque. Receipts are in cash and bank cheques including outstation cheques. Nidhis maintain their resources in banks and, as can be seen from Table 19.5, about 8 per cent to 11 per cent of their assets are held in banks. A major part of this balance is in fixed deposits and the rest in current accounts. The banks in turn give little facility to nidhis except perhaps loans against their FDs. Thus a part of informal sector funds finds its way to the formal sector banks, though this does not argue for influence of either institution on the other.

19.11 Distributional impact

19.11.1 As mentioned earlier, nidhis essentially serve middle class salary earners and pensioners and provide loans for purposes for which ready alternatives at reasonable cost do not exist.

19.12 Efficiency and allocative impact

19.12.1 Nidhis serve a category of clients who are not served or inadequately served by commercial banks. Consumption loans are discouraged, if not denied, by banks. But certain consumption expenditures cannot be brushed aside as unimportant because without such expenditure an individual may find it difficult to

carry on his social life. In some cases, the need for such expenditures comes suddenly. Nidhis extend loans at reasonable interest to members who would, otherwise, have gone for much costlier loans from money lenders or pawn brokers. Thus, the cost of financing unforeseen consumption needs is kept in check.

19.12.2 Loans against the mortgage of property by nidhis have helped many property owners to construct, renovate and expand buildings and houses. In Madras, there are several instances of borrowers paying back the loan amounts from rent realised from commercial buildings built or renovated with the help of finance from nidhis. Nidhis have also extended loans for construction and improvement of residential houses and acquisition of flats in cities and towns. Thus support for construction activities, vital at this stage of India's development, is clearly available.

19.12.3 Both of these points would tend to support the hypothesis that nidhis have a positive impact on saving and investment.

19.12.4 In savings mobilisation, nidhis have shown themselves to be innovators. In fact, it is said that nidhis are pioneers in recurring deposits in India. Currently, a range of deposit schemes which parallel commercial bank schemes are offered. For all categories of deposits, nidhis pay higher rates of interest than commercial bank and at least as much as company deposits. Furthermore, though there are other informal financial institutions which offer higher rates of interest than nidhis, the safety of deposits with nidhis is high. However, given their limited coverage, the impact of nidhis on aggregate saving is clearly small.

19.13 Recommendations for a regulatory framework

19.13.1 Two of the major recommendations of the Banking Commission (1972) on nidhis were for a minimum liquidity ratio and minimum paid up capital and reserves. Nidhis have already

accepted these voluntarily as can be seen from the data presented in Table 19.5. In both these respects they have a better position than commercial banks. They also strengthen their reserves every year by distributing only a small portion of net profits (not more than 25 per cent) as dividends.

19.13.2 Enquiries revealed that the present method of incorporation of nidhis under the Companies Act and the exemptions granted to them under Section 620-A were based on sound principles and did not require change.

19.13.3 From the preceding discussion, it is clear that nidhis serve a particular segment of borrowers and lenders well. This segment is clearly restricted in that only loans against collateral are given. However, their loan portfolios appear to complement the formal sector and include a relatively high proportion of long term loans. Furthermore, depositor security is high. Given the recent growth of the housing finance market in India and alternative formal deposit channels which are both safe and offer higher returns than commercial banks, the future of nidhis is not at all obvious. However, were banks to increase the range of assets acceptable to them as collateral to include gold and various types of bonds, the combined impact of these formal sector developments on nidhis would clearly be adverse. The question that we are thus faced with is whether formal institutions should compete with nidhis (or work through them). Since nidhis have lower establishment costs than banks and since monopoly rents are not significant, the answer is clearly in the negative if the social benefits resulting from the nidhis loan portfolio are more or less correctly reflected in their loan rates. Thus, it is suggested that the only additional regulatory step required is bank support in augmenting resources of nidhis by refinancing their fully secured loans.

TABLE 19.1

Growth of Nidhis

Year	Number of reporting companies (Nos)	Deposits (Rs crore)
1967	59	10.11
1968	64	10.74
1969	63	11.99
1970	64	13.63
1971	63	14.96
1972	65	15.80
1973	67	18.20
1974	66	19.60
1975	68	19.60
1976	66	20.00
1977	66	19.80
1978	66	21.70
1979	62	24.60
1980	63	28.10
1981	62	31.50
1982	62	31.10
1983	61	35.60
1984	61	39.60
1985	64	60.40
1986	65	73.50

Note: As on March 31.

Source: Growth of Deposits with Non-Banking Companies, Reserve Bank of India Bulletin, various issues.

TABLE 19.2

State-Wise Details of Nidhis (March end 1981)

State	Number of reporting companies	Deposits		Net own funds (capital and reserves) (Rs lakh)
		Number of accounts	Amount (Rs lakh)	
Tamil Nadu	49	176914	3049.54	182.29
Andhra Pradesh	1	4194	34.54	5.60
Kerala	1	563	24.75	3.15
Karnataka	1	390	3.63	1.76
A. Southern Region	52	182061	3112.43	192.80
B. All India	62	NA	3150.00	200.00
Share of Southern Region	83.87	-	98.81	96.40

Sources: For (A) C.P.S. Nayar, A Study on Non-Banking Financial Intermediaries, Institute for Financial Management and Research, Madras, 1984.

For (B), Reserve Bank of India Bulletin, October 1982.

TABLE 19.3

Age Distribution of 65 Nidhis
(1986)

Range	Number	Share (%)
More than 100 years	7	10.77
More than 75 upto 100 years	19	29.23
More than 50 upto 75 years	14	21.54
More than 25 upto 50 years	14	21.54
Below 25 years	11	16.92
TOTAL	65	100.00

TABLE 19.4

Details of Selected Nidhis

S.No.	Name of Company	Age (Years)	No. of Shareholders		
			A class	B class	Total
A. Tamil Nadu					
1.	Abiramapuram Fund Ltd Madras City	31	-	-	2,563
2.	Egmore Benefit Fund Society Ltd., Madras City	116	-	-	55,672
3.	Kilpauk Benefit Society Ltd., Madras City	12	-	-	14,472
4.	Madras Purasawakkam Hindu Janopakara Saswatha Nidhi Ltd. Madras City	105	-	-	40,000
5.	Nagapattinam Permanent Fund Ltd. Nagapattinam	85	-	-	2,325
6.	Nungambakkam Saswatha Dhana Rakshka Nidhi Ltd. Madras City	104	-	-	25,600
7.	Sriman Madhwa Siddhantha Onnahini Permanent Nidhi Ltd. Madras City	105	390	15,663	16,053
8.	Srivasavi Parameswari Permanent Fund Ltd. Karur	25	-	-	7,142
9.	Triplicane Permanent Fund Ltd. Madras City	61	287	10,866	11,153
B. Andhra Pradesh					
10.	Adoni Arya Vysya Fund Ltd Adoni	76	-	-	2,370
11.	Bellary Brucepet Hindu Mutual Benefit Fund Ltd. Bellary	135	-	-	1,923
12.	Nellore Permanent Fund Ltd Nellore	99	-	-	975
					1,80,248

TABLE 19.5

Consolidated Balance Sheet of 12 Nidhis

(Rs lakh)

Particulars	1983-84	1984-85	1985-86
A. Liabilities			
1. Paid up Capital	12.73 (0.40)	14.62 (0.32)	16.14 (0.30)
2. General Reserves	198.78 (6.36)	228.54 (5.09)	257.47 (4.79)
3. Specific Reserves	28.30 (0.90)	37.59 (0.83)	40.32 (0.75)
4. Deposit Liabilities	2570.58 (82.28)	3802.06 (84.77)	4648.31 (86.49)
a) Fixed Deposits	1615.24	2432.82	3099.87
b) Recurring Deposits	414.92	564.35	616.51
c) Savings Deposits	157.04	246.64	295.19
d) Other deposits	383.08	558.25	636.74
5. Current Liabilities	313.36 (10.06)	401.40 (8.99)	412.16 (7.67)
TOTAL (A)	3124.05 (100.00)	4484.21 (100.00)	5374.40 (100.00)
B. Assets			
1. Net Fixed Assets	61.07 (1.95)	69.81 (1.55)	76.39 (1.42)
2. Investments	10.97 0.35	14.82 (0.33)	19.66 (0.36)
3. Loans and Advances	2482.94 (79.48)	3682.14 (82.11)	4402.73 (81.9)
4. Cash and Bank Balance	341.95 (10.95)	386.11 (8.61)	419.52 (7.80)
5. Current Assets	227.12 (7.27)	331.33 (7.40)	456.10 (8.49)
TOTAL (B)	3124.05 (100.00)	4484.21 (100.00)	5374.40 (100.00)

Note: Figures in brackets indicate percentage to total.

TABLE 19.6

Interest Rates of Nidhis and Commercial Banks (April 1987)

Period in months	Average of twelve nidhis			Commercial banks
	Recu- rring deposits	Term deposits	Cash certifi- cates	
(1)	(2)	(3)	(4)	(5)
3	-	9.00	-	4.00
6	-	10.00	-	8.16
12	17.32	12.00	14.00	9.31
24	22.28	13.00	16.00	10.38
36	22.56	14.00	16.00	10.38
48	21.99	14.50	16.00	10.38
60	21.34	15.00	16.00	11.46
72	20.77	18.00	-	11.46
84	20.17	18.00	17.80	11.46
96	19.62	18.00	16.95	11.46
108	19.07	18.00	16.95	11.46
120	18.53	18.00	-	11.46

- Notes: 1. All rates are annual compound rates.
 2. Commercial bank rates are compounded quarterly.
 3. Interest on recurring and cumulative deposits for nidhis are quoted on a simple interest basis. For recurring deposits this ranges from 10% (12 month) to 16.5% (120 month). The range for cumulative deposits is 14% (12 month) to 33.33% (108 month).

TABLE 19.7

Schedule of Interest Rates on Loans of Nidhis (1987)

Sr.	Type of Loan	Rate of Interest (% p.a.)	Remarks
1.	Jewel loan	18-20	Rs 1000 per sovereign
2.	Loans against FDR and RD	1.5 to 2% more than the contra- cted rate for deposits	80 to 95 per cent of deposits
3.	Mortgage loans	16.20- 22.80	Repayment upto 7 years
4.	Special mortgage loans	18.00	Repayment within 3 years
5.	Produce loans ¹	18.00- 23.00	Against pledge of agricultural and commercial commodities
6.	Consumer-credit loans ¹	18.00- 22.00	For purchase of consumer durables on hypothecation basis
7.	Personal surety loans ¹	18.00	On the surety of two guarantors and on production of salary certificate

Notes: 1. These are extended only by one or two nidhis.

TABLE 19.8

Consolidated Profit and Loss Account of 12 Nidhis

(Rs lakh)

Particulars	1983-84	1984-85	1985-86
A. Income			
1. Interest received	439.81	525.85	564.35
	(97.20)	(98.02)	(98.04)
2. Other income	12.65	10.27	11.27
	(2.80)	(1.98)	(1.96)
TOTAL (A)	452.46	536.12	575.62
	(100.00)	(100.00)	(100.00)
B. Expenses			
1. Interest paid	305.85	378.47	402.64
	(67.60)	(70.59)	(69.95)
2. Salaries	56.74	67.49	77.12
3. Director's fees	5.27	5.37	5.61
4. Depreciation	6.15	5.17	4.83
5. Administrative expenses	24.33	24.44	24.69
6. Total establishment expenses (2+3+4+5)	92.49	102.47	112.25
	(20.44)	(19.11)	(19.50)
7. Total expenses (1+6)	398.34	480.94	514.89
	(88.04)	(89.70)	(89.45)
8. Gross profit (A-7)	54.12	55.18	60.73
	(11.96)	(10.29)	(10.15)
9. Provisions (tax etc.)	8.95	9.37	10.11
	(1.98)	(1.75)	(1.76)
10. Net profit (8-9)	45.17	45.81	50.62
	(9.98)	(8.54)	(8.79)
TOTAL (B)(7+8)	452.46	536.12	575.62
	(100.00)	(100.00)	(100.00)

Note: Figures in brackets indicate percentage to total.

TABLE 19.9

Decomposition of Interest Rates from Annual Report Data

Particulars	12 Selected Nidhis		
	1983-84	1984-85	1985-86
Financial Statistics (Rs Lakh)			
1. Share Capital and Reserves	239.81	280.75	313.93
2. Total Deposits	2570.58	3802.06	4648.31
3. Total Credit	2482.94	3682.14	4402.73
4. Total Earnings (income)	452.46	536.12	575.62
5. Interest Paid	305.85	378.47	402.64
6. Salary, Allowances, etc.	86.34	97.30	107.42
7. Other Expenditure	6.15	5.17	4.83
8. Total Expenses	398.34	480.94	514.89
9. Gross Profit (4+8)	54.12	55.18	60.73
10. Provision for Tax Etc.	8.95	9.37	10.11
11. Net Profit	45.17	45.81	50.62
Interest Rates (per cent)			
a. Loan Rate	-	21.59	15.63
b. Deposit Rate	-	14.72	10.59
c. Spread	-	6.87	5.04
Ratios to Total Funds (per cent)			
d. Earnings	-	19.08	14.10
e. Deposit Cost	-	13.47	9.86
f. Establishment Cost	-	3.65	2.75
g. Opportunity Cost at 18%	-	1.54	1.24
h. Economic Rent	-	0.42	0.25
Break Up (per cent)			
i. Deposit Cost + Opportunity Cost	-	78.67	78.72
j. Transactions Cost	-	19.13	19.50
k. Economic Rent	-	2.20	1.78

TABLE 19.10

Distribution by Age and Deposits of 12 Nidhis (1986)

Age Range	No.	Deposits (Rs. lakh)	Percentage to Total	
			Deposits	No
More than 100 years	5	3939.82	84.76	41.67
75 years to 100 years	3	93.56	2.01	25.01
50 years to 74 years	1	179.80	3.87	8.33
25 years to 49 years	2	147.11	3.16	16.67
Below 25 years	1	288.02	6.20	8.33
Total of Selected Nidhis	12	4648.31	100.00	100.00
Total reporting nidhis in India	65	7350.00	-	-
Selected nidhis as % of total nidhis	18.46	63.24	-	-

CHAPTER 20

FINANCE CORPORATIONS OF SOUTH INDIA

20.1 Introduction

20.1.1 A finance corporation is an informal financial intermediary set up for making profit from the business of lending money raised by way of deposits or borrowing. It may be a proprietary concern, a partnership firm or a limited company. The nomenclature of this financial intermediary is found to vary from place to place. Besides the term finance corporation, bankers, financing company, financiers, trust, fund, capital centre, financial enterprise, investment company, investment corporation, investment, finance and exchange, traders and financiers, credit corporation, benefit corporation, commercial corporation, finance and chit fund, finance syndicate and commercial syndicate are all used. Despite the suffix 'corporation', which is normally associated with an incorporated body, none of the finance corporations we studied was found to be incorporated under the Companies Act. Out of a total of 450 finance corporations identified in an extensive survey in South India, as many as 95 per cent were partnerships under the Indian Partnership Act, 1932 and the rest were proprietary concerns (Nayar 1982, 1984).

20.1.2 For a proprietary concern, an individual, alone or in association with members of his family, starts the business of lending money after taking a license under the State moneylender's act wherever applicable. Initially he starts lending his own money but very soon he invites his relatives and friends to deposit their savings with him at attractive rates of interest. This money is lent out for periods ranging from one or two days to

3 to 4 months. As the business grows and confidence increases, deposits come from outside the circle of relatives. The proprietor gradually diversifies his lending portfolio by discounting cheques, negotiating trade bills and lending to other financiers.

20.1.3 A partnership firm requires registration under the Indian Partnership Act which is a relatively simple process. After registering a partnership, one or more partners become managing partners for administrative convenience. The partners meet frequently to take decisions on important matters and all major decisions, especially sanction of loans, are taken collectively. The managing partner is allowed to draw an honorarium for his services.

20.1.4 The initial funds for the operation of the finance corporation is contributed by partners as subscription capital. The main source of funds of the finance corporation, however, is deposits from the public. While corporations accept deposits from anybody, amounts are lent only to persons recommended by or known to at least one of the partners.

20.1.5 Finance corporations are similar to commercial banks in most of their functions. The corporations accept savings deposits, fixed deposits for different periods, recurring deposits and issue cash certificates under interest reinvestment plans. They allow periodical withdrawals from savings deposits by means of withdrawal forms and also permit premature closure of term deposits. Interest calculations and payments are similar to those of banks. They extend secured and unsecured loans, credit for purchase of automobiles and instalment credit for consumer durables. They also discount trade bills on the basis of lorry/railway receipts and even discount post dated cheques of private parties.

20.1.6 They differ from banks in that they do not issue cheque books to depositors, have a flexible approach in regard to payment

of interest on deposits and pay commission for canvassing deposits. Above all, they are not governed by the Banking Regulation Act 1949 or by any other regulation of the RBI as applicable to the formal banking sector.

20.1.7 Whereas a large majority of finance corporations at Bangalore conduct chit fund business on a minor scale to supplement their main income from loans, the majority of chit funds at Madras resort to the finance business mainly to create funds to pump into chit funds whenever necessary. In other places, chit funds by finance corporations and finance business by chit fund firms, is sporadic.

20.2 Geographical dispersion

20.2.1 Finance corporations are concentrated in South India. According to a country-wide study made in 1979-80 (Nayar 1982), 90 per cent of finance corporations in India were in the four southern States. The situation continued to be so up to 1982-83 according to a subsequent study (Nayar 1984) which states that corporations enjoy significant popularity both in Tamil Nadu and Kerala. Corporations in some districts in these States outnumber commercial banks. Furthermore, corporations, mobilising about 10 per cent of bank deposits and extending about 12 per cent of bank credit, are a financial intermediary to reckon with in the study area. The number of corporations and deposits with them from 1979-80 to 1982-83 are shown in Table 20.1.

20.2.2 Area surveyed, general description and description of sample: For this study, we have selected the same four southern States. As finance corporations were scattered in many places in each State and as there was no list containing their addresses, we had to select a few places of their concentration from each State. From these places 60 corporations were selected for interview and data collection. The selection was purposive and stratified and the collection of data was through a 45 point questionnaire. Besides these, 40 users of finance corporations, i.e., depositors

and borrowers, were selected independently from different areas and interviewed through a separate questionnaire. However, only 42 corporations and 31 users (14 depositors and 17 borrowers) furnished details and analysis is done by using these 73 respondents. Place-wise distribution of respondents is given in the appendix to this chapter.

20.2.3 Business practices of finance corporations generally do not vary much from place to place. They follow roughly the same pattern in respect of modalities, period of loan, purposes for which credit is given, repayment terms etc. However, while selecting places, care was taken to include areas of high concentration of finance corporations in the States. The year of establishment, deposits and loans of the selected 42 finance corporations are given in Table 20.2.

20.3 Sources of funds

20.3.1 Sources of funds of finance corporations are capital contributed by the partners/proprietors, reserves, borrowings from the public, relatives and partners. Generally, the contribution of own capital is small. One reason for this historically was that if the capital contributed by the partners in a partnership firm was above Rs one lakh, the firm would come within the regulatory orbit of the Reserve Bank of India under the provisions of the Banking Laws (Miscellaneous Provisions) Act 1963. It was only in 1984 the situation changed with the coming into force of the Banking Laws (Amendment) Act 1983, effectively from February 1984. So until 1984, all corporations kept their capital below Rs one lakh irrespective of the size of borrowed funds.

20.3.2 Only 17 corporations maintained reserve funds which formed about 23 per cent of total owned funds. Capital and reserves together was around 9.35 per cent of borrowed funds (Table 20.3).

20.3.3 As capital and reserves are relatively small the major source of funds for doing business is deposits and borrowings. Corporations accept almost all types of deposits, including current, savings, recurring and fixed deposits besides issuing cash certificates for various periods. Deposits are raised from the public through direct canvassing by proprietors, partners and employees and in larger cities through newspaper advertisements. Some corporations circulate attractive folders and other publicity material describing the various deposit schemes available with them among prospective depositors. The emphasis is invariably on the high rate of interest offered under different schemes.

20.3.4 Though savings and recurring deposits as also cash certificates were found in the deposit mix of some finance corporations, term deposits constituted the bulk (99 per cent) of total deposits of the selected corporations (Table 20.4). Term deposits ranged from less than one year to more than three years though 78 per cent of the fixed deposits were for one year.

20.3.5 A particular point to note is the large share of deposits from relatives. Out of total deposits of Rs 452.25 lakh, as much as Rs 102.95 lakh (23 per cent) came from relatives. Relatives are also offered interest, sometimes at a higher rate than that offered to the general public.

20.3.6 The growth of deposits of the 42 finance corporations between 1981 and 1986 presented in Table 20.6 shows a sharp fall from Rs 813.1 lakh in 1981 to Rs 452.25 lakh in 1986, recording a decline of 44.38 per cent over the five year period. It is seen from the table that the fall started slowly in 1983 but picked up momentum in 1984 reach an all-time low in 1986. One reason for the sharp fall from 1984 is the restriction in deposit acceptance activity of the corporations resulting from the operation of the Banking Laws (Amendment) Act 1983. In March 1987, finance corporations in Kerala faced a crisis situation. There was a run by depositors and secured borrowers which caused several corporations

to fail. Further discussion is in section 20.10 to 20.12 below.

20.3.7 Cost of funds: The cost of funds of finance corporations includes interest payments to depositors, fund raising expenses such as brokerage to agents, advertisements, preparation and distribution of publicity material and expenses incurred on personal contacts. Interest cost varies from 9 per cent per annum on savings deposits to 21 per cent per annum on three year term deposits for some corporations. This works out to a weighted average of 16.74 per cent per annum for all 42 firms. However, annual deposit costs are 10.38 per cent of end of year deposits (Table 20.16). A break-up of establishment/transactions costs is given in Table 20.15.

20.3.8 Fluctuations in cost: Field data suggest that there was almost no change in the financial cost of funds of finance corporations between 1980 and 1986. In March 1980, the financial cost of deposits (interest plus fund raising costs) of corporations was 17.54 per cent of deposits raised. The corresponding figure was 17.32 per cent in 1986.

20.4 Uses of funds

20.4.1 Finance corporations use almost all the funds mobilised, and in some cases even a part of own funds, in lending operations. The general pattern of lending is to sanction a loan either on the security of a demand promissory note (DPN) or tangible assets such as land, building, gold, jewellery and insurance policies. The borrowers are mainly those who are not able to get a loan from the formal sector banks because of the nature of their business or the nature of security that they can offer against the loan. The main reasons for borrowers approaching finance corporations are (a) loans from banks are inadequate to meet their overall requirements, (b) bank loans are generally not available for very short periods such as a day or two, (c) there is a minimum period for calculation of interest in banks, (d) bank loans are not given for certain purposes and the size of loan even for per-

missible purposes fluctuates according to its loan policy, and (e) there is inordinate delay in getting a bank loan.

20.4.2 There are a number of variations with regard to the types of loans. There is a daily repayment loan in which the interest is collected in advance and a part of the principal is regularly extinguished every day. The repayment for these loans starts the day after loan release. Table 20.21 gives examples of two 100 day loans showing that effective annual interest rates on "10 per cent and 12 per cent" loans can be 117 and 157 per cent per annum respectively. With a given deposit amount, the corporation effects many loan transactions by raising funds out of loan repayments. In each loan of the type mentioned above, one per cent of loan amount is repaid every day. If these repayments are lent again on similar terms, a chain of loans can be effected in the course of a year. Thus a "fully loaned up" corporation working 6 days a week can lend and obtain repayments for 10.4 times its initial capital in the course of a year (for a similar computation, based on slightly different assumptions, see Nayar, 1982).

20.4.3 Another method of lending by small size finance corporations is the daily loan system under which certain amount is given in the morning and collected sometimes in the evening itself or next day. The loans which are usually issued on (market) days are for quick moving and easily perishable items such as vegetables, fruits, fish, meat and flowers. The loan amounts are usually below Rs 1000 and the interest which is collected in advance varies from one paise to 5 paise per rupee per day. If interest is taken in advance at the rate of 5 per cent per day and if loans are issued on, say, 100 days in a year, gross earnings from such loans work out to a staggering 16788 per cent per annum (given $32 \times 6 = 312$ working days per year the compound interest to borrowers is an even more staggering 53.4 crore per cent per annum. Such calculations clearly have little relevance). But the net return on loans is only 87.66 per cent per annum due to high cost of recovery (2 per cent), the high risk of default (2.5 per

cent) and the fact that capital used for such loans lies idle for 200 days in the year. Thus only a few corporations extend daily loans while others consider them to be "nuisance loans". On the whole these loans form only 0.5 per cent of loan portfolios of corporations.

20.4.4 Some corporations extend credit on the basis of letters of credit (LCs) to exporters. Exporters also get credit from banks. But delays, formalities and uncertainties associated with bank finance force some exporters to turn to finance corporations who provide finance to the extent of 75 per cent of the LC after ascertaining that the LC is irrevocable.

20.4.5 Some well organised and established finance corporations finance internal or domestic trade bills. They purchase or discount the documentary bill consisting of a lorry receipt or railway receipt and an invoice on the consignee for goods despatched. They then collect the proceeds of the bill from the consignee. Where the buyers and sellers settle the accounts through present dated or post dated cheques, the corporations discount them provided they are presented by known local purchasers and customers.

20.4.6 Classification of loans during 1985-86 by purpose is in Table 20.7. Trade and business accounted for the major share (47 per cent) of total credit of finance corporations. The next important item was small industry (22 per cent), mainly handloom textiles. This was followed by transport operations (14 per cent) and personal consumption (6 per cent). Comparative figures for 1979-80 are also given in the table. Over the six year period, the shares of trade and business, small industry, transport operations and small business rose significantly, while those of agriculture, personal consumption, cinema theatres and other uses declined. However, the differences in the samples covered should be kept in mind.

20.4.7 Size of loan: One corporation fixed a loan floor at Rs 10000. For others, the minimum loan varied from Rs 100 (5 corporations) to Rs 5000 (3 corporations) (see Table 20.8). 16 corporations extended loans above Rs 1 lakh and in one case the maximum loan was Rs 5 lakh. The usual loan transaction was around Rs 12750 per borrower. In fact, for 18 corporations, the usually transacted amount was Rs 5000 or less.

20.4.8 A break-up of loans to small, (below Rs 9999), medium (Rs 10000 to Rs 25000) and large (above Rs 25000) borrowers (Table 20.9) shows that one corporation had only small loans while, for 20 other corporations, 50 per cent of their loans were below Rs 1000. On the whole, small and medium loans dominated the loan portfolios of corporations.

20.4.9 Advances of finance corporations fell in tune with the fall in deposits over the five-year period commencing 1981. Corporation-wise details of loans are given in Table 20.10. The trend can be seen to be one of steady and sharp decline.

20.4.10 Interest, margin, primary security and collateral: Finance corporations do not publicise their lending rates although they vie with each other in advertising rates on deposits. The need for secrecy arises due to the existence of a ceiling on lending rates under moneylenders acts as well as the desire not to attract the attention of income tax authorities. Also, since it is the type of security and the relationship between the lender and the borrower that influences the lending rate, there is no fixed lending rate as such. Generally, lending rates are based on demand for and supply of funds and vary according to the type of security.

20.4.11 The interest rate for DPN loans, which constituted the major part of loans of finance corporations, was about 37 per cent simple interest per annum in 1986. Jewel loan rate was lower at around 32.50 per cent per annum, while the rate for other secured loans was around 34.14 per cent per annum. Discounting of post

dated cheques which was practised by some corporations mostly at Bangalore and Trichy was done at a rate of about 37.44 per cent per annum (Table 20.11). Commodity loan was extended by only 3 corporations and their average interest rate was 26.33 per cent per annum. Compound interest rates are difficult to work out as loan durations vary.

20.4.12 The trend in interest rates on loans presented in Table 20.12 shows that there was a steady increase in these rates between 1982 and 1986. The inverse correlation with loanable funds, discussed earlier, is striking.

20.4.13 Except for loans for transport operations, export finance and contract work there is no margin requirement for loans sanctioned by finance corporations. For transport loans, corporations require an investment by the borrower of about 20 per cent to 50 per cent of the price of the vehicle financed, depending on the age of the vehicle. In export finance, the borrower's margin is 25 per cent. In contract work, corporations lend 75 per cent of the estimated amount of the contract.

20.4.14 Loans are given against DPN (signed individually by the borrower and in certain cases individually and jointly by two guarantors), movable assets such as gold jewellery, insurance premia, government and other trustee securities, title deeds of property, vehicles and fixed deposit receipts and immovable assets such as land and buildings. In trade bill discounting, documents consisting of lorry receipts or railway receipts and invoices on the consignee for goods despatched form the security. In post dated cheque discounting, cheques duly endorsed are deposited with the discounting corporation. The break-up of loans according to security is given in Table 20.13.

20.4.15 Movable securities other than motor vehicles are held by the corporations under lock and key with proper records of weight, number of items, identification numbers, etc. When the loan is repaid the pledged article is released. In respect of

loans against vehicles the registration book, undated sale deed mentioning that the vehicle is sold for so much amount to one of the partners by name and an undated request by the vehicle owner to the regional transport authority to transfer the vehicle to the name of the purchaser are given to the corporation. When the loan is cleared, documents are returned to the borrower. Regarding loans against immovable property, title deeds are usually mortgaged to the corporation through necessary registration with the registering authority in the area.

20.4.16 Loans to forest and Public Works Department contractors are given by corporations in Kerala on the basis of a power of attorney signed by the borrower. The power of attorney is registered with the Sub-Registrar of the area. One copy of the power of attorney is kept with the authorities who 'pass' bills of work completed. On completion of the contract work, the payment is sent to the holder of power of attorney. The power of attorney is executed in addition to the usual DPN.

20.4.17 Loan duration: All corporations reported that there was no restriction on the minimum period of loan. As many as 18 corporations issued loans on daily basis charging interest for the exact days of loan. However, some corporations took interest for 15 days or even for a month even if the loan was closed earlier than a week. The maximum duration was 90 days for 10 firms and 120 days for another 13 firms. Loans against DPN were for a maximum of 90 days in the sample, though some borrowers (section 3) received DPN loans for up to 2 years (although legally the lender can present a DPN for payment on any day before it becomes time barred after the issue of the loan, there is an informal understanding between the lender and borrower that it will not be presented before the agreed number of days). Longer periods were for loans secured against assets with, in some cases, the duration exceeding two years.

20.4.18 Bad debt and overdues: Data on defaults in repayments by borrowers given in Table 20.14 show that 23 out of the 42 corpora-

tions had the problem of defaults. The usual defaulters were transport operators and industrial borrowers. However, overdues were small and loans taken to courts for recovery were nil. Debts which were written off as completely nonrecoverable were negligible.

20.4.19 There are several reasons for the very low overdue position and negligible bad debts. First, loans were given only to sound and known parties who had a reputation for honouring commitments. A businessman borrower would be punctual in repayments because a delay or default in repayments would tarnish his image, thereby lowering his 'credit rating'. Even when faced with temporary financial difficulties, borrowers have been known to borrow from other sources and honour their commitments. This apart, partners of finance corporations keep in touch with the borrowers and if necessary, renew loans and even give additional credit. Generally, there was thus a good business relationship reported between lenders and business borrowers.

20.4.20 Secondly, the loan period was so short that complete collapse of business of the borrower within that period was not likely.

20.4.21 Thirdly, there was a good follow-up system. Except in the case of secured loans, borrowers would be contacted by phone or in person the day after the expiry of the agreed loan period. If the borrower happened to be in deep financial trouble, negotiations would be held, if necessary with third parties. Only in very rare cases would corporations turn to a court of law.

20.4.22 Corporations, who maintain minimal reserves, face situations when unexpected demand for premature withdrawal of deposits come up, resort to temporary borrowing without security from other corporations situated in the same area, borrow from banks on the pledge of securities acceptable to them or, in rare cases, borrow from corporations or moneylenders by repledging pledged articles (mostly gold jewellery). In extreme cases,

loans given against DPN may be called back (but see section 20.10 for a discussion of runs on corporations).

20.4.23 Creditworthiness assessment procedure: Assessment of a borrower is made by partners of finance corporations. DPN loans are given only to parties known to and recommended by at least one of the partners who then takes special interest in recovering these loans. Repeat loans depend on the parties credit history. Sometimes partners of one corporation check with partners of other corporations about the credit worthiness of a particular party if the amount of loan is high and the party is not very well known. Normally, borrowers are from the same or nearby localities.

20.5 Cost of intermediation and profitability

20.5.1 Respondent corporations did not furnish the full details of income, although they gave the details of expenses and some estimates of their income. As per these details, income from loan operations was about Rs 131.60 lakh while administrative and fund raising expenses totalled Rs 35.86 lakh (Table 20.15). Deposits interest payments are estimated at Rs 81.81 lakh (16.75 per cent of Rs 488.68 lakh). Thus total expenses of sample corporations are estimated at Rs 116.69 lakh against total income of Rs 131.60 lakh.

20.5.2 The financial operations of finance corporations are given in Table 20.16. The 1980 figures for corporations are taken from earlier published data (Nayar 1982). The main feature of interest in the table is that the credit deposit ratio has moved up to about 100 per cent.

20.6 Industry structure

20.6.1 All corporations in the sample had below Rs 1 crore in deposits during the year 1981. Furthermore, though there are some

corporations with large deposits, with some of them being multi-branch institutions, none of them can be termed market leaders. Barriers to entry or exit, apart from funds availability, are minimal.

20.6.2 Interest rates offered on deposits and charged on loans showed very little variation among corporations operating in the same area, though variation could be observed at inter-district and inter-State levels. While inter-district differences in deposit rates were only around one to two percentage points in Tamil Nadu, they were around six to nine percentage points in Kerala. Inter-State differences ranged from nine to twelve percentage points. In general, there is less variation in deposit rates than in loan rates.

20.6.3 While in Trichur district of Kerala, a conservative financial centre, the interest rate for a one year deposit was 12 per cent to 15 per cent per annum, corporations in the neighbouring Ernakulam and Kottayam districts offered 18 per cent to 24 per cent per annum for these deposits. Similarly, there is considerable inter-State variation in deposit interest rates among the four southern States. Since some finance corporations have branches in several places and are able to engage in price discrimination even for deposits, this is evidence of regional segmentation and also transactions cost differentials across regions.

20.6.4 Overall, while there is evidence of various imperfections, it is difficult to see how such a market could sustain excessive monopoly rents.

20.7 Estimate of overall size

20.7.1 Our survey of finance corporations shows that they have been on the decline since 1983. According to the data presented in Table 20.1, there were 3071 corporations with a total deposits of Rs 6522 million in India at the end of 1979-80. These rose further to about 9000 to 10000 corporations and Rs 12503 million

by 1982-83 (Nayar 1984). The data on selected sample of 42 corporations (Table 20.6) show that the decrease in deposits with these corporations over the previous year was 4.4 per cent in 1983, 19 per cent each in 1984 and 1985 and 12.6 per cent in 1986. Thus the average fall between 1983 and 1986 was of the order of 13.75 per cent per annum. If we assume that this rate of fall is applicable at the all India level, deposits with the finance corporations at the end of 1986 comes to Rs 6918.98 million (Table 20.18), a level just above the position in 1979-80.

20.8 Reactions of finance corporation clients

20.8.1 The reaction of the users of finance corporations regarding their intermediation role in different States in South India is mixed. While borrowers everywhere appreciated the services rendered by them, many depositors, especially in Kerala and the city of Madras, described them as cheat and robbers. This is due to loss of money as a result of the failure of corporations in Kerala and in Madras during the first half of 1987 which coincided with the first round of our field survey. Depositor security is thus, once more, seen to be problematic.

20.8.2 The monthly income of selected depositors ranged from Rs 1000 to Rs 4000 and above. A little more than half of them had monthly incomes below Rs 2500 (Table 20.19). The data show that there were many small savers among the depositors. The depositors included 3 pensioners, an ex-service man, 5 housewives, 2 agriculturists, an advocate and 2 businessmen. It appears that service people and some of those with regular taxable income have deposited their money in the names of their unemployed wives and others probably to save tax and conceal unaccounted income. This becomes possible because the corporations accept benami deposits even in the names of minors and do not deduct tax at source. For pensioners, the attraction is the high return on their accumulated savings made available monthly. Similarly, the stated income of agriculturists is small. On the whole, high return, possibility for benami deposits and including the opportunity to earn income

on unaccounted money, seem to be the major attractions to depositors.

20.8.3 In contrast to depositors, 11 borrowers belonged to the high income category of Rs 3000 and above per month while 6 borrowers were in the income category of Rs 1500 and Rs 3000 per month (Table 20.20).

20.8.4 The 17 borrowers consisted of 12 traders/businessmen, two transport operators, 2 master weavers and one housewife. All borrowers except the housewife used loans to meet short term working capital requirements in the expansion of their business. The housewife borrowed for personal consumption by offering jewellery as security. All other loans were against DPN.

20.8.5 The period of loan varied from five days to 100 days in case of DPN loan for traders and master weavers and 24 months for transport operators. For jewellery loan no time limit was fixed. The amount of loan was Rs 1500 under jewellery loan, Rs 30000 under transport loan and Rs 10000 to Rs one lakh under DPN loan.

20.8.6 The effective interest rates paid for loans varied from 34 per cent per annum for the secured loan by the housewife to 157 per cent per annum paid by two traders for a 100 day loan. Details are presented in Table 20.21.

20.8.7 All borrowers remarked that the corporations render a service to them. Some traders and the master weaver are regular borrowers from them and the advantages of loans from finance corporations as cited by them are quick availability, non availability or inadequate availability from banks, acceptable security (rarely do the banks extend loans against DPN) and easy repayment facility. Loans, though high cost, are superior to no credit at all. No borrower interviewed wanted them banned.

20.9 Regulatory environment and impact: General features

20.9.1 Till recently, finance corporations were completely free to carry on the business of borrowing and lending in any part of the country because the Indian Partnership Act, 1932, did not impose any regulation on their working.

20.9.2 In States where there are moneylenders acts, their lending rates are regulated. The objective of moneylenders acts is to prevent moneylenders from charging usurious rates of interest for small loans. Finance corporations succeeded in circumventing these acts by granting loans above the ceiling on loans to which these acts applied. Recently, after the collapse of many finance corporations, the State of Kerala removed this limit and all finance corporations have been brought under the State moneylenders act.

20.9.3 Even though these corporations handle banking business, they do not come under the Banking Companies Act 1949 or any of the regulatory measures of the Central Banking Authority because of the exemption granted to firms with a capital of Rs one lakh and less under the Banking Laws (Miscellaneous Provisions) Act 1963.

20.9.4 The Banking Commission's Study Group on Non-Banking Financial Intermediaries (1971) which examined regulation of finance corporations suggested that the Reserve Bank's control be extended to finance corporations and necessary enabling legislation be passed. Other recommendations of the Study Group include (1) compulsory licensing of corporations by the Reserve Bank of India, (2) the prescription of a ratio between the owned funds of corporations and their deposit liabilities, (3) prescription of liquidity ratios, (4) periodical inspection of corporations on a sample basis to be undertaken by the RBI and (5) prescribed maximum deposit rates higher than those prescribed for commercial banks.

20.9.5 Later, in 1975, the RBI Study Group on Non Banking Companies recommended the regulation of their activities by imposing a ceiling on borrowing and also by regulating their utilisation of funds.

20.9.6 In the light of these findings, the Banking Companies (Amendment) Act 1983 was enacted and came into force on 15th February, 1984.

20.9.7 The Act's main provisions lays down deposit ceilings as follows:

- a) For an individual not more than twenty five depositors, excluding depositors who are (specified) relatives of the individual.
- b) For a firm or an unincorporated association of individuals , not more than twenty five depositors per partner and not more than two hundred and fifty depositors in all, excluding depositors who are relatives of any of the partners.

20.9.8 Thus, from February 1984 onwards, finance corporations' access to public deposits/borrowings is limited to a maximum of 250 depositors. However, there is no limit on the amount that a depositor can place with the corporation. The reason for these limits, as given by RBI sources, is that in the event of failure of a corporation, only on a limited number of depositors will be hurt.

20.9.9 The adverse impact of this regulation (Table 20.6 and Table 20.10) on deposits and advances of finance corporations has been discussed earlier.

20.10 Failure of Finance Corporations

20.10.1 By the early seventies, Karnataka, more specifically Bangalore, and a few districts in Andhra Pradesh such as Ananthapur and Chittoor, had a large number of finance corporations (about 100 at Bangalore and about 60 at Madanapalle in Chittoor

district). The late seventies saw the failure of about a dozen finance corporations at Bangalore and about four times that figure at Madanapalle. While corporations at Madanappalle were small, the majority of corporations at Bangalore were big units. Three major failed corporations at Bangalore in the seventies were the Maharaja Finance Corporation, the Imperial Finance Corporation, and the East India Corporation. One striking feature of the 40 odd failed corporations at Madanapalle was that there was no swindling of depositors' money. Before the closure of their business, they repaid borrowed funds in full (for details of origin, growth and failures of finance corporations, see Nayar 1982).

20.10.2 One interesting aspect of the failures at Bangalore was that there was no general panic. Despite the failures of a few, new units came up and at the end of 1979-80, there were about 50 more corporations than the number at the beginning of the 1970's. In the eighties there was only one major failure.

20.10.3 The nineteen-seventies were the heyday of finance corporations in Kerala and Tamil Nadu although there were such institutions in Kerala during the 1940's and in Tamil Nadu during the 1960's (Nayar 1982). While in Tamil Nadu the corporations expanded in selected districts like Salem, Trichy, Coimbatore and the city of Madras, their expansion was universal in Kerala. One indirect incentive for the establishment of finance firms everywhere was provided by the Banking Laws (Miscellaneous Provisions) Act 1963. According to this Act which came into force on December 30, 1963, a firm registered under the Indian Partnership Act 1932, was exempt from its provisions if the capital subscribed by its partners did not exceed one lakh of rupees. Taking advantage of this provision, many partnership firms were registered with partners' capital of Rs 1 lakh or less to function as finance corporations.

20.10.4 In many cases the establishment of finance corporations in Karnataka and Tamil Nadu was generally on account of this relatively easy entry into the field of para-banking. But their expan-

sion was mainly due to the high local demand for business credit. Barring a few, all were single office corporations which raised funds locally for lending to local businessmen.

20.10.5 In Kerala, there was another factor which prompted the establishment of new finance corporations and quickened the process of expansion of existing ones. The unprecedented out-migration of job seekers from Kerala to the Gulf countries in the early 1970's (precisely from 1972-73 onwards) initially created a great demand for funds from informal sources and then provided a source of funds for them (Prakash, 1984, 1987). Many who borrowed from finance corporations remitted large sums not only for clearing loans taken, usually against the pledge of property or jewellery, but also as deposits for making interest payments to their families. Coupled with the access to Gulf remittances, the corporations also received a good chunk of agricultural income raised by affluent commercial crop producers, especially of cardamom, pepper, rubber and coconut. The major part of deposits of corporations, however, came from engineers, doctors, contractors, traders, politicians, officials occupying key positions and even trade union leaders - collectively termed as black money sources (Mathruboomi, 11th May and 5th June, 1987).

20.10.6 By 1982-83, finance corporations in Kerala had estimated deposits of about Rs 300 crore (Nayar 1984). Their number was 11261 according to a study by a RBI official published in Mathrubhoomi 29th May, 1987. Then started the decline culminating in the great crash (in March 1987 and subsequent months) of almost all corporations established in the boom period (the 1970's). These crashes were preceded by two major failures in the city of Madras in 1984 and 1985. (Details of some of the major corporations which failed in recent years and the estimated outstanding deposits with working corporations in Kerala at the end of 1987 are given in Table 20.22 and Table 20.23). About 56 per cent of the deposits at the end of March 1987 are estimated to have been

blocked with the failed corporations between March and December 1987.

20.10.7 The RBI had made it clear that the provisions of the Banking Laws (Amendment) Act 1983 which imposed restrictions on the acceptance of deposits by the finance corporations would be strictly enforced by February 1986. This was challenged by 40 finance corporations of Kerala in the Delhi High Court, which however dismissed their petitions. The Supreme Court had granted a conditional stay on these corporations but prohibited the soliciting of fresh deposits by misrepresenting facts to the public.

20.10.8 The immediate reason for the crisis in Kerala appears to be the objections to certain phrases and tall claims used in the advertisement for deposits (offering 28 to 35 per cent interest per annum) of Oriental Finance and Exchange Company (registered in Kerala with an administrative office in Madras and 13 branches in different parts of India) by the Monopolies and Restrictive Trade Practices Commission (MRTPC). The Commission also observed that the company had no arrangements for earning such high rate of return on the deposits collected. Soon after the Commission's remarks were published in the newspapers, the company was flooded with requests for withdrawal of deposits. At the same time fresh deposits dried up and the proprietor absconded. He was later arrested. (The company now is placed under a Receiver by the Court). The confusion got confounded when the RBI officials and the State Sales Tax Intelligence Wing conducted simultaneous raids on a number of corporations in different places with police help. The scare created by these incidents was so widespread that there was a general run on all finance corporations in Kerala. Not many survived the run and a large majority of them closed their doors leaving practically no tangible assets to cover their liabilities.

20.11 Reasons for failures:

20.11.1 It is clear that no deposit taking intermediary, which exploits a positive term structure of interest rates to 'borrow short' and 'lend long' is proof against a loss of depositor confidence. However, the reasons for this loss of confidence in each instance are of interest. Lack of financial discipline and absence of control over funds flows were, we will argue, the root causes of most of the recent failures of corporations. It should be emphasised that these practices are not typical of most finance corporations.

20.11.2 The diversion of funds to risky businesses and own concerns, under the impression that inflow of funds in the form of deposits is perennial, are several.

- i. A case in point is the Oriental Finance and Exchange Company which acquired ownership interest in a losing hotel, entered film production in a big way with 10 completed films which were big box office failures, (Mathrubhoomi, 30th April, 1987) and then entered film distribution because other distributors were not forthcoming to distribute the films produced by it. It also purchased costly foreign made cars and sold them after a few months at great loss, acquired office premises at fantastic rents in key areas and furnished them luxuriously and spent large amounts on the personal comforts of the partners (Mathrubhoomi, Ibid). No investment which will give a sure return at least equal to the cost of funds appeared to have been made. Interest payments seem to have been made by this firm out of fresh deposits.
- ii. A second example is that of Labella Financiers who, through a subsidiary, invested in diverse fields such as cement, fertilisers, construction, film development, travel, plantations and distilleries (Centre for Development Studies, 1988).
- iii. The owner of Shalimar Financiers produced and financed a film with himself as the hero (Centre for Development Studies, Ibid).

20.11.3 Another major cause of failures is the multi-branch system (Table 20.22 shows that all the major failed corporations had branches, some having more than 20) and the consequent mis-

management by the branch manager and staff. Funds were mobilised at branch level and used by the head office without taking into consideration the branch requirements. Again, pledges received by the branches were sent to head office which repledged them with other corporations for obtaining emergency funds. It was reported (Mathrubhoomi 6th June, 1987) that one corporation at Ernakulam repledged gold jewellery worth Rs 10 million with another corporation.

20.11.4 Lastly, own funds were low and liquid funds were not sufficient to meet even day to day operations.

20.12 Consequences of failures

20.12.1 Field enquiries with partners, depositors and employees of some failed corporations enable us to estimate the percentage of genuine depositors as between 30 per cent and 40 per cent of depositors. Others are depositors who have deposited their unaccounted money under aliases. This view is supported by the fact that many depositors of failed corporations did not turn up to register their claims before the authorities and with the depositor's associations formed for recovering the amount. Thus it appears that only a part of the impact of failures was on white money depositors while the major impact was on black money depositors.

20.12.2 However, it is the borrower of secured loans who is left high and dry by the failures. The fact that one of the failed corporations (Labella Financiers) had lent Rs 42.94 million against the security of gold (Malayala Manorama, 21st May, 1987) indicates the dependence of borrowers on finance corporations. Gold loans occupied the major item of lending of finance corporations in Kerala, although such loans were very limited in the case of corporations in other States. Despite the high interest rate of 36 per cent (simple) per annum, many borrowers borrowed from finance corporations against the security of gold jewellery because of certain advantages such as a relatively high loan amount

per tola of gold, (while banks give only 40 to 50 per cent of the market value of gold as loan, finance corporations give up to 80 per cent) unlimited loan amount per borrower (the general limit in banks is Rs 3000 per borrower, while no limit is fixed by corporations) loan availability on any day (banks specify certain days of the week for gold loans) and informality in dealings. It is reported that in spite of the government directions to the State Cooperative Institutions to raise the gold loan limit to Rs 10000 per borrower, many a borrower is unserved.

20.12.3 Our field enquiry revealed that one immediate result of the closure of finance corporations was an increase in bank gold loans. Two branches of Ernakulam District Cooperative Bank at Muvattupuzha in Ernakulam district reported a 50 per cent increase in gold loan accounts within six months after the failure started in March-April 1987.

20.12.4 One interesting point is that even after the failure of many big corporations, others have survived the shock and continue to function, though with less business. These surviving units are mostly single office institutions operating with own funds. Many old firms who were in business during the 1940's and 1950's have also not closed their doors despite large withdrawals of deposits. These time tested corporations did not embark upon unwise expansion during the Gulf boom period. In fact such behaviour would appear to be typical of companies established prior to the boom.

20.12.5 It is also of interest to note the position of one corporation, TVR Funds, Karamana, a suburb of Trivandrum, which was raided by the RBI and State officials on 31st December, 1987 to see if there was any violation of the RBI Act and State money-lenders act. According to details supplied by an RBI official, deposits with this corporation were Rs 134.40 million and the number of depositors was 22390. This two partner firm can raise deposits only from 50 depositors as per the RBI Act. However, under the protection of the Supreme Court conditional stay on enforcement of the RBI Act, the firm was reported to be reducing the

number of depositors. It appears that it had lent money only against gold jewellery and property.

20.13 Complementary/substitutability with formal finance:

20.13.1 The purpose-wise classification of loans by corporations shows that 45 per cent were for agriculture, transport operations, small scale and decentralised industries and small business. Borrowers in all these categories are served by banks, but requirements of many are either met only partly or not at all by banks. For these borrowers corporation loans may be said to complement bank loans. Another part of credit from corporations flows to trade and business. Some traders also get credit from banks but such credit is restricted due to the operation of selective credit controls. Complementarity is thus the hypothesis supported.

20.14 Influence of formal sector lending rate/loan availability on business:

20.14.1 Interest rates of finance corporations are fixed independently of the formal sector lending rate. As the major consideration of a borrower of finance corporation is timely availability, cost of borrowing becomes less significant. Formal sector lending rate could have some influence over the lending rates of finance corporations if either the finance corporation or the borrower has access to both bank finance at similar terms and conditions for the former. This has not been the case. However, that there has been a secular increase in interest rates of both formal and informal intermediaries has been pointed out earlier (Chapter 13) which means that the possibility of a long run impact is still left open.

20.15 Equity/distributional impact

20.15.1 Corporations generally preferred small loans to big

ones. However evidence from borrowers suggests that they are predominantly from the lower income groups.

20.16 Efficiency and allocative impact

20.16.1 The functional efficiency of an intermediary is to be judged, among other things, by (1) the speed with which it mobilises funds from surplus units and lends these to deficit units, (2) the rate of recovery of loans and the promptness with which borrowed funds are returned and (3) the package of services offered to the clients.

20.16.2 When we examine the operations of finance corporations in the light of the points mentioned above, we find that in most respects they are efficient. First, the time lag between receipt of deposits and disbursement of loans is low. Secondly, since loan interest accrues, in many cases, on a daily basis, borrowers have the incentive to repay loans early which leads to greater efficiency in credit use as compared, say, to commercial banks which have a minimum loan duration.

20.16.3 It is when one examines recovery of loans that one finds the real advantage of finance corporations. First of all, they restrict all unsecured loans to short periods. The procedures adopted by corporations in sanctioning and recovering loans, as discussed, show that overdue loans of corporations are few and bad debts negligible.

20.16.4 Against this performance of the finance corporations, we may examine the position of commercial banks. A recent study on priority sector lending of commercial banks under the "Lead Bank Scheme" conducted in four districts of Tamil Nadu and Kerala covering 69 bank branches, states the following:

"All the good performance of the banks and their branches is marred by the very high overdue percentages. When a loan is not paid on due date by the borrower, the lender makes a demand for the principal and interest dues. Some amount may be collected as per the demand and the balance will remain as

overdue. The overdue percentage is worked out as overdues x 100/demand. Without exception all the four districts showed very high overdue percentages in each year under review (1982 to 1985). Among the public sector bank branches in 1985, ten out of 19 branches in Coimbatore district, five out of eight branches in Pudukottai district, five out of ten branches in Palghat district and eight out of eleven branches in Trivandrum district had overdue percentages above 50. Regretful still was the position of nine public sector bank branches which showed an overdue percentage of 70 and above. The highest overdue percentage in 1985 was 88.64 recorded in Pudukottai". (Nayar 1987).

20.16.5 Regarding the repayment of borrowed funds, respondent corporations appeared to be prompt. However, in and after March 1987, many failed corporations did not repay borrowed funds in Kerala and Madras. On the other hand, the personalised services offered to clients by finance corporations are superior to bank service to their clients.

20.16.6 Finally, one must take into account the finding that rates of interest offered on borrowed funds by corporations are higher than those of commercial banks. Interest rates on loans of corporations are, however, much higher than those of commercial banks. In a capital poor economy this itself may be an indicator of efficiency since monopoly practices are ruled out.

20.16.7 Efficient intermediation relative to banks and profit maximising allocation of funds is clearly supported by this evidence. However, this must be weighed against the vulnerability of these institutions to runs.

20.17 Impact on savings mobilisation

20.17.1 Finance corporations offer no security other than the personal assets of partners to depositors. Their deposits are not insured like bank deposits. Even with these limitations they are able to mobilise sizeable sums from the public by offering high deposit rates. In the 1970's and early 1980's, these corporations became a threat to some bank branches in South India because many bank depositors withdrew their term deposits prematurely in

order to deposit money with corporations and take advantage of high interest rates.

20.17.2 Besides high interest, corporations also offered monthly interest on term deposits, interest payment at the doors of depositors, liberal loans (up to 95 per cent) against fixed deposits, gift linked deposit schemes, and so on. Some corporations advertised their deposit schemes and interest rates regularly in national dailies. Coupled with the aggressive marketing strategy of corporations was the indifferent attitude of the bank personnel, especially of the nationalised banks, towards depositors. Not all finance corporation deposits reflect portfolio shifts from banks. In particular, black money is attracted by anonymity of deposits possible with finance corporations. While all but one of these features tend to suggest that finance corporations help in mobilising savings, it is clear that no direct evidence of additive savings mobilisation can be brought to bear without further evidence.

20.18 Recommendations for regulatory framework

20.18.1 The question that needs addressing here is depositor security and protection of secured borrowers against loss of security - especially movable securities. As a good part of loans are against DPN, how will corporations repay depositors in case of default by borrowers? Again, how will they face a situation when there is a sudden unexpected demand for withdrawal of deposits, especially when the credit deposit ratio moves to around 100 per cent?

20.18.2 We have earlier described the current regulatory framework covering the corporations and the suggestions for reform by the Banking Commission and the RBI Study Group on Non-Banking Companies. The main suggestion of the Banking Commission was that "no finance corporation may be allowed to work without a license from the Reserve Bank of India". We endorse this view and recommend that the RBI should take steps to issue licenses to finance

corporations on the basis of carefully thought out criteria. The licensing procedure should be relatively simple but more than a routine affair. Issue of licenses should be coupled with a provision for scrutiny of records and the affairs of corporations, at least on a random checking basis. Fresh licenses should be required if a corporation wishes to open a branch and should be issued only if the ability of the corporation to exercise adequate supervision over its branches has been ascertained.

20.18.3 The Banking Laws (Amendment) Act 1983 does not prescribe any relation between owned funds and borrowed funds of a corporation. We suggest that an own funds to deposit ratio be prescribed for finance corporations as is done for HP firms. This will give a greater measure of protection to depositors than a ceiling on the number of depositors. A fraction of owned funds, the amount to be linked with deposits, should compulsorily be deposited in a nationalised commercial bank.

20.18.4 Finally, we do not subscribe to the view that interest rate ceilings, whether on deposits or loans, should be prescribed without a careful assessment of their efficiency costs.

20.19 Lessons for the formal sector

20.19.1 Despite total lack of security for deposits, finance corporations are able to mobilise sizeable deposits from savers. Apart from offering a high rate of interest, they also use different techniques including innovative deposit schemes and public relations methods. These can be examined by the formal sector and suitable ones can be adopted.

20.19.2 It is the innovative lending operations of the corporations which should be examined in detail by the formal banking sector. The daily loan system, the day-to-day calculation of interest, interest charges on the exact days of loan, the 100 day loan system with provision for daily repayment - all these are attractions, especially to the small and medium size borrowers. It

is incomprehensible that a bank can have a recurring deposit scheme with provision for daily remittance, but cannot offer a daily loan scheme. If such a scheme is instituted, interest charges collected by some finance corporations and moneylenders should come down due to bank competition.

20.19.3 A third lesson for banks is implicit in the high recovery percentage of finance corporations. The extension of loan by the banks and finance corporations may be based on different criteria. Yet some of the procedures adopted by the corporations to recover their dues could possibly be tried by banks. In particular, it is vital for bank branch officers to develop adequate credit rating methods for potential and past borrowers.

20.20 Summary of main points

20.20.1 Finance corporations accept all types of deposits and allow withdrawals just as is allowed by banks except that they do not issue cheque books to depositors.

20.20.2 They extend secured and unsecured loans, instalment credit for consumer durables and discount trade bills.

20.20.3 The main concentration of finance corporations is in South India. In some districts in these States, corporations outnumber commercial bank branches.

20.20.4 The total cost of funds of sampled corporations was around 17.32 per cent of borrowed funds.

20.20.5 Loans vary from Rs 100 to Rs 1 lakh and, in certain cases, Rs 5 lakh. Small and medium loans predominate.

20.20.6 Interest rates on loans tend to be high and loan durations are from one day to over 2 years.

20.20.7 Defaults in repayments were low, overdues were small and loans taken to courts for recovery were nil. Debts which were written off as completely non-recoverable were negligible.

20.20.8 The major part of credit of corporations flows to trade.

20.20.9 Finance corporations have been on the decline since 1983. Deposits with finance corporations in India are estimated at around Rs 6918.98 million at the end of 1986.

20.20.10 The reaction of depositors with finance corporations in different States is mixed though borrowers have a positive reaction to the role played by finance corporations.

20.20.11 Depositors and secured borrowers, especially the latter, have been hurt by the recent rash of failures of finance corporations. Failures of both fraudulent and genuine corporations was precipitated by RBI action though it is not clear that a superior alternative was open to the RBI.

20.20.12 The RBI should take steps to issue licenses to finance corporations on the basis of suitable criteria. An own fund to deposit ratio of, say, 1:10 should also be prescribed.

20.20.13 Three aspects of corporations which may be examined by the formal sector banks are their excellent deposit mobilisation efforts, innovative lending practices and their loan recovery procedures.

TABLE 20.1

**Number of Finance Corporations and Deposits with Them
(1979-80 to 1982-83)**

(Rs lakh)

State	Number of cor- porat- ions	Deposits outstanding at the end of			
		1979-80	1980-81	1981-82	1982-83
Tamil Nadu	1233	34132.7	44372.5	57684.2	74989.5
Kerala	1224	18441.6	23052.0	28815.0	30018.8
Karnataka	200	5540	5956.1	6403.4	6884.2
Andhra Pradesh	107	582.4	598.6	615.2	632.3
Total in Southern Region	2764	58696.7	73979.1	93517.8	112524.8
Total in India	3071	65218.5	82199.1	103908.7	125027.5

- Source: 1. Figures for 1979-80 from C P S Nayar, Finance Corporations, Institute for Financial Mangement and Research (IFMR), Madras, 1982.
2. Figures for 1980-81 onwards from C P S Nayar, A Study on Non-Banking Financial Intermediaries, IFMR, Madras, 1984.

TABLE 20.2

**Year of Establishment, Deposits and Loans of Selected
Finance Corporations at the End of December 1986**

S. No.	ESTB	Deposits		Loans	
		No. of accounts	Amount Rs. lakh	No. of accounts	Amount Rs. lakh
1	1980	60	2.50	25	2.50
2	1975	80	2.30	50	2.50
3	1973	300	3.25	100	3.00
4	1965	500	10.75	190	10.75
5	1972	500	5.35	128	5.10
6	1975	325	3.15	90	3.80
7	1970	1000	16.00	100	15.00
8	1974	700	5.00	140	5.00
9	1970	800	7.25	180	7.25
10	1972	1500	13.75	315	12.15
11	1976	250	5.00	85	5.10
12	1973	1000	14.50	90	14.00
13	1971	950	10.80	94	9.00
14	1978	100	3.60	35	3.50
15	1975	350	10.20	112	9.90
16	1978	100	5.25	40	6.40
17	1980	100	16.00	350	18.70
18	1960	1050	70.30	318	68.32
19	1970	100	3.00	110	3.10
20	1974	225	3.70	90	4.00
21	1972	500	5.40	100	5.00
22	1975	300	4.60	50	4.50
23	1973	625	15.30	190	14.25
24	1974	183	4.75	70	4.25
25	1974	650	11.00	138	10.00
26	1975	75	3.00	40	2.90
27	1976	120	2.50	70	2.50
28	1962	1750	50.00	200	48.00
29	1970	250	12.00	150	12.00
30	1974	225	4.00	120	4.00
31	1971	250	6.50	70	6.50
32	1969	250	9.00	60	9.00
33	1985	17	11.00	21	16.00
34	1983	29	16.00	54	22.00
35	1969	600	18.00	210	17.50
36	1970	200	4.30	100	4.50
37	1974	250	12.50	150	12.50
38	1971	200	10.00	90	9.50
39	1972	75	6.75	64	5.20
40	1972	250	15.00	120	14.50
41	1978	50	4.00	30	3.90
42	1970	250	15.00	200	15.00
Total		17089	452.25	4939	452.57

TABLE 20.3

Sources of Funds of Selected Corporations (1986)

(Rs lakh)

S.No.	Capital	Reser- ves	Own funds (2+3)	Borrowed funds		Total (5+6)	Own funds as percen- tage of borrowed funds
				Public	Relative		
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	0.50	0.00	0.50	1.50	1.00	2.50	20.00
2	0.50	0.00	0.50	0.80	1.50	2.30	21.74
3	0.25	0.00	0.25	2.75	0.50	3.25	7.69
4	1.00	0.00	1.00	8.75	2.00	10.75	9.30
5	1.00	0.00	1.00	5.00	0.35	5.35	18.69
6	0.25	0.00	0.25	2.40	0.75	3.15	7.94
7	1.00	1.00	2.00	12.00	4.00	16.00	12.50
8	0.50	0.00	0.50	5.00	0.00	5.00	10.00
9	0.50	0.25	0.75	7.25	0.00	7.25	10.34
10	1.00	1.00	2.00	10.00	3.75	13.75	14.55
11	0.25	0.10	0.35	4.00	1.00	5.00	7.00
12	1.00	0.10	1.10	12.00	2.50	14.50	7.59
13	0.50	0.10	0.60	8.80	2.00	10.80	5.56
14	0.50	0.00	0.50	3.10	0.50	3.60	13.89
15	1.00	0.00	1.00	10.00	0.20	10.20	9.80
16	1.00	0.00	1.00	1.25	4.00	5.25	19.05
17	1.00	0.00	1.00	1.00	15.00	16.00	6.25
18	2.00	1.00	3.00	65.30	5.00	70.30	4.27
19	0.30	0.05	0.35	1.50	1.50	3.00	11.67
20	0.45	0.00	0.45	3.00	0.70	3.70	12.16
21	0.50	0.00	0.50	4.40	1.00	5.40	9.26
22	0.25	0.05	0.30	3.00	1.60	4.60	6.52
23	1.00	0.00	1.00	15.00	0.30	15.30	6.54
24	0.25	0.00	0.25	4.00	0.75	4.75	5.26
25	0.40	0.10	0.50	8.00	3.00	11.00	4.55
26	0.15	0.05	0.20	1.00	2.00	3.00	6.67
27	0.25	0.00	0.25	2.00	0.50	2.50	10.00
28	1.00	2.00	3.00	40.00	10.00	50.00	6.00
29	0.50	0.10	0.60	10.00	2.00	12.00	5.00
30	0.10	0.00	0.10	4.00	0.00	4.00	2.50
31	1.00	0.00	1.00	3.00	3.50	6.50	15.38
32	0.50	0.00	0.50	5.00	4.00	9.00	5.56
33	4.00	1.50	5.50	11.00	0.00	11.00	50.00
34	5.00	1.75	6.75	0.00	16.00	16.00	42.19
35	0.50	0.50	1.00	16.00	2.00	18.00	5.56
36	0.40	0.00	0.40	4.00	0.30	4.30	9.30
37	0.10	0.00	0.10	12.50	0.00	12.50	0.80
38	0.50	0.00	0.50	8.00	2.00	10.00	5.00
39	0.15	0.00	0.15	5.00	1.75	6.75	2.22
40	0.50	0.00	0.50	12.00	3.00	15.00	3.23
41	0.10	0.00	0.10	3.00	1.00	4.00	2.50
42	1.00	0.00	1.00	13.00	2.00	15.00	6.67
Total	32.65	9.65	42.30	349.30	102.95	452.25	9.35

TABLE 20.4

Term Structure of Deposits of Selected Corporations (1986)

(in per cent)

S.No.	Saving	Term deposits					R.D./cash certificates		Total
		<1YR	1YR	2YR	3YR	>3YR	3YR	5YR	
1			100.00						100
2			100.00						100
3		10.00	90.00						100
4		5.00	60.00	10.00	25.00				100
5		10.00	60.00	10.00	20.00				100
6			85.00	5.00	10.00				100
7		5.00	75.00	5.00	15.00				100
8		5.00	75.00	5.00	15.00				100
9		1.00	80.00	12.00	7.00				100
10	0.50	2	60.00	10.00	25.00		2.50		100
11		15.00	80.00		5.00				100
12	2	10.00	60.00	5.00	15.00			8	100
13		10.00	70.00	5.00	15.00				100
14			100.00						100
15			70.00	10.00	20.00				100
16			100.00						100
17			100.00						100
18	5	10.00	60.00	10.00	15.00				100
19			100.00						100
20		10.00	70.00	5.00	15.00				100
21		15.00	70.00	5.00	10.00				100
22		10.00	75.00	5.00	10.00				100
23			70.00	5.00	25.00				100
24			80.00		10.00		10.00		100
25		5.00	70.00	5.00	20.00				100
26			90.00		10.00				100
27			90.00		10.00				100
28		2.00	70.00	2.00	25.00				100
29		5.00	80.00		15.00				100
30			100.00						100
31		15.00	85.00						100
32		20.00	80.00						100
33		24.00	19.00	21.00	36.00				100
34		42.00	16.00	17.00	25.00				100
35			70.00		30.00				100
36			80.00		20.00				100
37		10.00	70.00		20.00				100
38		5.00	95.00						100
39			100.00						100
40			100.00						100
41		10.00	90.00						100
42		10.00	90.00						100
Average	0.18	6.36	78.21	3.62	11.14	0.0	0.30	0.19	100

TABLE 20.5

**Rates of Interest Offered on Deposits by Finance Corporations
and Commercial Banks (1986)**

(in per cent)

S.No.	Saving	Term deposits				R.D./Cash certificates	
		<1YR	1YR	2YR	3YR	3YR	5YR
1			18.00				
2			18.00				
3		15.00	18.00				
4		12.00	15.00	16.60	21.00		
5		12.00	15.00	15.00	18.00		
6			15.00	16.00	18.00		
7		9.00	15.00	16.00	18.00		
8		10.00	16.00	15.76	18.00		
9		9.00	16.00	15.76	19.00		
10	9.00	10.00	15.00	15.00	18.00	18.00	
11		12.00	15.00	15.00	20.00		
12	9.00	10.00	15.00	16.00	18.00		18.00
13		12.00	15.00	16.00	20.00		
14			18.00				
15			15.00	16.00	20.00		
16			18.00				
17			18.00				
18	9.00	12.00	18.00	16.62	20.00		
19			15.00				
20		12.00	15.00	16.00	20.00		
21		12.00	17.00	16.62	20.00		
22		12.00	16.00	15.76	20.00		
23			15.00	16.00	20.00		
24			15.00		18.00	15.00	
25		9.00	15.00	16.00	20.00		
26			16.00		21.00		
27			16.00		20.00		
28		12.00	15.00	16.00	20.00		
29		12.00	18.00		21.00		
30			21.00				
31		15.00	18.00				
32		15.00	18.00				
33		12.00	12.50	13.14	16.00		
34		14.00	15.00	16.00	18.00		
35			18.00		20.00		
36			18.00		21.00		
37		14.00	18.00		21.00		
38		12.00	18.00				
39			18.00				
40			18.00				
41		12.00	18.00				
42		12.00	18.00				
Average rate	9.00	12.32	16.54	16.25	19.41	16.50	18.00
Commercial banks	5.00	8.24	9.31	10.38	10.38	10.38	11.46

Notes: 1. Commercial bank rate for 3 month to 1 year deposits is 8% compounded quarterly.

2. Weighted average interest rate is 16.74% per annum.

TABLE 20.6

**Outstanding Deposits of Selected Corporations At The End
of December And Growth Rate Between 1981 & 1986**

(Rs lakh)

S. No.	1981	1982	1983	1984	1985	1986	Growth rate 1981-1986
1	2.00	3.50	4.25	3.10	2.75	2.50	25.00
2	7.50	6.30	6.50	5.00	2.50	2.30	-69.33
3	10.50	10.75	8.25	7.50	6.00	3.25	-69.05
4	40.00	38.43	33.25	24.00	15.90	10.75	-73.13
5	12.70	13.29	10.15	8.40	6.90	5.35	-57.87
6	3.00	3.30	4.15	3.75	3.60	3.15	5.00
7	25.00	24.00	22.00	21.50	18.00	16.00	-36.00
8	8.00	8.50	9.00	7.50	6.75	5.00	-37.50
9	9.50	10.00	8.00	9.75	7.75	7.25	-23.68
10	14.75	15.80	16.95	17.25	16.50	13.75	-6.78
11	12.25	13.50	10.30	8.29	7.00	5.00	-59.18
12	28.00	27.45	25.00	22.00	16.00	14.50	-48.21
13	18.30	17.49	17.00	15.00	12.40	10.80	-40.98
14	5.00	4.50	6.30	5.00	4.25	3.60	-28.00
15	12.00	14.00	13.50	11.25	11.00	10.20	-15.00
16	15.00	14.70	14.90	13.75	9.50	5.25	-65.00
17	6.50	6.50	10.75	10.70	11.00	16.00	146.15
18	92.00	90.00	87.00	88.50	74.25	70.30	-23.59
19	6.00	5.50	4.30	3.00	3.00	3.00	-50.00
20	7.35	7.50	6.90	5.40	4.10	3.70	-49.66
21	9.60	9.75	10.50	8.30	7.20	5.40	-43.75
22	7.50	7.90	7.00	6.50	5.00	4.60	-38.67
23	23.50	24.00	22.15	20.30	17.22	15.30	-34.89
24	15.35	14.40	13.70	11.25	7.50	4.75	-69.06
25	14.50	15.30	14.00	13.75	12.90	11.00	-24.14
26	5.00	6.50	7.00	4.75	4.00	3.00	-40.00
27	2.50	3.70	5.20	3.40	3.00	2.50	0.00
28	95.00	97.00	93.50	90.00	65.00	50.00	-47.37
29	30.00	28.50	27.00	20.25	14.75	12.00	-60.00
30	10.25	11.00	9.50	7.50	5.00	4.00	-60.98
31	35.00	37.50	32.00	21.00	10.00	6.50	-81.43
32	30.00	31.00	29.00	18.00	12.50	9.00	-70.00
33	0.00	0.00	0.00	0.00	5.00	11.00	120.00
34	0.00	0.00	5.00	7.00	11.00	16.00	220.00
35	85.00	88.00	82.00	32.00	25.00	18.00	-78.82
36	7.00	7.90	8.25	6.10	5.30	4.30	-38.57
37	26.00	28.00	28.50	20.00	16.00	12.50	-51.92
38	17.85	17.25	16.00	12.50	10.00	10.00	-43.98
39	15.40	15.75	12.00	9.30	7.50	6.75	-56.17
40	18.50	18.00	17.00	16.25	15.00	15.00	-18.92
41	4.80	5.00	6.15	5.00	4.70	4.00	-16.67
42	25.00	25.75	26.50	16.00	15.00	15.00	-40.00
TOTAL	813.1	827.21	790.4	639.79	517.72	452.25	-44.38

TABLE 20.7

Corporation-Wise Distribution of Loans According to Purpose
 (Percentage Share in Total Credit Outstanding in December, 1986)

Corp. No.	Trade/ bus.	Agri- const.	Bldg. oper.	Transpt. oper.	Small. Indus./ handlm.	Small bus. halls	Cinema work	Contract consum.	Pers. consum.	Other
1	70	10		0	0	10	0	0	10	0
2	40	30				20			10	
3	80					10			10	
4	40	25		10		10			10	5
5	50	20		10		10			5	5
6	40				50	10				
7	60				30	5			5	
8	50				40	10				
9	60				25	5			10	
10	40			15	25	10			10	
11	10			80	5	5				
12	60				20	10			10	
13	60				20	10			10	
14	25			60		10			5	
15	10			80	5	5				
16	20			70					5	5
17				75					25	
18	20			60		10			5	5
19		30							70	
20	75				15	10				
21	70			15	10	5				
22	60			10	15	10			5	
23	40			30	20	5				5
24	70				20	10				
25	70				20	6			4	
26	80				10	10				
27	100									
28	40	5		15	20	5	10		5	
29	60	0		15	25	0	0	0	0	0
30	60	0		0	40	0	0	0	0	0
31	80	0		10	0	0	0	0	10	0
32	80	0		0	0	0	0	0	20	0
33	12	0		28	4	9	0	3	6	38
34	33	0		20	0	11	0	16	0	20
35	50	0		0	50	0	0	0	0	0
36	40	0		0	60	0	0	0	0	0
37	50	0		0	50	0	0	0	0	0
38	40	0		0	60	0	0	0	0	0
39	30	0		0	70	0	0	0	0	0
40	40	0		0	60	0	0	0	0	0
41	20	0		0	80	0	0	0	0	0
42	30	0		0	70	0	0	0	0	0
Averages for sample corporations:										
	47	3	0	14	22	6	neg	neg	6	2
Averages for 114 corporations in 1979-80:¹										
	35	10	9	4	6	2	5	2	12	16

Note: Source of 1: Nayar (1982), pp.44-45.

TABLE 20.8

Size of Loans

(in Rs)

Corporation	Minimum	Maximum	Usually transacted amount
1	1000	20000	5000
2	100	30000	3000
3	100	25000	3000
4	250	100000	10000
5	100	50000	5000
6	500	50000	5000
7	1000	300000	25000
8	500	50000	5000
9	250	100000	5000
10	500	200000	10000
11	5000	50000	10000
12	1000	100000	25000
13	500	100000	10000
14	500	50000	20000
15	5000	100000	25000
16	1000	50000	25000
17	500	50000	25000
18	250	100000	25000
19	100	5000	2000
20	250	25000	5000
21	500	50000	10000
22	500	50000	5000
23	1000	100000	25000
24	500	100000	25000
25	1000	200000	10000
26	100	25000	5000
27	500	50000	5000
28	500	500000	37500
29	500	50000	50000
30	500	25000	5000
31	500	50000	5000
32	500	50000	10000
33	5000	100000	25000
34	10000	100000	50000
35	1000	100000	10000
36	1000	25000	5000
37	1000	100000	10000
38	1000	30000	10000
39	1000	25000	5000
40	1000	50000	10000
41	500	20000	5000
42	1000	50000	10000
Average per corporation	1131	81071	12750

TABLE 20.9

Break-up of Loans

(Number of reporting corporations)

Number of corporations reporting:	Small (below Rs 9999)	Medium (Rs 10000- Rs 25000)	Large (above Rs 25000)
Less than 10%	0	0	5
10% to 20%	13	13	8
21% to 30%	7	10	5
31% to 40%	2	3	0
41% to 50%	0	6	1
51% to 60%	7	6	2
61% to 70%	3	2	2
71% to 80%	6	1	1
81% to 90%	3	0	0
91% to 100%	1	0	0
TOTAL	18.2	13.55	6.3
Average loan portfolio (%)	47.83	35.61	16.56

TABLE 20.10

Loans Outstanding at the End of December and the
Growth Rate Between 1981 and 1986

(Rs lakh)

S. No.	1981	1982	1983	1984	1985	1986	Growth rate: 1981-1986 (%)
1	4.50	5.50	6.25	5.00	3.20	2.50	-44.44
2	8.00	7.25	6.75	4.50	3.00	2.50	-68.75
3	11.00	11.25	8.00	6.00	5.00	3.00	-72.73
4	38.00	35.50	32.00	22.25	14.75	10.75	-71.71
5	12.00	12.50	9.25	7.90	6.50	5.10	-57.50
6	5.00	5.50	4.75	4.50	4.00	3.80	-24.00
7	24.00	23.00	20.00	18.50	15.00	15.00	-37.50
8	7.50	8.00	8.75	7.20	6.00	5.00	-33.33
9	9.50	9.90	8.00	7.85	7.00	7.25	-23.68
10	14.00	15.50	16.05	17.00	16.00	12.15	-13.21
11	12.00	13.50	10.00	8.10	7.50	5.10	-57.50
12	27.25	25.00	22.30	22.50	15.00	14.00	-48.62
13	17.50	16.25	15.80	13.30	10.75	9.00	-48.57
14	7.50	6.25	5.00	4.10	4.00	3.50	-53.33
15	12.00	13.50	13.00	10.40	10.50	9.90	-17.50
16	15.00	13.25	12.00	11.20	8.50	6.40	-57.33
17	6.50	9.00	10.50	12.00	15.00	18.70	187.69
18	108.15	100.40	92.65	90.17	79.10	68.32	-36.83
19	5.75	5.50	4.50	3.25	3.00	3.10	-46.09
20	7.00	6.50	6.00	5.00	4.40	4.00	-42.86
21	10.20	10.50	11.00	8.50	7.50	5.00	-50.98
22	7.00	7.25	6.50	6.00	4.90	4.50	-35.71
23	22.00	23.00	21.20	19.00	16.00	14.25	-35.23
24	14.50	13.75	12.00	10.90	7.75	4.25	-70.69
25	14.00	14.25	13.50	13.00	12.35	10.00	-28.57
26	5.00	6.25	7.00	4.25	4.00	2.90	-42.00
27	2.75	3.25	5.00	3.25	2.90	2.50	-9.09
28	93.00	95.00	90.00	86.00	60.00	48.00	-48.39
29	29.00	27.00	25.00	19.00	14.00	12.00	-58.62
30	10.00	9.75	9.00	7.00	5.00	4.00	-60.00
31	33.00	34.00	30.00	20.00	10.00	6.50	-80.30
32	28.00	27.00	25.00	16.00	12.00	9.00	-67.86
33	0.00	0.00	0.00	0.00	9.00	16.00	77.78
34	0.00	0.00	14.00	19.00	27.00	22.00	57.14
35	77.00	78.00	75.00	30.00	24.00	17.50	-77.27
36	6.90	7.40	8.00	6.00	5.45	4.50	-34.78
37	25.00	26.50	26.00	20.00	16.00	12.50	-50.00
38	17.00	16.75	15.50	11.40	9.50	9.50	-44.12
39	14.30	15.00	10.50	9.05	6.45	5.20	-63.64
40	4.50	4.80	6.00	4.50	4.10	3.90	-13.33
41	18.00	18.25	17.00	15.25	14.00	14.50	-19.44
42	24.00	25.00	26.00	15.00	15.00	15.00	-37.50
TOTAL	807.3	805.75	764.75	621.82	525.1	452.57	-43.94

TABLE 20.11

Lending Rates in 1986

(Simple Interest in Percent Per Annum)

Corporation	DPN	Jewel	Other secured loan	Commodity loan	Cheque discounting
1	36.00	36.00			
2	36.00	36.00	36.00		
3	48.00	36.00			
4	36.00	36.00	36.00		
5	36.00	30.00	33.00		
6	36.00		30.00		
7	36.00	24.00	30.00		
8	36.00		30.00		36.00
9	36.00	24.00	30.00		36.00
10	36.00	24.00	24.00	24.00	
11	36.00		30.00		
12	36.00	30.00	33.00		30.00
13	36.00	30.00	33.00	30.00	30.00
14	36.00	36.00	36.00		
15	36.00		33.00		
16	36.00	36.00	36.00		
17		36.00	36.00		
18	36.00	36.00	36.00		
19		30.00			
20	36.00		36.00		
21	36.00		36.00		
22	36.00	30.00	33.00		
23	36.00				
24	36.00		33.00		
25	36.00	30.00	33.00		
26	36.00	30.00	33.00		
27	36.00				
28	36.00	30.00	33.00		
29	40.00	36.00	36.00		
30	42.00	36.00	36.00		36.00
31	42.00	36.00	36.00		
32	42.00	36.00	36.00		
33	24.00			25.00	30.00
34					
35	40.00		36.00		48.00
36	42.00				48.00
37	42.00	36.00	36.00		43.00
38	36.00				
39	36.00				
40	36.00				
41	36.00				
Average ¹	36.97	32.50	34.14	26.33	37.44

¹ Weighted average lending rate is 35.41 per cent per annum.

TABLE 20.12

Trend in Lending Rates of Finance Corporations:
Average of 42 Corporations

(per cent per annum)

Type of loan	1982	1983	1984	1985	1986
I. DPN Loans	28.97	30.77	32.90	36.15	36.97
II. Jewel Loans	18.28	19.79	22.03	25.19	32.50
III. Other secured loans	19.35	21.35	22.95	23.57	34.14
IV. Cheque discounting	21.00	24.00	30.00	36.00	37.44

TABLE 20.13

Break-Up of Loans According to Security
(Percentage of Total Loans, 1986)

Corporat- ion	Secured against collat- eral	Unsecu- red (against DPN)	Trade bills	Cheque discoun- ting	Power of attorney	Total
1	25.00	75.00				100.00
2	60.00	40.00				100.00
3	40.00	60.00				100.00
4	70.00	30.00				100.00
5	60.00	30.00	10.00			100.00
6	25.00	75.00				100.00
7	30.00	65.00	5.00			100.00
8	30.00	60.00		10.00		100.00
9	25.00	70.00		5.00		100.00
10	25.00	70.00	5.00			100.00
11	90.00	10.00				100.00
12	30.00	60.00		10.00		100.00
13	20.00	60.00	10.00	10.00		100.00
14	75.00	25.00				100.00
15	70.00	30.00				100.00
16	80.00	20.00				100.00
17	100.00					100.00
18	85.00	15.00				100.00
19	100.00					100.00
20	10.00	90.00				100.00
21	15.00	85.00				100.00
22	10.00	90.00				100.00
23	30.00	60.00			10.00	100.00
24	20.00	80.00				100.00
25	20.00	80.00				100.00
26	10.00	90.00				100.00
27		100.00				100.00
28	40.00	60.00				100.00
29	60.00	40.00				100.00
30	50.00	40.00	10.00			100.00
31	60.00	40.00				100.00
32	70.00	30.00				100.00
33	9.00	11.00	20.00	16.00	44.00	100.00
34	12.00	16.00	37.00	28.00	7.00	100.00
35	25.00	70.00		5.00		100.00
36	0.00	70.00		30.00		100.00
37	30.00	50.00		20.00		100.00
38	15.00	85.00				100.00
39	5.00	95.00				100.00
40	100.00					100.00
41	10.00	90.00				100.00
42	20.00	80.00				100.00
Average	39.43	53.50	2.31	3.31	1.45	100.0

TABLE 20.14

Number of Corporations with Defaults in Repayments

Corporation	Corporations reporting defaults	Corporation reporting no defaults
1		0
2		0
3		0
4	1	
5	1	
6		0
7	1	
8	1	
9	1	
10		0
11	1	
12	1	
13	1	
14	1	
15	1	
16	1	
17	1	
18	1	
19		0
20		0
21		0
22	1	
23	1	
24	1	
25	1	
26		0
27		0
28	1	
29	1	
30	1	
31	1	
32		0
33		0
34		0
35	1	
36		0
37	1	
38		0
39		0
40		0
41		0
42		0
TOTAL	23	19

Notes: 1. 1 indicates corporations with defaults in repayments.
 2. 0 indicates corporations with no default in repayments.

TABLE 20.15

Break-up of Establishment Costs Incurred by Corporations(1986)

Corporation	(in Rs)						
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Rent	Salary	Fund raising & brokerage, advt. & canvassing)	Printing & stationery	Total expenses	Total	staff strength
1	0	36000	0	3000	39000	3	
2	15000	48000	0	6000	69000	4	
3	12000	48000	0	5000	65000	4	
4	0	60000	0	8000	68000	5	
5	18000	48000	6000	6000	78000	5	
6	12000	33000	0	5000	50000	4	
7	24000	66000	18000	12000	120000	6	
8	15000	30000	10000	5000	60000	4	
9	12000	36000	15000	6000	69000	4	
10	24000	48000	12000	9000	93000	5	
11	12000	36000	15000	8000	71000	3	
12	24000	72000	18000	12000	126000	7	
13	21000	48000	15000	12000	96000	6	
14	9000	21000	0	5000	35000	3	
15	18000	48000	12000	8000	86000	5	
16	12000	21000	0	75000	40500	2	
17	12000	24000	0	6000	42000	2	
18	0	150000	12000	15000	177000	10	
19	6000	24000	0	3000	33000	3	
20	18000	48000	0	4000	70000	4	
21	15000	42000	0	5000	62000	4	
22	12000	36000	0	4000	52000	4	
23	24000	64000	12000	18000	118000	8	
24	12000	60000	12000	12000	96000	5	
25	18000	54000	12000	6000	90000	5	
26	12000	36000	0	4000	52000	4	
27	18000	36000	0	3000	57000	3	
28	30000	120000	100000	24000	274000	8	
29	30000	72000	12000	6000	120000	7	
30	15000	36000	0	3000	54000	3	
31	30000	60000	0	5000	95000	5	
32	0	72000	0	6000	78000	6	
33	42000	48000	4000	16000	110000	4	
34	30000	18000	81000	12000	141000	3	
35	36000	120000	5000	6000	167000	8	
36	12000	36000	0	3000	51000	3	

TABLE 20.15 (Contd.)

(1)	(2)	(3)	(4)	(5)	(6)	(7)
37	24000	72000	10000	5000	111000	7
38	18000	48000	0	9000	75000	4
39	15000	36000	0	2500	53500	4
40	18000	68000	0	9000	95000	5
41	12000	36000	0	4000	52000	3
42	0	80000	0	15000	95000	5
Total	687000	2195000	381000	323000	3586000	197
Average	16357.14	52261.90	9071.43	7690.48	85380.95	4.69
Percentage of total	19.16	61.21	10.62	9.01	100.00	-

TABLE 20.16

Earnings and Expenses of Finance Corporations

(in Rs '000)

	114 finance corporations (March 1980)	42 finance corporations (December 1986)
1. Capital and reserves	116.25	42.30
2. Average deposits during the year ¹	3373.78	488.68
3. Average credit during the year ¹	3223.78	
4. Earnings from loans and advances ²	694.04	131.60
5. Interest paid on deposits and borrowings	519.15	81.81
6. Administrative and other expenses	65.51	32.05
7. Fund raising expenses	72.47	3.81
8. Total operating expenses (5+6+7)	657.13	117.67
9. Profit before tax (4-8)	36.91	14.91
a. Ratios to total funds		
i. Earnings	19.89	24.78
ii. Deposit interest	14.88	15.22
iii. Transaction cost	3.94	6.75
iv. Profit before tax	1.06 ⁴	2.81
b. Spread between earnings on loans and cost of deposits	6.14	10.18
c. Decomposition of earnings		
i. Deposit cost plus opportunity cost	77.82	67.95
ii. Transactions cost	19.80	25.37
iii. Default cost	4.00	4.00
iv. Economic rent	3.00	2.68

Notes: 1. The average deposits and advances are worked out from two year end figures.

2. Downward bias because of concealment of is possible.

3. Earnings from investments and other uses are not separately available. The amount is small and is included in loan operations.

4. Decomposition of earnings assumes a 20% tax cost included in transactions costs, default cost at 4% of earnings and opportunity cost of own funds at 18% per annum.

Source: Column 2 is from Nayar (1982)

TABLE 20.17

Size Distribution of Selected Corporations
According to Deposits in 1986

Size range	Number of corporations	
	1981	1986
Less than Rs 10 lakh	15	23
Rs 10 lakh and above but less than Rs 20 lakh	13	17
Rs 20 lakh and above but less than Rs 30 lakh	5	Nil
Rs 30 lakh and above but less than Rs 50 lakh	4	Nil
Rs 50 lakh and above but less than Rs 75 lakh	Nil	2
Rs 75 lakh and above but less than Rs 100 lakh	3	Nil
Rs 100 lakh and above		Nil
TOTAL	40 ¹	42

1 Two corporations were established after 1981.

TABLE 20.18

**Estimate of Deposits with Finance
Corporations in India**

Year	Deposits (Rs crore)
1979-80	652.19
1980-81	821.99
1981-82	1039.09
1982-83	1250.28
1983-84	1078.36
1984-85	930.09
1985-86	802.20
1986-87	691.90

Source: For 1979-80: Nayar, (1982).
 For 1981-82 to 1982-83:
 Nayar (1984).
 From 1983-84 to 1986-87: worked
 out using the calculated fall
 in growth at the rate of 13.75
 per cent per annum.

TABLE 20.19

Income Groups of Selected Depositors

Income group (per month)	No. of depositors
Less than Rs 5000	0
Rs 501 to 1000	2
Rs 1001 to 1500	3
Rs 1501 to 2000	1
Rs 2001 to 2500	2
Rs 2501 to 3000	3
Rs 3001 to 4000	1
Rs 4001 and above	2
TOTAL	14

TABLE 20.20

Income Groups of Selected Borrowers

Income group (per month)	No. of borrowers
Less than Rs 500	0
Rs 501 to 1000	0
Rs 1001 to 1500	0
Rs 1501 to 2000	1
Rs 2001 to 2500	1
Rs 2501 to 3000	4
Rs 3001 to 4000	1
Rs 4001 and above	10
TOTAL	17

TABLE 20.21

Effective Interest Rate Paid by Selected Borrowers

Category of borrowers	No./ place	Security	Nominal rate	Annual Compound rate (%)
Housewife	1 (Salem)	Jewellery	2.5% per month	34.49
Master weavers	2 (Salem Karur)	DPN	10 paise per Rs 100 per day	44.03
Transport operator	1 (Coimbatore)	Hypothecation of vehicle	18% flat	36.00 (approx)
Transport operator	1 (Ernakulam)	-do-	20% flat	40.00 (approx)
Traders	2 (Ernakulam)	DPN	12% for 100 days with advance interest & daily remittance at 1% of loans	156.96
Trader	1 (Ernakulam)	DPN	10% for 100 days with advance interest & daily remittance at 1% of loans	117.10
Traders	2 (Trichur)	DPN	20 paise per Rs 100 per day	107.36
Traders	7 (Coimbatore, Salem, Trichy, & Bangalore)	DPN	10 paise per Rs 100 per day	44.03

TABLE 20.22

**Details of Selected Recent Failed Finance Corporations
(Upto December 1987)**

S. No.	Name of the corporation (head office in parentheses)	No. of branches	Year of collapse	Estimated deposits (Rs million)	Estimated number of depositors	Major source of information
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1.	Vumidiar Bankers (Madras)	1	1984	30.00	2500	Financial Express, Madras
2.	Sugesan Finance (Madras)	7	1985	65.00	16000	-do-
3.	Samarias Fin. (Madras)	12	1987	65.00	11000	
4.	Mukkadan Fin. (Cochin)	3	1987	3.00	200	Mathrubhoomi 20.5.87
5.	Shalimar Fin.(Kottayam)	23	1987	65.00	8716	-do- 16.6.87
6.	New Bharat Fin. Corporation (Kottayam)	2	1987	5.00	1000	-do- 4.6.87
7.	Labella Fin. (Ernakulam)	28	1987	120.00	9500	-do- 16.6.87
8.	Southern Fin. (Kottayam)	9	1986	48.00	1000	-do- 8.5.87
9.	Oriental Fin. & Exchange Company (Kottayam)	13	1987	80.00	14000	
10.	Amanichkal Traders & Fin. (Pathanamthitta)	1	1987	8.00	1500	
11.	Noble India (Cochin)	1	1987	10.00	1000	
12.	National Fin. (Kottayam)	2	1987	10.00	2000	
13.	Toni Chennikkadan Company (Ernakulam)	2	1987	7.50	1600	
14.	Aditya Fin. & Investment (Bombay)	140	1987	160.00	N.A.	
		(only Kerala)		(only Kerala)		
		244		676.50	70016	

Note: The operational area of all firms except serial No.1 and a part of 2 was Kerala.

TABLE 20.23

Estimated Deposit with Finance
Corporations in Kerala

Year	Deposits (Rs crore)	Source
1982-83	300.19	Nayar (1984)
1983-84	258.91	1
1984-85	223.31	1
1985-86	192.60	1
1986-87	166.11	1
1987 (December)	73.71 ²	Newspapers and our estimate

- Notes
- 1 For 1983-84 to 1986-87, worked out at the 13.75 per cent fall in the growth rate obtained from the field survey.
 - 2 For December 1987, Table A20.2 and our estimate as follows: Deposits with the 13 failed corporations in Kerala (Table A20.2) were Rs 616 million (Kerala's share in total of Rs 676.5 million by 14 corporations). Deposits with hundreds of small non-reported failed corporations are estimated by us as 50 per cent of the 13 big corporations. Thus the total deposits of failed corporations was about Rs 924 million, leaving a balance of about Rs 737.1 million.

CHAPTER 21

HANDLOOM FINANCIERS IN BANGALORE AND KARUR

21.1 Introduction

21.1.1 Cloth production by handlooms is a labour intensive occupation and enjoys official support in India because of its employment potential, especially its rural employment potential. The strategy adopted in the Seventh Five Year Plan for the development of the handloom sector is in accordance with the textile policy announced in June 1985 which envisages that "In the weaving sector the distinct and unique role of the handloom sector shall be preserved and that the growth and development of this sector shall receive priority".

21.1.2 The Sixth Five Year Plan envisaged a production target of 4100 million metres of handloom cloth and an employment target of 87 lakh persons besides a substantial increase of looms in the cooperative sector. However, as the Seventh Plan document notes, "during the Sixth Plan, the major thrust has been to increase the cooperative coverage. Although the gross coverage is about 60 per cent (of the total handlooms in the country), yet the effective coverage of looms in the cooperative fold is around 32 per cent, as many societies have become dormant". In effect, this means that 68 per cent of the total looms in the country were still outside the fold of cooperative societies.

21.1.3 We highlight cooperativisation because official financial support to handlooms (from State corporations, the Reserve Bank of India scheme of handloom finance operated by the National Bank for Agriculture and Rural Development, etc.) is for cooperatives. Official financial support flows to only about 32 per

cent of the country's handlooms. However, there are State run corporations, such as the Tamil Nadu Handloom Finance and Development Corporation which provide working capital finance to weavers outside the cooperative fold.

21.1.4 On the whole, about half the handloom weavers in the country are outside the cooperative fold. These weavers include individual artisans who own one or two looms and employ family labour and master weavers owning upto three hundred looms and employing hired labour on piece rates. In Tamil Nadu and Karnataka, individual weavers purchase yarn and other raw materials from the market, produce cloth and sell it either directly to consumer or to nearby merchants. Master weavers invest towards the cost of looms and accessories, procure raw materials in bulk, pay wages either daily or weekly to weavers and helpers and market goods either in their own premises to travelling salesmen or to cloth traders and merchants spread throughout the country.

21.1.5 Handlooms in these states use cotton yarn from mills natural silk yarn or synthetic silk yarn. The majority of looms are engaged in production of cotton cloth.

21.1.6 While cotton handlooms, are to be found in most States in India, silk handlooms are less widespread.

21.2 Geographical dispersion

21.2.1 In South India and in Maharashtra, where there is a concentration of handlooms, there are private financiers such as finance corporations, yarn trader-cum-financiers, or cloth merchant-cum-financiers. Although all types of financiers are found in each major handloom centre, there are certain places where particular categories of financiers dominate. For instance, at Nagpur (Maharashtra), cloth merchant-cum-financiers are dominant, in Bangalore (Karnataka), silk yarn trader-cum-financiers predominate while at Karur (Tamil Nadu), the main agent is the whole time private financier.

21.2.2 Finance corporations are a familiar financial intermediary in South India. They generally extend finance for any purpose. But, there are some who specialise in lending for particular activities such as for production of cloth by handloom weavers. We have noted such specialisation at Karur and at Bangalore and this case study deals with the handloom finance activities of these corporations.

21.3 Area surveyed

21.3.1 Cotton handlooms of Karur: Karur in Tiruchirappali (Trichy) district of Tamil Nadu is an export-oriented production centre for cotton handloom cloth. It can be reached by road from Salem, Erode, Trichy and other towns in Southern Tamil Nadu. It is also the headquarters of two private sector commercial banks, the Karur Vysya Bank Ltd., and the Lakshmi Vilas Bank Ltd. Situated at the centre of a predominantly agricultural area, Karur is a trading centre for a variety of agricultural commodities. It has no big industrial unit, but is among the top cotton handloom cloth producing and trading centres in Tamil Nadu.

21.3.2 In Karur, as elsewhere in Tamil Nadu, the handloom industry consists of two sectors - the organised sector consisting of cooperatives under an apex body, the Tamil Nadu Handloom Weavers Cooperative Society Limited, and the unorganised sector consisting of master weavers and independent weavers unattached to the organised sector. The organised sector, covering about 50 per cent of handlooms and weavers at Karur, gets financial support in the form of a subsidy on sales and loans from the Government and formal financial institutions.

21.3.3 The unorganised sector of about 20,000 weavers and 10,000 master weavers has no assured source of finance and enjoys no subsidy on sales. This sector requires credit primarily for yarn purchases from spinning mills. Finance corporations and cloth merchants (there are about 400 of the latter extending tied credit to weavers) are the main sources of such finance. Cloth

merchants also borrow occasionally from finance corporations. The total handloom cloth sale by the unorganised sector at Karur is around Rs. 25 crore a year.

21.3.4 Within Karur we came across 36 finance corporations of which 24 were on both sides of the main street, Jawahar Bazaar. Of these 36, we selected 5 corporations, four from Jawahar Bazaar and one from Car Street, for study.

21.3.5 Silk handlooms of Bangalore: Bangalore, a prominent metropolis and the capital of Karnataka State is noted for natural silk yarn and fabric production as also for silk trade. The bulk of natural silk yarn used in the production of silk fabrics in both Tamil Nadu and Karnataka is produced in and around Bangalore. The renowned "Kancheepuram Sarees" woven at Kancheepuram and "Pattu" woven at Salem (both in Tamil Nadu), use silk yarn mostly produced at Bangalore.

21.3.6 One can see vast stretches of mulberry cultivation a few kilometres outside the city of Bangalore and a few kilometres away from Tumkur, a town about 50 kilometres away from Bangalore lying on the Bangalore - Bombay bus/rail route. In these areas, all activities connected with the production of silk fabrics, from mulberry cultivation to weaving silk cloth by handloom have been carried on for generations. Besides, there is the chain of silk traders - the local middlemen who buy the silk yarn or unprocessed cocoons from the cultivator, the reelers who process the cocoons to extract fibre, the yarn merchants who purchase the yarn for sale to the producers of silk fabrics. Producers may be co-operatives master weavers or independent weavers.

21.3.7 At each stage of production and marketing, the problem of finance arises. "The cultivator of mulberry/rearer of cocoons gets loan from the dealer of cocoons who moves about in the cocoon producing centres. When the cocoons are ready the dealer buys them by paying the balance after adjusting the loan amount, and gives the same to the reelers, sometimes on credit or in exchange

for silk yarn. Those reelers who purchase the cocoon, sell the yarn either to the very same dealer or to others in the open market. The other reelers who get the cocoon in exchange for yarn give it to the dealer after receiving the conversion charges. The dealer disposes of his yarn either in the yarn market at Bangalore or sells it to master weavers or independent weavers. Here again there may be credit sales and exchange (yarn in exchange for cloth) business. Those reelers and weavers who can afford to market their products independently go to the market; while the others resort to the less remunerative method of exchange" (Nayar 1982).

21.3.8 The bulk of silk handlooms at Bangalore is in the unorganised sector. The main reason for the low coverage by cooperatives is that silk fabric production is highly specialised and mass production, as is practised in cotton handloom cloth, is not easy. Each silk saree is different. The broad design and colour of silk may be the same, yet the zari (silver or gold thread) content, floral design, and so on differs from piece to piece. This is the main difference between a mill made silk saree and a handloom silk saree where each piece shows the individuality of the weaver.

21.3.9 Unlike cotton handlooms which use mill made cotton yarn, silk handlooms use natural silk yarn reeled from processed cocoons. Silk yarn is much costlier than cotton yarn and its supply fluctuates from season to season. Another major raw material which goes into the production of a silk saree or silk (pattu) "veshti or dhoti" is the costly zari. Thus the raw material cost of silk fabric is high. Moreover, the period taken to weave a five metre saree may go up to three months if the design is complicated and the zari content is high. Because of these reasons, the handloom silk industry requires a lot of credit. The finance corporation and the yarn trader or cloth merchant directly or indirectly provide a substantial volume of this credit.

21.3.10 There are different methods of financing used by finance corporations. Direct short term loans to silk fabric merchants, yarn traders and master weavers on the security of demand promissory notes (DPN), small loans to independent weavers on the security of jewellery and discounting of post dated cheques from wholesale to independent weavers or master weavers are the main methods.

21.3.11 One estimate puts the number of finance corporations in Bangalore in March 1980 at 150 (Nayar 1982). Many of these were general finance corporations, with no specialisation in any particular activity or trade. Our recent survey showed that there were about 50 finance corporations specialising in handloom silk finance, although they extended loans to other categories of borrowers also. We selected five for this study.

21.4 Sources of funds

21.4.1 Sources of funds of the five cotton handloom finance corporations at Karur include own capital and borrowing from the public and relatives. There was neither any reserve funds nor borrowings from the formal sector. At the end of 1986, their total subscribed capital amounted to Rs. 2.25 lakh against total borrowings of Rs. 50.75 lakh. Thus own capital was about 4.2 per cent of available funds. As much as Rs. 9.75 lakh of borrowed funds came from relatives.

21.4.2 Funds of the five corporations in Bangalore include own capital and reserves and borrowings from the public and relatives. There was no borrowing from the formal sector. Own funds of these corporations, at Rs. 3.20 lakh at the end of 1986 formed about 5.05 per cent of total capital while funds borrowed from the public (net of borrowing from relatives) formed about 89 per cent of capital.

21.4.3 The data on borrowings from 1981 to 1986 presented in Table 21.1, covering both the centres, shows a decline since 1982. The fall may partly be due to the reduction in the number of depositors as per the Banking Laws (Amendment) Act, 1983. As can be seen from the table, the average number of depositors in both centres has reduced over the years though in Bangalore the number of depositors is still in excess of the ceiling laid down by the Act given that , in both places, there was an average of five partners per corporation. This excess is made up of - real or spurious - deposits from relatives which are outside the scope of the restriction).

21.4.4 Period of funds availability: Corporations at both places offered different interest rates for different periods. Deposits at Karur were generally for a one year period. In Bangalore 70 per cent of deposits were for a period of one year, 22 per cent for 3 years and 8 per cent for less than one year.

21.4.5 Cost of funds: Interest paid by corporations both at Karur and Bangalore was 18 per cent per annum for a one year deposit. At Bangalore 20 per cent per annum was paid for a three year deposit. Since interest was usually paid monthly, annualised compound rates work out to be 19.56 per cent and 21.94 per cent respectively. On the whole, cost of funds of corporations was about 10 per cent higher than that of commercial banks. Interest rates showed little or no fluctuation since 1984. Prior to 1984, rates were about three percentage points less. In 1980, the average interest rate for a one year deposit was 13 per cent per annum (Nayar 1982). In the wake of restrictive credit policy in the formal banking sector instituted in the wake of a Rs 500 crore IMF loan in 1981, interest rates in the sector moved up to 15 per cent in March 1983 and further to 18 per cent by March 1984. Thereafter the rate remained more or less static as finance corporations, especially large ones, started reducing the number of depositors as per the provisions of the Banking Law (Amendment) Act 1983, which came into force on 15th February, 1984 despite the subsequent easing of monetary controls.

21.5 Uses of funds

21.5.1 Types of borrowers: The bulk of credit at Karur flows to, cotton handlooms usually to meet working capital needs. As Karur is an export oriented centre, informal consortia of finance corporations sometimes finance master weavers who receive large export orders. Independent weavers, master weavers and cloth merchants all receive finance.

21.5.2 At Bangalore, borrowers include individual silk cloth weavers, yarn merchants, reelers and master weavers besides wholesale and retail silk cloth merchants. A feature of credit through the discount of post dated cheques is that only cheques of established parties are accepted by corporations to reduce the risk of subsequent dishonour of cheques.

21.5.3 Size of loans: The average loan per borrower at Karur was Rs 8000 though loans of Rs 50,000 on one hand and Rs 900 on the other were reported. Most loans were at or near the average.

21.5.4 At Bangalore, the average loan was Rs. 12,000, though the range of loans observed (Rs 900 to Rs 1 lakh) and the dispersion were both higher. This is, of course, due to the cost of silk and the duration of finance required in silk production discussed earlier.

21.5.5 Interest, margin and security: About 95 per cent of loans at Karur were against DPN. The interest rate charged was a uniform 10 paise per Rs. 100 per day, (44 per cent annualised) and there was no other charge. The interest was calculated for the exact period, in days, of loan use.

21.5.6 At Bangalore, 60 per cent of loans were against DPN, 20 per cent against collateral such as property or gold jewellery and another 20 per cent against post-dated cheques. For DPN, the interest rate was 10 to 12 paise per day (44 to 55 per cent annualised). Post-dated cheques were discounted at the rate of

one paise per rupee for seven days (67.8 per cent annualised), the interest calculation being made for multiples of seven days. Secured loans were charged 36 per cent per annum on a simple interest basis. The average interest charged therefore works out to 55.68 per cent. Assuming that funds lie idle at most 10 per cent of the time, the interest earned on funds deployed works out to 45.41 per cent.

21.5.7 Loan duration: The loan period at Karur did not exceed three months in any case. The period varied from one day to 90 days, most of the loans being closed before 15 days. The average period for all loans was about 15 days.

21.5.8 The loan period at Bangalore was longer, from one week to one year. DPN loans were for a maximum of 90 days, while loans for longer than 90 days were secured against property or jewellery. Therefore, DPN loans and discounting of post dated cheques formed 80 per cent of total loans with their duration varying from five to ninety days for DPN loans and from seven to thirty days for post-dated cheques. The average loan period for unsecured loans was about 45 days. Thus, loan capital turned over several times a year in both centres implying that a large number of borrowers were served each year.

21.5.9 Bad debts and overdues: It was found that bad debts were negligible in both the places, even for loans against DPN. One respondent at Karur reported that 3 per cent of loans usually became past due but that few outright defaults occurred.

21.5.10 Complementarity/substitutability with formal finance: There are several agencies which finance the handloom textiles sector. Banks and organised financial sector mainly finance cooperatives handloom. The informal financial sector is thus not only complementary to the formal financial sector but also an equally important supplier of credit since the bulk of finance for the unorganised sector is from informal sources.

21.6 Cost of intermediation and profitability of intermediaries

21.6.1 No financial figures enabling an accurate decomposition of loan interest rates are available. Hence, the decomposition is estimated assuming (i) an average deposit interest rate of 9.5 per cent for Karur and 21 per cent for Bangalore, (ii) management remuneration at Rs 24,000 per year per managing partner, (iii) an opportunity cost of own funds at 18 per cent, (iv) tax at 10 per cent of pre-tax profit and (v) bad debts provision at 1 per cent of advances - the figure given by a respondent in Karur. Deposits, advances and own capital is from data supplied by respondents. The results of the decomposition (Table 21.2) show that, while opportunity cost of own funds and deposits make up the bulk of interest cost, economic rent in Bangalore makes up about 20 per cent of interest cost if the opportunity cost of funds is 18 per cent. In fact, while the gross return on capital in Karur is estimated at 18.2 per cent, the return on capital at Bangalore is estimated at 184.7 per cent. Since, on average, five partners per corporation were reported in both towns, the earnings per year for the managing partner (inclusive of management remuneration) works out to be Rs 32,200 in Karur and Rs 1,42,200 in Bangalore. Thus, while earnings in Karur are at the junior management level, earnings at Bangalore would exceed that of presidents of many small corporations.

21.7 Regulatory environment and its impact

21.7.1 Most finance corporations are registered under the Indian Partnership Act 1932. Although they are engaged in banking - accepting deposits and lending money - they are not covered under any Reserve Bank of India rule applicable to organised banking. However, they have recently been brought under the purview of the Banking Laws (Amendment) Act 1983, according to which they can accept deposits from the public to the extent of 25 depositors per partner with a maximum of 250 depositors. Partners can also accept deposits from any number of (specified) relatives. The Act does not put any ceiling on the amount of deposits per depositor.

21.7.2 The average number of depositors per partner in corporations at Karur in 1981 was 59. This came down to 33 by 1986 which gives an indication of the impact of the Act. Likewise, at Bangalore, the average number of depositors dropped from 260 per partner in 1981 to 120 in 1986. Restricting the number of depositors per partner has seriously affected the lending business of corporations, especially at Bangalore.

21.8 Market structure:

21.8.1 At Karur there was no evidence of market leadership. However, markets were local and showed evidence of long standing relationships since, apparently, familiarity reduces costs by saving on time spent for negotiation. Interest rate competition was absent.

21.8.2 At Bangalore, there was one relatively large corporation in terms of deposits and advances. But no evidence of market rates being influenced by the big corporation's interest rates was found. Deposits were mobilised by partners through their influence and not through interest rate competition. After the RBI Act restricting the number of depositors, there is evidence of the market becoming a sellers' market since the level of operations with restrictions on depositors is not lucrative enough to attract enough new firms at a great rate. Thus, observed economic rents could be due to recent regulation. If so, they are clearly a short run phenomenon.

21.8.7 Entry and exit barriers: Entry to the market is easy because there is no legal formality in registering a partnership firm. There is no minimum capital requirement also. Exit is similarly free from regulatory hurdles.

21.9 Estimate of overall size

21.9.1 Unlike auto finance corporations, which are found only in certain pockets in South India and elsewhere in the country,

handloom finance corporations are scattered throughout handloom cloth production and sales centres. Again, unlike the auto finance corporations, these corporations are multi-purpose financing units with a larger share of loans flowing to the handloom sector. It is difficult to segregate the handloom finance corporations from other corporations. Because of these difficulties, no attempt is made to estimate the number of firms and volume of business of such corporations throughout the country.

21.10 Distributional impact

21.10.1 Corporations in both places generally extend loans to small borrowers. The per capita loan at Karur in 1986 was Rs. 9544 and at Bangalore it was Rs. 8928 (Table 21.3). Similar loan sizes were computed for earlier years. Since the unorganised sector including small independent weavers, is largely dependant on loans from finance corporations, a positive impact on credit availability to small borrowers in absolute terms appears indicated. Whether or not there is a relative distributional gain in credit availability is hard to estimate.

21.11 Efficiency and allocative impact

21.11.1 One distinguishing feature of the borrowers of finance corporations, both at Karur and Bangalore was that the borrowed funds were used in industrial production or trade. Producers of cotton and silk handloom cloth in the unorganised sector who were side-tracked by the organised financial sector and those who traded the goods got working capital finance. This was especially the case with many small sized master weavers with 20 to 30 looms and independent weavers owning one or two looms who did not get any worthwhile financial assistance from other sources.

21.12 Impact on savings mobilisation and investment

21.12.1 Finance corporations paid interest on deposits at rates about 10 per cent higher than bank rates though risk costs can be

expected to be higher. Furthermore, loans from them were productively utilised. Thus a positive direct and indirect impact on saving can be hypothesised though no direct evidence is available.

21.13 Recommendations for regulatory framework

21.13.1 It is only very recently that the Banking Laws (Amendment) Act 1983 was passed after a great deal of discussion and deliberation. Deposits with finance corporations come under this Act. We have seen in Table 21.1 that their deposits as also lending operations came down drastically after 1983. As a consequence, an estimated 2,300 borrowers at Karur and 10,000 borrowers at Bangalore were deprived of credit in 1986 as compared to the level in 1983. The purpose of the 1983 Act is to protect the interest of depositors. But, in the process, it is instrumental in denying credit to a vital sector of the economy.

21.13.2 As handloom finance corporations serve a vital sector of the economy, there is no reason as to why they should not be allowed to function unimpeded. The wisdom of an across the board restriction on deposit taking is, therefore, questionable.

21.14 Lessons for formal sector

21.14.1 There is one lesson which the formal sector can learn from these informal finance corporations: Extension of loans for very short periods, charging interest only for the exact period of the loan. In such a short period loan, the interest rate is worked out per day and calculation is easy even for an illiterate borrower.

TABLE 21.1

Consolidated Position of Deposits and Advances

(Amount in Rs)

Year (December end)	Deposits		Variation in deposits over the pre- vious year	Advances		Variation in advances over the previous year
	No. of depositors	Amount outstanding		No. of borrowal accounts	Amount outstanding	
A. FIVE CORPORATIONS AT KARUR						
1981	1480	81.55	-	750	77.80	-
1982	1447	81.75	0.20	753	79.80	2.00
1983	1376	77.65	-4.10	735	75.00	-4.80
1984	1015	59.05	-18.60	567	55.15	-19.85
1985	845	52.20	-6.85	517	49.05	-6.10
1986	825	50.75	-1.45	504	48.10	-0.95
B. FIVE CORPORATIONS AT BANGALORE						
1981	6510	164.30	-	1560	153.65	-
1982	6595	168.84	4.54	1558	153.15	-0.50
1983	6375	160.75	-8.09	1425	147.10	-6.05
1984	4700	95.10	-65.65	1150	89.80	-57.30
1985	3700	74.90	-20.20	738	64.70	-25.10
1986	3000	60.10	-14.80	644	57.50	-7.20

TABLE 21.2

**Earnings and Expenses of 5 Corporations Each at
Karur and Bangalore - 1986**

(Rs lakh)

	Karur	Bangalore
1. Capital and Reserves	2.25	3.20
2. Average deposits	50.75	60.10
3. Average advances	48.10	57.50
4. Estimated Earnings from Loan Operations	17.21	27.29
5. Interest paid to Deposits (at 18 per cent)	9.00	12.08
6. Administrative Expenses	4.08	5.51
7. Provision for Bad Debts (at 3 per cent of 3)	1.44	1.80
8. Total expenses (5+6+7)	15.42	19.39
9. Profit Before Tax (4-8)	1.79	7.90
10. Tax (at 10 per cent)	0.18	0.79
11. Estimated net profit	1.61	7.11
Decomposition of interest cost (per cent)		
1. Cost of deposits	52.30	44.27
2. Cost of default	8.36	6.60
3. Administrative cost	23.71	20.19
4. Opportunity cost of owners' capital at 18% plus Rs 24000 labour cost per managing partner	9.32	6.53
5. Taxation	1.05	2.89
6. Economic rent	0.03	19.53

Note: See section 6 for basis of computations.

TABLE 21.3**Average Loan Size at Karur and Bangalore**

Year	Karur (Rs)	Bangalore (Rs)
1981	10373	9849
1982	10597	9828
1983	10204	10322
1984	9726	7808
1985	9487	8766
1986	9544	8928

CHAPTER 22

HIRE PURCHASE IN SOUTH INDIA AND DELHI

22.1 Introduction

22.1.1 Hire purchase finance (HPF) is a type of instalment credit whose essence lies in the hirer agreeing to hire goods at a stated periodical rental with an option to purchase. It is to be distinguished from a credit sale. In a credit sale contract the ownership of goods is instantly transferred to the purchaser when he makes the first instalment or down payment. If he fails to pay the balance, the seller has no claim over the goods but can only sue the purchaser for the amount due. Similarly, the purchaser has no right to return the goods he has once purchased. In contrast, under the hire purchase system, the seller retains ownership of the goods until the final instalment is paid. The hirer cannot dispose of the goods in any manner except by surrendering them to the seller and is bound to take care of them during the entire period of the contract.

22.1.2 The institution of HPF is fairly old and well organised in developed anglophone countries. In India, it came into existence in the years following the first world war. One of the earliest references to HPF in India was made by the Travancore Banking Enquiry Committee in their Report published in 1930. At that time, HPF was confined only to the road transport industry and was concentrated in the hands of a few individuals and private business houses. A plethora of goods in addition to automobiles are

now sold under hire purchase credit by a variety of institutions.

22.1.3 HPF institutions in India can be grouped under two heads - the organised sector and the unorganised sector. The organised sector consists of commercial banks, cooperative banks, state financial corporations (SFCs) and HPF companies. The unorganised sector comprises partnership firms and sole proprietary concerns and individuals. The role of banks in financing hire purchase credit is indirect. They extend refinance to HPF companies and financiers. Their direct lending to the road transport industry is on the basis of hypothecation of vehicles and not on hire purchase basis.

22.1.4 Under the hypothecation system, banks and the SFCs extend loans to the extent of 75 per cent of the cost of the vehicle, to be repaid in monthly instalments for upto five years. Interest on outstanding balances varies presently from 12.5 per cent per annum for self employed single truck operators to 16.5 per cent for fleet owners and large transport operators.

22.2 Geographical dispersion and numbers

22.2.1 This study of HPF institutions covers public limited and private limited companies, partnership firms and proprietary concerns. Although the number of HPF companies and the amounts of deposits with them are given by the Reserve Bank of India (RBI) in its annual review of growth of deposits with non-banking companies, no data on partnerships and proprietary concerns are available. RBI data from 1962 to 1986 are given in Table 22.1.

22.2.2 RBI data only cover companies which report deposits. Thus there are limitations which, however, are not major. We may take the RBI figures as representative of all HPF companies. The

RBI review for 1986 gives the number of HPF companies as 412 with total deposits of about Rs 280 crore. Deposits with these companies show a significant increase since 1971.

22.2.3 A serious limitation of the RBI review is that it does not give any operational details such as the stock on hire of these companies. From deposits alone one cannot measure the volume of business transacted by the HPF companies.

22.2.4 Regarding the number of HPF institutions in the unorganised sector (partnerships and proprietary concerns), we have some data supplied by the Federation of Indian Hire Purchase Association (FIHPA). The federation's membership consists of 9 regional level associations. These associations have a membership of 1110, comprising companies, partnership firms and individual units as shown in Table 22.2. There may be as many non-member HPF institutions. One estimate puts the total number of HPF institutions in the country in 1984 at 2500. Of these, the large majority are partnerships and proprietary concerns and only a few are companies. The number of HPF companies in 1984 as per the RBI data was 354.

22.2.5 This chapter discusses the results of two separate field studies in Delhi and South India. These are taken up in turn.

22.3 The South India Case Study

22.3.1 The South India study covers 23 HPF institutions and 12

borrowers in Tamil Nadu. Ownership pattern, business practices, terms and conditions of credit, etc., of HPF institutions in the other southern States are similar. In fact, a leading HPF company of Madras, Sundaram Finance Limited, has a network of 35 branches in these states. Our sample of 23 HPF institutions, which include this leading company, consists of 10 corporate units (8 public limited and 2 private limited), and 13 non corporate units of which 12 are partnerships and one is a proprietary concern. The ten companies have 95 branches, mostly in South India. The sample forms 5 per cent of the total membership (460) of the South India Hire Purchase Association, Madras and 7.5 per cent of the HPF institutions in Madras.

22.4 Sources of funds

22.4.1 Sources of funds of these HPF institutions are capital and reserves, deposits from the public, borrowings from banks and other formal financial institutions and payments made against hired goods.

22.4.2 Own funds and deposits: Corporate units which intend to raise large deposits from public must keep a high own funds position since the Non-Banking Financial Companies (Reserve Bank) Directions, 1977, stipulates that an HPF company can raise deposits only to the extent of ten times its net owned funds.

22.4.3 Non-corporate units are not covered under these Directions. They are free to fix any ratio of owned funds to deposits in place of the 1:10 prescribed for companies. However, their deposit acceptance is governed by the Banking Laws (Amendment) Act, 1983 according to which they can raise deposits from public to the extent of 25 depositors per individual (in the case of in-

dividual concerns) and 25 depositors per partner subject to a maximum of 250 depositors in a 10 member partnership. In addition to this, both categories can accept deposits from relatives.

22.4.4 The data on own funds and deposits presented in Table 22.3 show that in spite of the freedom to fix a low level of own funds, the non-corporate units generally had a higher own funds position than corporate units. This is because the shortfall in deposits resulting from the operation of the Banking Laws Act was made up by own sources.

22.4.5 No corporate unit reached a level of deposits equal to ten times the own funds figure. Since there is a ceiling on interest payable by companies, including HPF companies, on deposits, it is likely that this is due to a shortage in the supply of deposits. This hypothesis is supported by the fact that HPF companies add to reserves year after year.

22.4.6 The trend in growth of deposits of the selected HP institutions from 1981 to 1986 is given in Table 22.4. The deposits of these HPF companies grew at an average annual compound rate of 26.89 per cent against the growth of 22.79 per cent by all HPF companies as given in Table 22.1. The non-company sector also had an impressive growth rate of 23.78 per cent.

22.4.7 Borrowings from the formal sector: All corporate units and some non-corporate units get refinance from the formal banking sector. Some large size proprietary concerns and partnerships also get overdrafts from banks. The figures of refinance obtained by the company sector are available for seven out of the ten selected companies. One company did not raise any amount through refinance because its own funds and deposits were in excess of the

stock on hire. The seven companies together got refinance to the extent of Rs 579.15 lakh in 1986 equal to 3.64 per cent of their stock on hire. One reason for the low refinance appears to be the high cost associated with it. Refinance by banks is at their maximum lending rate (presently 16.5 per cent per annum). Since HPF companies can borrow from the public at 14.5 per cent (including 0.5 per cent brokerage) they will clearly resort to refinance only when they fail to raise public deposits or if they exceed the statutory limit of borrowings.

22.4.8 For non-corporate units, it is cheaper to borrow from banks as their cost of borrowing from the public is high, usually around 18 per cent to 19 per cent per annum. Thus they make use of bank accommodation to the maximum possible extent. Although no non-corporate HPF firm furnished data on bank accommodation, all of them said that it was inadequate. Thus, while the complaint of the company sector on refinance from banks was regarding the high refinance charges, the grievance of the non-company sector was about its inadequacy. However this net flow of cash is likely to be spurious since the high cash balances are most probably associated with a temporary dip in fresh loan business due to the closing of books at the end of the financial year.

22.4.9 Table 22.5 presents details of borrowing from banks and cash balances with banks. It is seen that banks received Rs 1515.90 lakh from the 10 HPF companies and extended refinance to them to the tune of Rs 579.15 lakh. This represents a net flow of Rs 936.75 lakh from the informal to the formal sector. As a ratio to total stock on hire, this works out to 5.21 per cent for the company sample. Much of this cash flow to the formal sector may be illusory, reflecting a temporary dip in fresh HPF agreements due to the closing of books at the end of the financial year.

22.4.10 Column 4 of Table 22.5 shows that the ratio of bank finance to stock on hire ranged from less than 1 per cent to 47 per cent. As the norm for refinance of HP credit for companies is common to all companies, the low percentages of some HPF companies is clearly demand determined.

22.4.11 Period of funds availability: The duration distribution of deposits is given in Table 22.6. The table shows that 69.31 per cent of the total deposits of the company sector was for three years, compared to 13.58 per cent for the non-company sector. The great majority of deposits (80.42 per cent) of the non-company sector was for a one year period. The company sector is therefore seen to have superior access to long term deposits.

22.4.12 Though both the company and non-company deposits are unsecured, depositors generally have greater confidence in the company sector which explains the longer average duration of deposits with them.

22.4.13 Cost of funds and comparison with bank rates: The items under cost of funds of HPF companies are interest payment on deposits, brokerage paid to authorised brokers through whom deposits are raised, advertisement expenses and deposit servicing charges. Unincorporated units also incur these expenses, though commissions paid to deposit canvassing agents and advertisement expenses are small. For companies which raise deposits from the public, advertisements are compulsory as per the RBI Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules 1977 (see the Appendix to this chapter).

22.4.14 Interest rates on deposits for banks and in HPF are

given in Table 22.7. The rates of HPF companies are 4 to 6 per cent higher than those of banks for term deposits. Non-corporate HPF institutions pay interest at rates about 7 to 10 per cent higher than those of banks.

22.4.15 The weighted average interest rate of the selected HPF companies for all periods in 1987 came to 14.81 per cent per annum and of the selected non-corporate units to 18.92 per cent per annum. In addition to the interest payments, the HPF institutions also incurred other financial costs as shown in Table 22.8. When these are added, the total cost of funds of corporate units worked out to 15.94 per cent of deposits and that of non-corporate units to 19.67 per cent. On the whole, the cost of funds of corporate units and non-corporate units was about 6 and 8 percentage points higher than that of commercial banks.

22.4.16 No marked fluctuations in the period, cost and availability of funds to HPF institutions were reported after the RBI revised the deposit rates of banks on 1st April, 1987. This is indicative of a lack of effectiveness of bank rate policy on HPF.

22.5 Uses of funds

22.5.1 The funds of HPF institutions mainly finance the road transport industry (trucks, buses operated by private companies and individuals, light commercial vehicles and taxis) and to a smaller extent private cars, two-wheelers and other consumer durables. Generally, HPF companies finance new vehicles and used vehicles that are for commercial use. HPF institutions in the non-corporate sector mainly finance used vehicles, taxis, cars, two and three-wheelers and household items.

22.5.2 Uses of funds of eight selected HPF companies (two companies did not supply the balance sheets for 1986) given in Table 22.9 show that about 83 per cent of the total assets in 1986 was held in net current assets including stock on hire, bills purchased, cash and bank balances and loans and advances less current liabilities and provision. Net block assets accounted for about 16 per cent of the asset mix. Four companies had some investments, mostly in shares of sister concerns and total investment was a negligible one per cent of assets. Similar details on the uses of funds of the non-corporate sector are not furnished by the respondent institutions.

22.5.3 A user-wise categorisation of stock on hire or a size-wise break-up of HP credit is not maintained even by the HPF companies. Information supplied on these points was only in general terms. The major share of credit, as shown in Table 22.10, was for trucks/buses. This was followed by passenger cars and jeeps. These two items accounted for about half the total credit of the selected HPF companies. Table 22.10 also shows the approximate amounts of credit per vehicle of each type.

22.5.4 Hire charges of companies varied across companies but not periods between 13 and 15 per cent (flat) on new vehicles during the three year period ending 1986. For used vehicles not older than 7 years, all companies charged about two per cent more.

22.5.5 The non-company sector, on the other hand, charged different rates during the three year period. Six firms charged 19 per cent, 20 per cent and 21 per cent flat per annum during 1984, 1985 and 1986 respectively. Four others charged 18 per cent, 19

per cent and 20 per cent per annum respectively during the same three years while two charged only 16 per cent per annum during all the three years. One firm, probably because of its location at Madras, charged only 14 per cent per annum during 1984, 1985 and 1986. During this period, the commercial bank loan interest rate (as proxied by the State Bank of India advance rate) was 16.5 per cent, 16.5 per cent and 17.5 per cent respectively.

22.5.6 The important point to note here is the vast difference between the flat rate charged by the HPF institutions and the effective annual compound rate calculated on the unpaid balance after each instalment is paid (i.e. on a 'reducing balance' basis).

22.5.7 For the range of interest rates mentioned above, compound annual rates are as in the table below.

Period (months)	Flat rate per annum		
	14	17	21
12	28.0	33.9	43.5
36	27.6	33.3	41.3

22.5.8 Another point of interest related to hire charges is that there are considerable variations in hire charges of HPF institutions in different regions in India as can be seen from Table 22.12 which presents data for two points of time. Commercial bank loan rates (the State Bank of India Advance Rate) in these two

years (1970-71 and 1985-86) were 9.3 per cent and 16.5 per cent respectively.

22.5.9 In addition to hire charges, most HPF institutions also collect service charges (SC), additional finance charges (AFC) and incidental charges (IC). The service charge or management fee is usually a one time charge ranging between 0.5 per cent to 2 per cent of the amount financed and is collected in advance before signing the agreement. AFC is levied, normally at 30 per cent simple interest per annum on each instalment for the number of days delayed in case delay in payment. However, such AFC is recovered at the time of conclusion of the contract or, if it is settled early or assigned to another party, on settlement or assignment.

22.5.10 Besides AFC, in terms of typical contracts, an HP financier is also entitled to recover the following.

- i. Reasonable transport expenses incurred in connection with inspection of the asset and collection of hire charges.
- ii. Bank charges incurred for collection of outstation cheques tendered by the hirer.
- iii. Insurance premium paid for taking out insurance policy.
- iv. Repossession charges.
- v. Tax, penalty, compounding fee, etc. paid by the financier.
- vi. Repair charges if any paid by the financier.
- vii. Reasonable selling expenses incurred in connection with the sale of the repossessed asset.
- viii. Legal expenses incurred in connection with filing of suit for recovery of the dues.

22.5.11 HPF companies generally finance up to 75 per cent of the invoice price of new vehicles/goods and up to 60 per cent of the market price for used vehicles in good condition and not older than seven years. In other words, the hirer's margin is around 25 per cent to 40 per cent of the price of hired goods. Apart from this, the HPF companies usually take a demand promissory note (DPN) from the hirer. There are ample provisions in the HP agreement to repossess the goods hired in case the hirer defaults.

22.5.12 The situation is slightly different for non-corporate units. These institutions finance up to 80 per cent of the actual price (for new vehicles) and up to 75 per cent of the market price for old vehicles. In addition to the hire purchase agreement, these institutions also take a DPN for the amount financed from the hirer. The HP agreement is usually a tripartite agreement, the three parties being the financier the hirer and the guarantor. The guarantor guarantees the fulfillment of all contract obligations to the financier. It is in addition to this guarantor, that a hirer executes the DPN in many cases.

22.5.13 The limit of finance for finance by non-corporate units depends on, among other things,

- a. the type of the asset, its age and whether it is a general purpose or a special purpose one,
- b. the durability and marketability of the asset,
- c. if used, the assets condition and its market value,
- d. the hirer's financial standing and credit rating in the opinion of the firm,

- e. the financier's appraisal of the rate of depreciation of the asset.

22.5.14 Duration of HP credit: The credit period in hire purchase transactions is generally between 12 months and 60 months. The maximum period of 60 months was offered by only one company in the corporate sector and two partnerships in the non-corporate sector. For others, the maximum period ranged between 36 months and 48 months. The minimum period was 12 months for all the HP institutions engaged in financing automobiles. Three HPF companies which financed household durables also extended finance for six months. In both cases, most of the transactions were for periods between 24 months and 36 months.

22.5.15 Under the hire purchase system the hirer can terminate the contract during its currency, pay up hire money dues up to that period and return to the financier the asset in good order and condition, excepting for normal wear and tear. Hence it is essential that the period of the contract be much shorter than the economic life of the asset. Further, for companies, the maximum period for which public deposits can be accepted is three years. Thus, the nature of the asset financed determines the maximum duration of finance an HP firm will extend.

22.5.16 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 instalments, bad debts are very small in HP transactions. There may be some overdues at any point of time but the arrears are generally collected during the currency of the HP agreement. Even in cases where the asset is repossessed by incurring expenditure, the financiers may not lose money as the value of the repossessed asset, the paid up instalments and initial margin invested by the hirer will normally

cover the financiers' cost.

22.5.17 In some cases, hirers default on payments due to genuine difficulties as for example with new firms. In such cases, financiers show a sympathetic attitude towards the hirers. The financiers may extend the hire period or reduce the monthly instalment amount. They may even extend further finance by executing fresh HP agreements cancelling the previous agreements. But in case the financiers feel that there are regular and willful defaults by some hirers, steps are taken to enforce the hire purchase agreement. These include reminders to the hirers and guarantors and repossession of the assets financed, if necessary through force.

22.5.18 Assessment procedure: HPF institutions have several methods to assess the creditworthiness of hirers. The institutions never go entirely by papers presented by the hirers. They assess the character of the hirer, his capacity to repay, his own stake in the venture, the security offered and its marketability and the position of the guarantor, gathering the requisite information through personal enquiry, market enquiry and bank intelligence especially when the HP credit is high and the parties are new. The papers they scrutinise include partnership deeds in case of partnership firms, financial statements, income tax, wealth tax and sales tax assessment orders and property statement. The financiers cross check figures presented in financial statements or information provided by the party through visits to the party's place of business or residence.

22.6 Cost of intermediation

22.6.1 We have noted in Table 22.8 that the average cost of

funds of the company sector among the HPF institutions is 15.50 per cent of borrowed funds and that of the non-company sector 18.20 per cent. Assuming that the entire borrowed funds are given as HP credit at an average flat rate of 14.5 per cent per annum (as was the case with the selected companies) or an effective rate of 29 per cent per annum, the spread between the interest paid and interest earned, comes to 13.5 per cent per annum. In the case of non-companies, the spread works out to 18.80 per cent (interest paid at 18.20 per cent and effective interest earned at 37.0 per cent per annum). To determine the composition of the spread, component parts are first examined.

22.6.2 Profit and loss accounts of sample companies are presented in Table 22.13. For one company the relevant figures are not available for all three years. Details of income and expenditure of another two firms are not available. Profits of the selected companies showed a steady increase during the three years except in the case of a leading company which incurred an increased expenditure due to quick expansion and heavy depreciation in 1986. The combined profits of the other 9 companies was Rs 76 lakh, Rs 123.6 lakh and Rs 192.5 lakh respectively during the three year period ending 1986. The ratio of expenses to stock on hire (17.4 per cent), the average return on capital before taxes (22.8 per cent), an assumed 20 per cent tax on pre-tax profits, the cost of borrowing (14.81 per cent) and the fact that risk cost for delayed payments is low since it handled by penal interest can be used to decompose the interest rate. Assuming an opportunity cost of own funds of 18 per cent we can compute the following ratios to stock on hire:

	% of stock on hire	% of total
	-----	-----
Interest cost on borrowed funds	10.93	56.49
Opportunity cost of own funds	2.11	10.90
Establishment cost	6.37	32.92
Risk premium (arbitrary)	0.50	2.58
Economic rent (residual)	(0.56)	(2.89)
Total lending cost	19.35	100

Our computations show that opportunity cost of own and borrowed funds is highest, while economic rent is absent.

22.7 Industry structure

22.7.1 The size distribution of firms in the sample distribution given in Table 22.16 shows that all but two of the 13 non-corporate units were small with stock on hire less than Rs 1 crore each. The two comparatively big units which were located in the city of Madras had stock on hire between Rs 3 crore and Rs 6 crore. Of the ten corporate units, two were relatively small while seven were medium sized units with stock on hire ranging between Rs 2 crore and Rs 20 crore. One company was exceptionally large with a stock on hire of Rs 135 crore. The stock on hire of all other companies put together was only about Rs 45 crore. This large company had a stock on hire of Rs 47 crore even in 1980. Since 1960, this company, 'Sundaram Finance Limited', with its head office at Madras, has been the leader of HPF in South India. In places where this company has a branch, the first choice of a hirer of vehicles is usually this company. Of late, another HPF company has started acquiring the position of a leader in another

industrial town of Tamil Nadu, Coimbatore. This HPF company, Sakthi Finance Limited, had a stock on hire of Rs 15 crore in March 1986.

22.7.2 Interest rates on deposits in the case of non companies, show some variation ranging from one to three percentage points between different centres and firms. The hire charges of companies are generally around 14-15 per cent flat rate per annum. In the city of Madras there is a uniform rate of 14 per cent flat for all new vehicles, a rate fixed by the market leader for its clients. Competition in business forces even non-corporate units to charge the same rate in Madras, although outside Madras they charge at higher levels. The variation in hire charges of selected HPF institutions is shown in Table 22.17. Hire charges generally do not move up or down with reduction or expansion in the supply of funds of HPF companies.

22.7.3 No hurdles are there either in entering the market or leaving it except for availability of finance and some market familiarity. As has been seen, the HP business has been growing rapidly in recent years. Overall, the evidence of a market leader, coupled with relatively free entry, suggests a market structure consisting of a dominant firm with a competitive fringe.

22.8 The Delhi Case Study

22.8.1 Seven HPF companies were examined in Delhi, a fast growing centre of HPF, to find out if substantial interregional differences exist. While firms in the unorganised sector were

also approached, no cooperation was forthcoming, a feature probably due to the relative recency of most firms. While no important differences came to light, the main findings are nevertheless reported on below.

22.8.2 Sources of funds: companies in sample: As can be seen from Table 22.17, firms in the sample had, on average, the same ratio of borrowed to owned funds (Column 12) as prevailed at the All India level though the dispersion is high. Other details are as follows. The total net owned fund of HP companies in the sample was Rs. 294.97 lakh (average: Rs. 49.16 lakh). The net owned funds range from Rs. 1.47 lakh to Rs. 115 lakh. All six companies borrowed money from individuals to the tune of Rs. 1151 lakh, which represents 86.48 per cent of the total borrowing. The remaining 13.52 per cent is borrowed from banks. None of them borrowed from other financial institutions or non financial institutions.

22.8.3 The term structure of borrowed funds from individuals is given in table 22.18. All six companies offered the maximum permissible interest rate for companies as fixed by RBI on 1.4.87. That rate is 12 per cent for six months, and 14 per cent for one, two and three years (Table 22.18). Around 45 per cent of the deposits are of one year duration, 40 per cent are of two and three years duration and the rest are of six months duration. Thus, on average, deposits remain for longer periods with the older South Indian firms.

22.8.4 The structure of interest paid on borrowed funds can be seen in Table 22.19 where the estimated ratio of total interest paid (in Rs. lakh) to borrowed funds is given in column 3 of the table. The fact that the ratio of interest payments to borrowed funds is less than the weighted ratio of quoted interest rates is

indirect evidence of growth of deposits during the year. The growth rate worked out using this discrepancy is a remarkable 103 per cent on the assumption of a uniform rate of growth during the year.

22.8.5 The average period of deposit is around one year. Five companies borrowed from banks at 16.5 per cent interest per annum. In fact, H.P. companies are ready to pay more on deposits if the RBI permits them to do so. Their argument here is that, since they are ready to pay 16.5 per cent per annum to banks, why not to individuals? The low rate of interest may be a partial reason for the low ratio of deposits to net owned funds as compared to the statutory ceiling.

22.8.6 Reasons for investing own funds in hire purchase: Based on the interviews, the two important reasons for investing money in the HP business is high return on investment and low risk due to a complete absence of permanently bad debts. In the opinion of HP companies, the return on own funds can be as high as 50 per cent though subject to fluctuations. When we analysed the profit given in the balance sheets however (See Table 22.23), the average rate of return worked out to be just 13.29 per cent (for three firms). However the average rate of return may be low because of two relatively new firms in the sample. The one old reporting company had a return of 27 per cent.

22.8.7 Overall, loan terms reported in Delhi were similar to the South India study. The specific attractions of vehicle loans (the major category) are as follows: (i) the investment is safe; (ii) only medium term loans are needed; (iii) the number of borrowers is kept within limits as the average loan size is large

relative to loans for consumer durables. (iv) due to the large average loan size there are economies of scale to be garnered in transactions costs.

22.8.8 Brokerage: The main source of borrowed funds is deposits received from friends and relatives. Two companies get depositors through brokers. The brokerage reported on one year, two year and three year deposits are respectively 1 per cent, 1.25 per cent and 1.5 per cent of the deposits.

22.8.9 Bank borrowings: HP companies are able to obtain refinance from banks at 16.5 per cent per annum. Banks fix borrowing limits for each company (for six out of seven companies). Though these limits are large relative to total HP loans made (Rs. 3 crore in one case) they are used only if insufficient deposits growth relative to new business is faced in any period.

22.9 Uses of funds

22.9.1 Sector-wise break-up: Five companies lend only to finance commercial vehicles. One of the remaining two companies finances only non commercial vehicles. The seventh firm finances commercial vehicles, non-commercial vehicles and consumer durables. Of commercial vehicle financiers, four firms financed new and old vehicles and one firm financed only old vehicles. The prevalence of old vehicle finance in Delhi is about the only contrast with South India since, in South India, old vehicle finance is limited. The total funds available to the five firms lending for commercial vehicles only is Rs. 1529.97 lakh. This constitutes 94.1 per cent of the business of six companies for which data are available.

22.9.2 Structure of loans given (Terms): The structure of loans varies from company to company though certain aspects are common to all firms. The interest rate charged on new vehicles loan is from 14 per cent to 16 per cent (flat). Most firms charge 14 per cent to 15 per cent flat in the case of new commercial vehicles. In the case of old vehicles, however, rates vary between 16 per cent to 20 per cent flat due to the possibility of bankruptcy on the part of borrowers if the vehicle financed turns out to be a 'lemon' (however no such cases were reported). Loans are given for 12-36 months with monthly equated loan repayments.

22.9.3 In the case of household durables, the interest rate is 18 per cent to 20 per cent per annum with 12 to 18 monthly instalments.

22.9.4 Firms advance 50 per cent to 75 per cent of the cost of vehicles (50 per cent or 60 per cent in the bulk of cases), the rest being financed by the purchaser. On durables, 50 per cent to 70 per cent of the cost of the item is financed. Durables include T.Vs., refrigerators, video recorders, air-conditioners, and furniture. Terms observed in Delhi were much as in South India.

22.9.5 Differences in collateral requirements: HP companies in Delhi showed, once again, no important differences in collateral requirements as compared with South Indian companies.

22.9.6 Overall, there is little observable difference between HPF in Delhi and in various centres in South India.

22.10 Users of HPF institutions

22.10.1 In order to assess the usefulness of the HPF institu-

tions to their clients, we interviewed, in South India, a few users of these institutions and elicited information through a separate questionnaire. In all twelve questionnaires, seven from depositors and five from borrowers, were canvassed.

22.10.2 Depositors: All the seven depositors were employed - two advocates, one doctor, one professor, one auditor and two private office employees. Four were in the monthly income bracket of Rs 3,000 and above while three were in the Rs 2,500 to Rs 3,000 bracket. All of them maintained bank balances. Deposits with HPF companies varied from 20 per cent to 70 per cent of their financial investment. The rates of interest they got on their investments which were for one to three years were 8 per cent per annum from banks and 14 per cent per annum from HPF companies. Three of them received interest monthly, the rest quarterly. Interest payments were regular. Five of the seven depositors were regular depositors with HPF companies. When their earlier term deposits matured, they renewed them. Two were depositing for the first time. On the whole, there was no complaint regarding payment by the creditors.

22.10.3 Borrowers: Four of the five borrowers were in the monthly income bracket of Rs 1000 to Rs 2000. One belonged to the bracket of Rs 4000 and above per month. Two were auto-rickshaw drivers, one a truck operator another a light commercial vehicle operator and the last one a tourism consultant. The HP credit of the vehicle operators varied from Rs 20000 to Rs 40000. The tourism consultant took Rs one lakh HP credit to buy two tourist taxis.

22.10.4 The HP credit operations of the five hirers are shown in Table 22.18. Four of them were self employed owner drivers who

did not get finance from banks as the vehicles were old. They got the necessary finance from HPF institutions without much difficulty on hire basis and the hire charges were comparable with those of HPF companies. The hirers did not mention any complaint against the financiers although they wished the hire charges were lower. When asked about views of HPF, borrowers were complimentary. Some were refused bank finance. We may quote the words of a hirer, Mr. Kannappan; "I approached a bank. The manager said that the bank is not giving loans to buy second hand vehicles even though my request was for a five year old good vehicle."

22.10.5 In sum, the view of users of HPF institutions are that these institutions serve both depositors and hirers. Some hirers say that these institutions are their only source of credit, as banks turn down their request for loans because of collateral restrictions. However, hirers wish that the hire charges were lower. High hire charges come in the way of regular repayments.

22.11 Estimate of overall size

22.11.1 Data on total hire purchase credit extended by companies and non companies in India are not available for any year. The RBI data cover only the number of reporting HPF companies and the deposits with them. Credit extension by companies is treated as beyond the scope of RBI study. When this is the case with the better organised company sector, the position of unorganised non company sector can well be imagined.

22.11.2 An estimate of HPF institutions in India (Nayar 1984), made with the help of the Federation of Indian Hire Purchase Associations (FIHPA), put the number at 2500 by March 1984. About half of this number were members of regional associations of the

Federation. The same source puts the total HP credit outstanding to the road transport industry by all HPF institutions in 1982-83 at Rs 750 crore. Annual extensions of credit were put at about one-third of the outstandings. Thus the extension of HP credit by HPF institutions in 1982-83 was of the order of Rs 250 crore. According to information gathered from the FIHPA, the growth rate in the number of HPF institutions in the 1980's was around 10 per cent per annum and in stock on hire around 20 per cent per annum. On this basis the number of HPF institutions and the stock on hire with them at the end of March 1987 would come to 3327 and Rs 1555 crore respectively. The annual extension of HP credit in 1987, at one-third of outstandings, was thus Rs 518 crore. This method of estimation has its own limitation in the sense that both the growth percentages are based on impressionistic views.

22.11.3 We may apply another method by using the RBI data on number of HPF companies and deposits held by them. In table 22.1, we have seen that the growth rates of companies and their deposits in the 1980's were 16.77 per cent and 22.79 per cent per annum respectively. Thus, in 1987, there were 481 companies with total deposits of 343 crore; giving an average of Rs 0.71 lakh per company. If we apply the RBI growth rate of 16.77 per cent per annum to the total number of 2500 HPF institutions as estimated for March 1984, the number of such institutions at the end of March 1987 would come to 3981. Now if we apply the per company deposit of Rs 0.71 lakh to these 3981 institutions, the total deposits outstanding with them will come to Rs 2827 crore.

22.11.4 From field data (table 22.3) we have seen that stock on hire or HP credit outstanding was higher than outstanding deposits. For the 10 South Indian companies, credit was 31.55 per cent higher than deposits in 1986. For all the 29 South Indian

HPF institutions for whom data was available, this percentage was 37.44. Credit/stock on hire was about one-third higher than deposits. On this reckoning, the credit outstanding with the 3981 HPF institutions would come to Rs 37591 crore in 1987.

22.11.5 The estimates given above, however, does not include credit to transport operators by the formal banking sector. Because of the differences in the mode of financing and calculation of interest, bank loans are treated separately. The relevant data shown in Table 22.14 show that bank finance outstanding under transport operators was Rs 1895 crore as at the end of June 1986. In bank finance also, in the absence of year-wise details of disbursements, the annual credit extension may be about one-third of the outstandings.

22.12 Influence of formal sector leading rate/loan availability on business

22.12.1 Evidence has been given earlier that bank and HP loan rates do not necessarily move together in the short run though there is some evidence of their moving together in the long run. Thus with the current level of involvement of banks in financing vehicles, there is little or no effect of movements in bank charges on HP. However, as many HP clients are those who were refused credit or were ineligible for credit from banks, a slackening of credit rationing by banks is likely to have an impact on the volume of HPF.

22.13 Equity impact

22.13.1 In the matter of transport loans, the major criterion of banks is individual/self employed operators or small size firms. This is seen in the number of borrowal accounts of public

sector banks under the category, transport operators which stood at 5,94,000 at the end of June 1986. But while concentrating on small borrowers, banks leave aside many large transport operators. These operators get finance largely from HPF institutions. Thus, the impact of HPF on poorer sections is limited to any benefit from employment generation by large operators. However, the finance of used vehicles for small operators (see the chapter on auto financiers in Namakkal) suggests that the entire sector may have a positive equity impact.

22.14 Efficiency and allocative impact

22.14.1 We have examined in another chapter (Auto Financiers in Namakkal) the efficiency impact of auto finance corporations. Such financiers give sustained life for used vehicles which otherwise would have been scrapped. It is a fact that in India almost all the commercial vehicles on the road are there because there is some financier or the other to finance the purchase. HP clearly contributes to a healthy transport economy and indirectly, the automobile industry.

22.14.2 Why do transport operators or the hirers in general turn to HPF institutions in spite of the fact that bank finance is cheaper? An article in the Reserve Bank of India Bulletin gives the answer. "Credit squeeze imposed by the Reserve Bank coupled with the reluctance on the part of commercial banks to expand their hire purchase advances portfolio, in particular against second hand vehicles, as also the cumbersome formalities required to be complied with before obtaining bank finance have given a fillip to the growth of HPF companies (RBI Bulletin, June 1983). Stated differently, the operational efficiency including efficiency of HPF institutions as counted by hirers, includes few

defaults, easy access, minimum formalities, quick availability, finance for used vehicles, courteous service and finance for more than one vehicle at a time. Finally, it is clearly inappropriate to impute pollution and congestion costs to financial institutions.

22.15 Impact on savings mobilisation

22.15.1 In savings mobilisation, the role of HPF institutions is akin to that of other non banking financial companies. All of these pay rates of interest fixed by the RBI on deposits which are about three to four percentage points higher than those of banks. The fact that most HPF institutions use mainly borrowed funds in their business indicates that substantial funds are mobilised. If higher interest rates influence the saving rate then there should be some additive saving impact even if it cannot easily be estimated.

22.15.2 One innovative method of raising deposits by an HPF company may be noted here. The company accepts fixed deposits for various periods by offering the maximum permissible rate of 14 per cent per annum uniformly for one, two or three years. It not only pays monthly interest but also sends post dated monthly interest warrants for the whole deposit period in advance along with the deposit receipt. Certain formal sector banks have copied this method. This company accepts even outstation cheques at par and sends refunds, interest payments etc., to clients who can encash the same at par. On the whole, a depositor is treated as an honoured guest and extreme care is taken not to displease him. Since reduced transactions costs lead to higher effective interest rates to depositors, the argument of the last paragraph is strengthened by such practices (since this chapter was written,

issuance of post-dated interest warrants has been taken up by some formal sector institutions).

22.16 Complementarity/substitutability with formal finance

22.16.1 Before we take up the question of whether credit from HPF institutions is complementary to or a substitute for formal sector finance, we may examine the supply of credit to transport operators who are also major clients of HPF institutions, by the formal banking sector. Banks have extended substantial credit to transport operators under the head 'priority sector credit' since 1969 when the major commercial banks in India were nationalised. The number of borrowal accounts to transport operators in 1985 was 47 times the figure in 1970. Similarly, outstanding credit rose by 68 times between 1970 and 1985. The incremental credit during the 15 year period ending 1985 was of the order of Rs 1867 crore.

22.16.2 Banks usually extend credit at subsidised rates to self employed and small transport operators under the head 'priority sector advances'. They may also finance fleet owners and large commercial operators at the maximum lending rate. Besides banks, SFCs also finance transport operators. But the total disbursement of transport loans by the organised sector representing banks and SFCs is not sufficient to meet the entire demand of transport operators in the country. In fact, the supply of finance by banks in 1985-86 to transport operators appears to be very small as compared to the total demand which was estimated at around Rs 1500 crore per annum for commercial vehicles alone in 1984-85 (Nayar 1984). The organised sector is also known to have large overdues from transport loans and therefore the outstandings shown in Table 22.14 cannot truly reflect the volume of finance extended by the banks year after year. In the absence of year-

wise details of disbursements, the differences of two year end out-standings will give some indication of a particular year's disbursement. In spite of the low cost of borrowing, a bank loan is not available to all those who apply for it. There may also be delays in getting a loan. Many transport operators therefore turn to HPF institutions to meet their requirements. Finally, banks give limited finance to used vehicles.

22.16.3 With the difference that banks have greater difficulty in impounding vehicles in case of default and the alleged strong arm tactics of HPF firms, there appears to be no difference between bank and HP collateral requirements for vehicle hire purchase. This is striking in view of the vast differences between HP and bank interest rates. This is additional indirect evidence of bank credit rationing.

22.16.4 To the extent that banks refinance HPF institutions, bank and HP credit are clearly substitutes. Overall, however, given the current low levels of bank finance and refinance and the limited class of borrowers they finance, HP credit currently complements bank credit. The two cannot be said to compete for the same segments of the vehicle finance business.

22.17 Recommendations for regulatory framework

22.17.1 The deposit acceptance activities of HPF institutions are controlled by the RBI and are observed as functioning smoothly. But hire purchase transactions in India is not covered under an Act. An Act called the Hire Purchase Act, 1972 (No. 26 of 1972) was passed by Parliament and it also got the assent of

the President on the 8th June, 1972. The Act defines the various terms associated with hire purchase transactions, sets out warranties and conditions implied in every hire purchase agreement in favour of the hirer including title, quality, etc., of the hired goods, and specifies limits on hire purchase charges. It also deals with the rights and obligations of the hirer as well as the owner (financier) and specifies conditions under which the owner can terminate the hire purchase agreement. However this Act has not been enforced so far. It is reported that the Act, formulated about a decade and a half back, requires modifications. We recommend that the Act be enforced without delay with suitable modifications. Among other things, the need for an interest rate ceiling, given the market structure of the sector, should be carefully re-examined.

22.17.2 It is also suggested that banks seriously evaluate the possibility of concessional refinance of concessional priority sector advances by HP firms given their obvious absolute advantage in the provision of credit to transport operators. In fact, banks may consider stepping out of the market altogether. However, to prevent malpractices, Reserve Bank scrutiny and enforcement of the HP Act are essential.

22.18 Summary of main points

22.18.1 The sources of funds of HPF institutions are (a) capital and reserves, (b) deposits from public, (c) borrowings from banks and other formal financial institutions and (d) repayments made against hired goods.

22.18.2 The corporate units maintain high own funds position to be eligible to raise large public deposits. Own funds and deposits of non-corporate units are not related by official regulation. Non-corporate units had a higher own funds position than that of companies.

22.18.3 Banks also extend credit to transport operators and such credit has grown sizeably since 1969. Technically, banks' credit to transport operators is not on hire purchase basis but on hypothecation of vehicles. Banks charge interest on loans on outstanding balances only, against the flat rates of HPF institutions. Thus bank credit is cheaper than HP credit.

22.18.4 The ratio of borrowed to owned funds of HP companies surveyed is approximately 3:1. This is much below the statutory ceiling of 10:1.

22.18.5 Most deposits by individuals with HP companies are of one year duration and earn interest at the statutory ceiling rate. HP companies are willing to pay higher rates. Some deposits were mobilised through brokers.

22.18.6 Banks refinance HP companies upto a limited extent.

22.18.7 A share of deposits with HP firms are from outside the immediate geographical area, suggesting a degree of market integration greater than a priori expectations.

22.18.8 Owners of firms found HP attractive due to high returns (with interest rates upto 41 per cent per annum) and low risk. The low risk resulted from the fact that HP agreements were

secured by hypothecation and guarantees.

22.18.9 Most HP companies in the sample financed commercial vehicles. Both new and old vehicles were financed, the latter at higher interest rates and margin. Non commercial vehicles and consumer durables were also financed.

22.18.10 HP companies tend to finance large commercial vehicle operators whereas banks finance smaller operators.

22.18.11 The total disbursement of transport loans by banks is not sufficient to meet the demand of transport operators in the country. Thus, many transport operators turn to HPF institutions which complement in a large measure the supply of credit of banks to this vital sector.

22.18.12 The number of HPF institutions and the stock on hire with them at the end of 1987 in India are estimated at 3327 and Rs 15552 million respectively. About one third of outstandings is estimated as annual credit extension. Thus annual credit extension was about 5184 million in 1987.

22.18.13 An Act called the Hire Purchase Act 1972 was passed by Parliament and it received the assent of the President on 8th June, 1972. It has not so far been enforced. We recommend that the Act may be enforced without delay, if necessary with some modifications.

22.18.14 Banks should also consider stoppage of direct finance of transport operators.

TABLE 22.1

**Growth Rate of Hire Purchase Companies and
Their Deposits in India**

Year (ending March)	Number of comp- anies report- ing de- posits	Annual growth rate of companies (%)	Amount of depo- sits (Rs. crore)	Annual growth rate of deposits (%)	Compound average annual growth rate (%)	
					No. of compan- ies	Amount of deposits
1962	113	-	10.9	-		
1963	136	20.35	12.1	11.01		
1964	140	2.94	14.8	22.31		
1965	112	-20.00	14.1	-4.73		
1966	123	9.82	14.4	2.13		
1967	143	16.26	16.5	14.58		
1968	135	-5.59	14.8	-10.30		
1969	129	-4.44	18.8	27.03		
1970	112	-13.18	18.8	0.0		
1971	137	22.23	25.1	33.51		
Growth Rate Between 1961 and 1971					0.41	7.59
1972	140	2.19	25.3	0.80		
1973	122	-12.86	25.8	1.99		
1974	162	32.79	31.9	23.64		
1975	200	3.46	40.1	25.71		
1976	237	18.50	45.2	12.72		
1977	245	3.33	53.2	17.70		
1978	223	-8.43	60.5	13.72		
1979	222	-0.45	7.0	15.70		
1980	254	14.41	91.1	30.14		
1981	276	8.66	111.3	22.17		
Growth Rate Between 1971 and 1981					8.31	18.07
1982	247	-10.51	133.3	19.77		
1983	209	-15.38	157.9	18.45		
1984	302	44.50	138.4	-12.35		
1985	354	17.22	280.3	102.53		
1986	412	16.38	279.3	-0.36		
Growth Rate Between 1981 and 1986					16.77	22.79
1987 ¹	481	16.77	343.0	22.79		

¹ Projected using the growth rate between 1981 and 1986.

Source: Growth of Deposits with Non-Banking Companies,
Reserve Bank of India Bulletin, Various Issues.

TABLE 22.2

**Membership of Federation of Indian Hire Purchase
Finance Institutions (1986)**

S. No.	Name of member association	Approximate number of members of each association
1.	Hire Purchase Association, Calcutta - 700 001	50
2.	Jammu and Kashmir Motor Financiers' Association, Jammu (Tawi)	50
3.	South India Hire Purchase Association, Madras - 600 002	460 ¹
4.	Upper India Hire Purchase Association, New Delhi - 110 002	120
5.	Western India Hire Purchase Association, Bombay - 400 001	50
6.	Punjab and Haryana Finance Companies Association, Jullundur City	130
7.	Kanpur Financiers Association, Kanpur - 208 012	50
8.	Andhra Pradesh Hire Purchase Association, Hyderabad - 500 029	50
9.	Krishna District Auto Financiers Association, Vijayawada - 2	150
TOTAL		1110

1 : Of these, 306 are in Madras city and surrounding areas.

TABLE 22.3

**Break-up of Own Funds, Borrowings and Stock on Hire of
Sample HP Finance Institutions In South India (1986)**

S. No.	Paid up capital (Rs. lakh)	Reserves (Rs. lakh)	Owned funds (2+3)	Deposits (Rs. lakh)	Stock on hire ¹ (Rs. lakh)	Owned funds as % of deposits	Owned funds as % of stock on hire	Eligible deposits as % of funds
A. Corporate Units								
1	600.00	658.58	1258.58	10410.48	13464.85	12.09	9.35	12585.8
2	100.00	105.60	205.60	1133.07	1748.84	18.15	11.76	2056.0
3	95.86	209.96	305.82	1073.00	1264.00	28.50	24.19	3058.2
4	29.64	11.33	40.97	189.47	229.50	21.62	17.85	409.7
5	95.15	13.25	108.40	273.24	436.61	39.67	24.83	1084.0
6	35.00	15.75	50.75	403.83	302.59	12.57	16.77	507.5
7	69.79	7.90	77.69	114.26	253.91	67.99	30.60	776.9
8	20.00	2.00	22.00	14.07	8.00	156.36	275.00	220.0
9	15.00	19.66	34.66	46.87	252.05	73.95	13.75	346.6
10	2.00	0.03	2.03	3.29	11.60	61.70	17.50	20.3
Total	1062.44	1044.06	2106.50	13661.58	17971.95	15.42	11.72	21065.0
B. Non-corporate Units								
11	50.00	70.00	120.00	170.00	460.00	70.59	26.09	N.A.
12	2.00	0.50	2.50	10.00	60.00	25.00	4.17	N.A.
13	3.00	0.25	3.25	8.00	30.50	40.63	10.66	N.A.
14	3.00	0.50	3.50	9.75	26.75	35.90	13.08	N.A.
15	1.50	0.50	2.00	14.00	25.00	14.29	8.00	N.A.
16	2.00	0.50	2.50	4.50	20.50	55.56	12.20	N.A.
17	2.00	0.00	2.00	0.00	20.80	-	9.62	N.A.
18	2.50	0.00	2.50	6.00	18.50	41.67	13.51	N.A.
19	2.00	0.00	2.00	7.00	17.50	28.57	11.43	N.A.
20	1.00	0.00	1.00	3.00	17.30	33.33	5.78	N.A.
21	2.00	0.25	2.25	7.00	13.50	32.14	16.67	N.A.
22	0.50	0.00	0.50	0.75	5.25	66.67	9.52	N.A.
23	25.00	5.00	30.00	125.00	590.00	24.00	5.08	N.A.
Total	96.50	77.50	174.00	365.00	1305.60	47.67	13.33	N.A.

¹ Stock on hire (current assets) represents amounts receivable under the various HP agreements including hire money dues in arrears, if any.

TABLE 22.4

**Trend in Growth of Deposits with Sample South Indian
HPF Institutions (1981 to 1986)**

(Amount in Rs. lakh)

S.No. of insti- tutions	1981	1982	1983	1984	1985	1986	Compound average annual gro- wth rate (%)
A. CORPORATE UNITS							
1	3546.47	4519.66	5910.00	7163.00	8649.06	10410.48	
2	200.69	293.51	440.71	614.63	843.27	1133.07	
3	348.00	509.00	667.00	783.00	908.00	1073.00	
4	0.00	35.92	47.18	72.67	131.33	189.47	
5	0.00	0.00	0.00	22.53	79.70	273.24	
6	0.00	8.74	18.87	109.21	297.58	403.83	
7	0.00	0.00	0.00	0.00	39.05	114.26	
8	0.00	0.00	6.60	13.18	13.46	14.07	
9	28.17	32.92	35.90	40.10	41.68	46.87	
10	2.23	2.25	2.53	2.66	2.98	3.29	
SUBTOTAL	4125.56	5402.00	7128.79	8820.98	11006.11	13661.58	26.89
B. NON-CORPORATE UNITS							
11	75.00	90.00	100.00	112.00	135.00	170.00	
12	7.00	8.50	9.00	10.00	10.00	10.00	
13	7.00	8.00	10.00	9.25	8.50	8.00	
14	7.00	7.35	7.90	6.50	8.45	9.75	
15	11.00	12.00	12.50	15.00	12.00	14.00	
16	1.00	1.50	2.25	3.00	4.00	4.50	
17	0.00	0.00	0.00	0.00	0.00	0.00	
18	5.00	7.00	7.00	8.00	7.50	6.00	
19	4.00	5.25	5.00	6.50	5.75	7.00	
20	3.00	3.50	3.90	4.05	3.75	3.00	
21	5.00	5.25	5.75	5.75	6.50	7.00	
22	0.00	0.50	0.50	0.25	0.75	0.75	
23	0.00	0.00	75.00	80.00	90.00	125.00	
SUBTOTAL	125.00	148.85	238.80	260.30	292.20	365.00	23.78
TOTAL	4250.56	5550.85	7367.59	9081.28	11298.31	14026.58	26.80

TABLE 22.5

**Borrowings and Cash Balances of
Sample South Indian HPF Companies (1986)**

Selected HP companies	Borrowings/ refinance from banks (Rs. lakh)	Cash balan- ces of HPF companies with banks (Rs. lakh)	Borrowings as % of stock on hire ¹
(1)	(2)	(3)	(4)
1	21.49	1420.96	0.16
2	N.A.	N.A.	N.A.
3	327.10	N.A.	25.88
4	37.64	24.38	16.40
5	26.50	34.97	6.07
6	N.A.	N.A.	N.A.
7	118.32	15.15	46.60
8	Nil	2.21	-
9	47.45	17.96	18.83
10	0.65	0.47	5.60
TOTAL	579.15	1515.90	3.64

1: Stock on hire figures of relevant companies are taken from column 6, of Table 22.3.

TABLE 22.6

Period of Funds Availability: South India

(% of total deposits)

HPF Institutions	6 month	1 year	2 years	3 years
A. Corporate Units				
1	-	3.55	4.30	92.15
2	-	2.46	1.56	95.98
3	-	14.00	9.00	77.00
4	10.00	20.00	30.00	40.00
5	12.00	23.00	37.00	28.00
6	10.00	30.00	20.00	40.00
7	-	20.00	10.00	70.00
8	-	5.00	5.00	90.00
9	-	2.00	8.00	90.00
10	-	30.00	-	70.00
Average of Corporate Units	3.20	15.00	12.49	69.31
B. Non-corporate Units				
11	42.00	50.00	5.00	3.00
12	-	60.00	10.00	30.00
13	-	90.00	-	10.00
14	-	85.00	-	15.00
15	-	75.00	-	25.00
16	-	80.00	5.00	15.00
17	-	80.00	-	20.00
18	-	90.00	-	10.00
19	-	100.00	-	-
20	-	75.00	5.00	20.00
21	-	100.00	-	-
22	-	80.00	5.00	15.00
Average of Non-corporate Units	3.50	80.42	2.50	13.58

Note: One non-corporate unit has no public deposits.

TABLE 22.7

**Interest Rates on Term Deposits of Banks and
HPF Institutions in South India (1.4.1987)**

Type of Institutions	Annual compound interest rates in per cent per annum					
	6 months	1 year	2 years	3 years	3 year cash certificate/ interest reinvestment plan	Weighted average per annum
(1)	(2)	(3)	(4)	(5)	(6)	(7)
A. Commercial Banks	8.24	9.31	10.38	10.38	11.50	N.A.
B. Selected HP finance companies (corporate) ¹	13.80	14.37	14.93	14.93	14.93	14.81
C. Selected HP finance institutions (non-corporate) ²	16.08	18.54	19.07	21.88	-	18.92

1 : Interest rates of HPF companies are regulated by the RBI and all companies pay almost the same rates.

2 : Average of 12 units.

3 : Interest is normally paid monthly by HPF firms.

TABLE 22.8

Cost of Funds of HP Finance Institutions: South India (1987)

Item	Cost as per cent of deposits/borrowings	
	Companies	Non-companies
(1)	(2)	(3)
Interest paid to deposits (weighted average)	14.89	18.92
Brokerage ¹ commission	0.25	0.25
Concessional interest ²	0.05	Nil
Advertisement expenses ³ (including supply of promotional literature)	0.75	Nil
Total	15.94	19.67
Rate of interest on refinance from banks	16.50	16.50
Average cost of funds	15.50	18.20

- 1 : Companies are allowed to pay brokerage at the rate of 1% to 1.5% of deposit amount depending on the period. However, it is only a one time payment at the time of deposit.
- 2 : Certain companies allow 0.5 per cent more for deposits of staff members and shareholders.
- 3 : All companies which accept deposit are required to advertise (see the Appendix). The percentage is calculated from annual reports of sample companies.

TABLE 22.9

Uses of Funds of South Indian HPF Companies (1986)

(Rs. lakh)

Company	Net block assets	Net current assets	Investments	Miscellaneous expenditure not written off or adjusted	Total sources/uses of funds
1	2020.50	11615.73	182.15	Nil	13818.38
2	N.A.	N.A.	N.A.	N.A.	N.A.
3	464.17	1978.28	41.27	Nil	2483.72
4	63.90	241.45	Nil	7.86	313.21
5	118.76	106.59	2.26	7.87	235.48
6	N.A.	N.A.	N.A.	N.A.	N.A.
7	88.80	247.97	2.25	10.66	349.68
8	6.64	32.46	Nil	0.25	39.35
9	12.63	116.36	Nil	Nil	128.99
10	0.92	12.57	Nil	Nil	13.49
Total of 8 companies	2776.32	14351.41	227.93	26.64	17382.30

TABLE 22.10

**Estimated Deployment of HP Credit by
South Indian HPF Companies**

S. Item financed No.	Per cent of total credit per firm	Average credit per (new) item (Rs)
1. Trucks/buses	30	1,50,000
2. Passenger cars/jeeps	20	70,000
3. Light commercial vehicles	15	75,000
4. Tourist taxis	10	60,000
5. Two wheelers	10	8,000
6. Equipment/machinery	10	20,000
7. Others (TV, refrigerator, air conditioner, etc.)	5	5,000

TABLE 22.11

Hire Charges of HPF Institutions in Different Regions

Region	Flat rate per cent per annum (1970- 71) ¹	Flat rate per cent per annum (1985-86) ²
Southern region	9-12	14-16
Western region	10-12	15-18
Northern region	10-15	16-18
Eastern region	10-15	18-20

Sources 1 : Report of the Study Group on Non-Banking Financial Intermediaries, Banking Commission, Govt. of India, p. 32.

2 : On the basis of information gathered from the Secretary General of the Federation of Indian Hire Purchase Associations, Sundaram Finance Building, Madras-2.

TABLE 22.12

Public Sector Banks' Advances to Transport Operators

Year (June end)	Number of accounts	Amount outstand- ing (Rs. million)	Growth rate over the previous year (%)		Incremental advances (Rs.million)
			Number of accounts	Amount outstanding	
1970	12690	277.4	-	-	-
1971	23276	398.5	83.42	43.66	121.1
1972	31098	504.7	33.61	26.65	106.2
1973	43953	628.0	41.34	24.43	123.3
1974	63572	833.7	44.64	32.75	205.7
1975	73446	1133.7	67.10	35.98	300.0
1976	107518	1934.0	46.39	70.59	800.3
1977	170415	2527.8	58.50	30.70	593.8
1978	198670	3066.1	16.58	21.30	538.3
1979	228625	3864.0	15.08	26.02	797.9
1980	259000	5273.3	13.29	36.47	1409.3
1981	311000	7570.0	20.08	43.55	2296.7
1982	367000	9930.0	18.00	31.18	2360.0
1983	435000	12990.0	18.53	30.82	3060.0
1984	520000	16600.0	19.54	27.79	3610.0
1985	583000	18550.0	12.12	11.75	1950.0
1986	594000	18950.0	1.89	2.16	400.0

Source: **Economic Survey**, Ministry of Finance,
Government of India, various issues.

TABLE 22.13

Profitability of Sample South Indian Companies

(Rs lakh)

Company	Income			Expenditure			Profit or loss (-) before tax		
	1984	1985	1986	1984	1985	1986	1984	1985	1986
1	2025.2	2470.6	3239.2	1745.1	2089.5	2950.9	280.1	381.1	288.3
2	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	22.1	28.7	47.1
3	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	41.5	65.3	85.7
4	24.4	42.6	70.4	19.6	33.3	55.8	4.8	9.3	14.6
5	N.A.	9.9	53.9	N.A.	8.1	33.5	N.A.	1.8	20.4
6	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
7	2.1	24.3	59.1	0.9	15.3	44.3	1.2	9.0	14.8
8	7.2	7.5	7.8	4.9	5.6	6.5	2.3	1.9	1.3
9	37.2	40.8	44.5	31.1	33.5	36.2	6.1	7.3	8.3
10	N.A.	1.8	2.5	N.A.	1.5	2.2	N.A.	0.3	0.3
	2096.1	2597.5	3477.4	1801.6	2186.8	3129.4	358.1	504.7	480.8

Source: Annual Reports of the Companies.

TABLE 22.14

**Distribution of Selected HPF Institutions According
to Size of Stock on Hire (1986)**

Range of stock on hire (Rs. lakh)	Number of HPF institutions		
	Corpor- ate units	Non cor- porate units	Total
Below 10 lakh	1	1	2
10 lakh to 20 lakh	1	4	5
20 lakh to 30 lakh	-	4	4
30 lakh to 50 lakh	-	1	1
50 lakh to 100 lakh	-	1	1
100 lakh to 200 lakh	-	-	-
200 lakh to 300 lakh	3	-	3
300 lakh to 400 lakh	1	1	2
400 lakh to 600 lakh	1	1	2
600 lakh to 1,000 lakh	-	-	-
1,000 lakh to 2,000 lakh	2	-	2
2,000 lakh to 10,000 lakh	-	-	-
Above 10,000 lakh	1	-	1
Total	10	13	23

TABLE 22.15

Variation in Hire Charges of South Indian
HPF Institutions

Hire charges (flat rate per cent per annum)	Number of institutions charging the same rate	
	Corporate units	Non corporate units
13	1	-
14	6	1
14.5	1	-
15	2	-
16	-	2
17	-	-
18	-	-
19	-	-
20	-	4
21	-	6
Total	10	13

TABLE 22.16

Details of HP Credit of Users of Credit

Hirer	Hired goods	H.P. credit (Rs)	Period (months)	Hire charges (flat rate in %)	Instalment per month (Rs)
1	Truck	40,000	36	14	1,578
2	Auto-rickshaw	25,000	30	14	1,125
3	Delivery van	35,000	30	15	1,605
4	Auto-rickshaw	20,000	30	14	900
5	Tourist taxis (2)	1,00,000	12	16	9860 for 10 month 8700 for 2 months

TABLE 22.17

Sources of Funds: Delhi Sample

Company No.	Owned funds (in Rs. lakh)	Borrowed funds						Total borrowed funds		Total available funds (in Rs. lakh)	Ratio of borrowing to net owned funds
		From Delhi			From Outside Delhi			Amount (in Rs. lakh)	Percentage of total available funds		
		From individuals		From banks	From individuals		Amount (in Rs. lakh)				
		Amount (in Rs. lakh)	Percentage of total borrowings	Amount (in Rs. lakh)	Percentage of total borrowings	Amount (in Rs. lakh)		Percentage of total borrowings			
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
1	8.00	25.00	78.13	5.00	15.63	2.00	6.24	32.00	88.00	40.00	4.00
2	7.50	43.00	86.00	7.00	14.00	NIL	-	50.00	86.96	57.50	6.67
3	1.47	9.60	80.00	-	-	2.40	20.00	12.00	89.09	13.47	8.16
4	88.00	17.00	7.87	5.00	2.31	194.00	89.82	216.00	71.05	304.00	2.45
5	75.00	8.00	38.10	13.00	61.90	-	-	21.00	21.86	96.00	0.28
6	115.00	100.00	10.00	150.00	15.00	750.00	75.00	1000.00	89.69	1115.00	8.70
Total	294.97	292.60		100.00		948.40		1331.00		1625.97	
Average	49.16	33.76	15.23	30.00	13.52	158.07	71.25	221.83	81.86	270.99	4.51

Notes: 1. RBI ceiling corresponding to column (12) is 10 times of own money.

2. In 1985 the All-India average for HP companies was 4.39.

TABLE 22.18

Term Structure of Borrowed Funds from Individuals: Delhi

(Percentages of total deposits)

Term	Company number						Interest per annum (%)
	1	2	3	4	5	6	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
6 months	N.A.	40	N.A.	NIL	NIL	20	12
1 year	N.A.	20	N.A.	40	70	50	14
2 years	N.A.	40	N.A.	60	30	30	14
3 years	N.A.		N.A.				14

Notes: 1. Interest corresponds to maximum specified by RBI.
 2. Corresponding bank interest rate for 1 to 3 years is 16.5%.

TABLE 22.19

Interest Paid on Borrowed Funds: Delhi

Company No.	Total interest paid (in Rs. lakh)	Estimated ratio of (2) to borrowed funds
(1)	(2)	(3)
1	1.40	0.0438
2	7.00	0.1400
3	1.45	0.1208
4	24.00	0.1111
5	2.00	0.0952
6	N.A.	-
Total	35.85	0.5109
Average	7.17	0.10218

TABLE 22.20

Uses of Funds

Company	Item		
	Commercial vehicles	Non-comm- ercial vehicles	Others
(1)	(2)	(3)	(4)
1	YES	NO	NO
2	YES	NO	NO
3	YES	NO	NO
4	YES	NO	NO
5	YES	YES	YES
6	YES	NO	NO
7	NO	YES	NO

TABLE 22.21

Interest Structure of Funds Advanced

Comp pany	Item	Int- erest rate (in %)	No. of instal ments	% of -cost of item finan- ced	Effec- tive annual compound interest rate (%)	Secu- rity colla- teral	Remarks known parties/ unknown/ both
1	Vehicle (N)	14-16	12-36	60	28-32	H;2T	Both
	Vehicle (O)	18-20	12-36	50	36-41	-do-	-do-
2	Vehicle (N)	15	12-36	50	30-31	-do-	known
	Vehicle (O)	16-18	12-36	50	32-36	-do-	-do-
3	Vehicle (O)	18-20	18-24	4	36-40	-do-	-do-
4	Vehicle (N)	15-16	36	75	29-32	-do-	Both
	Vehicle (O)	16-17	36	60	32-35	-do-	-do-
5	Vehicle (N)	14	12-36	50-70	28	-do-	-do-
	Household durables	18-20	12-18	50-70	36-41	H;1T	-do-
6	Vehicle (N)	14	24-36	75	28	-do-	-do-
	Vehicle (O)	18	24-36	60	36	-do-	-do-

- Notes: 1. Effective interest rates were computed.
2. Loan terms are independent of duration of loan.
3. O: Old; N: New; H: Hypothecation; 1T: one third party guarantee; 2T: 2 third party guarantees.
4. Loan plus interest amount should be less than 2/3 of the cost of the vehicle.

TABLE 22.22

Transactions with Banking Sector

(in Rs Lakh)

Company No.	Borrowings from banks	Deposits
(1)	(2)	(3)
1	4	NA
2	6	3.1
3	NIL	1.0
4	5	25.5
5	13	2.9
6	150	90.0
Average	29.6	21.2

1. Company 7 claims to enjoy limits of Rs. 3 crore for refinance from a bank.

TABLE 22.23

Profit as Given in Financial Statements: Delhi

(Rs lakh)

Company	Own funds	Profit earned	Percentage of profits to net own funds (3)/(2) x 100
(1)	(2)	(3)	(4)
2	7.50	2.07	27.60
4	88.00	7.62	8.66
7	201.00	7.31	3.64
		Total	39.89
		Average	13.29

TABLE 22.24

Growth of Deposits of H.P.
Companies: Delhi

(Rs. lakh)

Company	Deposits received		Growth rate (3)/(2)-1
	Previous year	This year	
(1)	(2)	(3)	(4)
2	43.86	43.57	(0.01)
4	106.02	205.58	0.939

CHAPTER 23

CHIT FUNDS IN SOUTH INDIA WITH A NOTE ON COMMUNITY CHITS

23.1 Introduction

23.1.1 A chit fund (or Kuri or Chitty or Chit) is an indigenous financial institution in India of the type known as a rotating savings and credit association (ROSCA). It predates the spread of modern banking and the advent of British rule in India (Brahmananda, 1973). A chit is a transaction in which a group of persons (the foreman) enter into an agreement with a number of other persons (the subscribers) who agree to subscribe a specified amount of money in periodical instalments for a specified period and receive the total collections, less any agreed deductions, in turn as determined by lot or auction or such other manner as is provided for in the bye-laws. Thus in an agreement with 50 persons subscribing Rs 100 per month for 50 months, each person receives the total collections of Rs 5000, less any agreed deductions, in turn once during the tenure of the scheme. Terms used in chit transactions are given in the Appendix to this chapter.

23.1.2 There are different methods to decide the turn of each subscriber for prize winning. In the early stage when chit funds were organised by small groups in villages for mutual help, the decision was taken by the Karapramani (village leader) or president (foreman) of the group, who functioned in an honorary capacity. For detailed description of evolution, working and development of chit funds see Nayar (1973), Nayar (1984), Nayar (1986) and Radhakrishnan and others (1975).

23.1.3 Lot chits: In lot chits the prized subscriber is selected from among eligible members (that is all members who are not defaulters and have not taken the prize amount) by lot. Usually members of lot chits are those who want to accumulate savings.

23.1.4 Auction chits: The auction principle was introduced to eliminate the chance element and give members the opportunity to take the prize amount when they want it. Under this system, the capital less the foreman's commission is kept open for bidding. The members or their proxies offer discount on this amount and the one who offers the highest discount (or accepts the lowest prize amount) is the prize winner. Auctions are normally of the type known as 'english auctions'. Auction chits are advantageous to businessmen who are in need of credit. By joining an auction chit of their choice and paying subscription for one or two months they can bid for a fairly big sum. In very long period chits of 100 to 120 months, the discount rate may reach 70 per cent if there is no restriction on bidding. However, customarily and legally, bidding is restricted. While the Chit Funds Act, 1982 restricts the bid to 30 per cent of the capital of the chit including foreman's commission, chit fund foremen fix it at 40 to 50 per cent under certain conditions. When maximum bids are tied, a draw is held among such bidders to decide the prize winner. Auction chits are also known as "business chits".

23.1.5 Tender chits: These use (first price) sealed bid auctions instead of english auctions.

23.1.6 Auction-cum-lot chits: Some chit funds follow this method to mix the features of lot chits and auction chits in one chit. There are two types of this mixed variety. In one scheme the auctions and lots alternate in different instalments. The second method is to auction and draw pre-specified fractions of the total prize amount, the fraction remaining constant across instalments. There are provisions for fractional membership also.

23.1.7 Fixed discount: In order to compensate late prize winners in lot chits and long term auction chits with a ceiling on discount and dividend distribution to all members, some foremen deduct a fixed sum, usually five per cent of the capital, and distribute it as fixed dividend among the non prize winners. As the chit period proceeds, the share of this dividend per non-prized member increases because the number of members eligible for dividend decreases with each instalment. In the last instalment, the entire dividend is received by the last prized member. Thus a form of interest with a rising term structure results.

23.1.8 Auction dividend: Initially, when auction chits were introduced, the discount offered at auction was distributed only among non-prized subscribers. The prized subscribers had to pay the full subscription at all instalments after taking the prize amount. This imposed a heavy burden on those who took the prize early, and therefore became unpopular among businessmen. Subsequently, the system was changed and discount offered at each instalment was distributed to all members. In auction chits with fixed discount, the prized subscribers get only auction dividend after taking the prize amount while the non-prized subscribers get both auction dividend and fixed dividend.

23.1.9 Pooval kuri/chitty: This is a long term chit extending upto 20 years with subscriptions made in three or four instalments a year. Traditionally, subscription to long term chits coincided with the harvest time. The name pooval is derived from the Malayalam word 'poo' or 'poovu' meaning crop.

23.2 Geographical dispersion of chit funds

23.2.1 About 75 per cent of chit fund institutions comprising companies, partnership firms and individual concerns and also total chit subscriptions in India are in South India. Again, in South India, Tamil Nadu and Kerala accounted for 73 per cent of the number of companies and chit subscriptions (Nayar 1984). However, after the promulgation of Kerala Chitties Act 1975, many

chit funds in Kerala either shifted to other States where there were no chit fund Acts (for instance Karnataka and Jammu and Kashmir) or started business from newly opened branches to circumvent the stringent provisions in the Act. According to RBI data, there were 1066 chit fund companies in India at the end of March 1986. Besides these, there are many chit funds owned by partnership firms and proprietary concerns. Table 23.1 gives details of deposits with chit funds in comparison to that of banks. The table shows that chit subscriptions rose from 0.03 per cent of bank deposits in 1971 to about 1 per cent in 1987 in the company segment.

23.3 The South India Study

23.3.1 Area surveyed and description of sample: As the concentration of chit fund companies is in South India, we selected firms in all four southern states in this region for study.

23.3.2 Primary data were collected from chit fund institutions, chit subscribers and a few associations of chit fund foremen. As there is no list of chit funds even for companies, we selected 50 chit funds and an equal number of chit subscribers from the four southern States. The selection of chit funds was purposive and stratified. Subscribers were selected from the list supplied by the sample chit funds. However, only 79 respondents, (37 chit funds and 42 members) furnished full details.

23.3.3 The expansion of the company sector in the 1980's, particularly from 1983, is due to the encouragement and concessions made available to the company sector by some State Chit Funds Acts and the recent Indian Chit Funds Act, 1982. This led many non-company chits to incorporate which is partly responsible for the steady increase in deposits after 1983 reported above.

23.3.4 The efforts of chit funds at savings mobilisation in South India can be appreciated better if a comparison is made between chit subscriptions and bank deposits in South India. The RBI surveys do not give State or region-wise details of chit com-

panies. One source (Nayar, 1984) puts the figures for 1981 at 397 in South India and 555 in the whole of India. Chit subscriptions of these 397 companies were Rs 113.40 crore out of a total of Rs 156.40 crore (72.5 per cent). In the same year, total deposits with all scheduled commercial banks was Rs 8426 crore (RBI, Banking Statistics). Thus chit subscription was 1.35 per cent of bank deposits in 1981. Bank deposits in the Southern region in 1984 (the latest year for which data are available) was Rs 1386.9 crore (RBI, Ibid). 72.5 of total chit subscriptions in 1984 (Rs 380.7 crore) equals Rs 276 crore, a rough estimate of aggregate chit subscription in South India. This puts chit subscription at 2 per cent of bank deposits in South India.

23.4 Sources of funds

23.4.1 Sources of funds of chit fund institutions include capital subscribed by promoters/shareholders, reserve funds, commission received from chit subscribers and contribution of initial instalment by all members. If it is a company incorporated under the Indian Companies Act, it can accept deposits equal to 40 per cent (25 per cent from the public and 15 per cent from shareholders and directors) of its paid up capital and free reserves. Chit funds are not permitted to conduct any other business as per the Chit Funds Act 1982.

23.4.2 In the early stage of its evolution, chit funds were organised by those who were in need of assistance. They took collections from members in the first instalment and returned the same in later instalments. There was no question of investment of capital by such organisers. In a very large number of cases "chits were organised by a person in need of such accommodation as a simple way of getting a loan on easier terms than he could procure from elsewhere" (Madras Provincial Banking Enquiry Committee, 1930) and not as a business requiring investment. A chit fund promoter was "usually a man of straw" (Ibid, para 487).

23.4.3 The situation changed after the introduction of the

auction principle for distribution of prize amounts and with the emergence of institutional foremen who conducted chit funds as a business. Financial investment was necessary for office premises, furniture, staff and publicity. Besides, provision had to be made for probable delays and defaults of instalments by members in order to make prompt payments to prize winners. Theoretically, if all members make payments regularly, there is no need for much investment in a chit fund as the foreman acts only as an intermediary who receives and distributes subscriptions.

23.4.4 As per the Chit Funds Act 1982, "a company shall not commence or carry on chit business unless it has a paid up capital of not less than rupees one lakh". Further, "every company carrying on chit business shall create and maintain a reserve fund and shall, out of the balance of profit of each year disclosed in its profit and loss account and before any dividend on its shares is declared, transfer to such reserve fund a sum equal to not less than ten per cent of such profit".

23.4.5 Before any chit fund legislation was introduced, the foreman's commission was customarily fixed at the rate of one instalment per chit. That is, if the subscription per month was Rs 100 and if there were 30 members (months), the total commission as also the chit amount would be Rs 3000. Each member would thus contribute Rs 3000 in 30 months and get back Rs 2900, Rs 100 being the commission. Even in auction chits, this principle was followed, the auction commencing with a capital of Rs 2900. In effect, the foreman would receive in the first month subscriptions from 29 subscribers (Rs 2900) without contributing any amount afterwards.

23.4.6 The Chit Fund Act 1982, specifies that the foreman shall be entitled "to obtain the chit amount at the first instalment without deduction of the discount specified in the chit agreement, subject to the condition that he shall subscribe to a ticket in the chit" and to such amount not exceeding five per cent of the chit amount as may be fixed in the chit agreement by way of

commission, remuneration or for meeting the expenses of running the chit." In the example mentioned above, the chit amount is Rs 3000 and the commission at the rate of five per cent is Rs 150. In the course of 30 months, the foreman is entitled to receive Rs 4500 (30xRs150) as against only Rs 3000 prior to chit fund legislation.

23.4.7 Chit fund companies do not get any refinance or temporary accommodation from banks, even though all of them keep security deposits as per the Chit Funds Act with them. These deposits individually run into lakhs of rupees and collectively into crores of rupees. In times when there are defaults by some members, these companies borrow at relatively high rate of interest mostly from directors, shareholders and partners and also from indigenous bankers.

23.4.8 Of the sources of funds of chit funds, commission from subscribers is a regular source of income and lasts until the end of each chit period. Borrowed funds are mostly for a short period of one year. As chit fund companies do not offer very high rate of interest, their access to public deposits in the informal market is limited. In most cases, the amount they get at the first instalment is utilised as security deposit as per the Chit Fund Act. This leaves chit funds with little cash for working capital requirements, although such requirements are small. Ploughed-back resources cannot ordinarily be used for working capital as the Act stipulates that "no company shall appropriate any sum or sums from the reserve fund except with the prior approval of the registrar".

23.4.9 Most chit fund companies do not borrow from the public. They limit the borrowings to shareholders and directors. To these depositors they pay interest as applicable to non-banking financial companies, presently at 13 per cent to 14 per cent per annum, for one to three year periods. The rates are about four to five percentage points higher than those of banks. Data presented in Table 23.2 show that their borrowings outside their chit business

are much less than the permitted level of 40 per cent of their net owned funds.

23.5 Uses of funds

23.5.1 A distinction will have to be made between chit funds and other financial intermediaries in discussing uses of funds. Other financial intermediaries raise funds from savers and lend them to borrowers. It is they who fix the rates for both deposits and loans and, more importantly, it is they who decide whom to lend to and whom not to lend to. Profit from the difference in interest rates on deposits and loans arises in the course of financial intermediation.

23.5.2 In contrast to such active financial intermediaries, a chit fund institution merely acts as a passive middleman without any right to fix the discount rate, select the prize winner and alter his income. Through the process of auction, a member of a chit fund fixes his discount (borrowing) rate and time of borrowing. The foreman simply receives the subscriptions, pockets the fixed income (commission) and releases the balance as prize amount and dividends. He cannot keep the amount, except for a short period to complete formalities, or lend it to anybody. Furthermore, it is difficult to classify members into investors and borrowers. Members of chits, except for the first and last prize winners, are both investors and borrowers. In auction chits, some members bid for the prize amount and pay a price for taking it in advance. These members are evidently 'borrowers' and in auction chits all except the foreman who takes the full prize amount at the first instalment by virtue of his unique position and the last few members who get the prize amount without bidding may be termed borrowers, while the last few members may be called 'investors'. Clearly, this is not entirely satisfactory. In the absence of exact information on specific borrowers, an alternative is to look at ex post data and treat subscribers whose total net subscription exceeds the prize amount as borrowers and those who receive more from the chit fund than their subscription as investors. Clearly,

this is equally unsatisfactory. As such, the main interest in examining the use of funds of chit funds is to examine the occupation of subscribers without attempting to distinguish between borrowers and savers.

23.5.3 Type of subscribers and loan size: Field data show that businessmen (45 per cent), salary earners (27 per cent), housewives and self employed (10 per cent each) and agriculturists (8 per cent) are the major subscribers (Table 23.3). This pattern of subscribers suggests that prize money does not primarily go for consumption loans, a presumption that is verified from our survey of borrowers (see below).

23.5.4 The size of borrowing from chit funds depends on the chit amount of each chit, the round of the chit during which the subscriber is prized and the (fixed plus auction) discount offered. According to the Chit Funds Act 1982, which fixes a maximum discount of 30 per cent, at least 70 per cent of the chit amount must be borrowed, the rest accounting for foreman's commission (5 per cent) and discount. As the chit period advances, the net amount of loan tends, on the one hand, to increase as the bidding intensity decreases but tends to decrease, on the other hand, since cumulative subscriptions of unprized subscribers grow. In general, a decreasing trend will be observed.

23.5.5 Security: Chit funds take security from prized subscribers in advance. In many cases (97 per cent of the sample companies), chit foremen accept personal guarantees signed by two sureties. Other securities accepted are life insurance policies, bank guarantees and landed property (94 per cent). As per the Chit Funds Act, 1982, a chit foreman is entitled "to demand sufficient security from any prized subscriber for the due payment of future subscriptions payable by him", and "a security shall be deemed to be sufficient if its value exceeds by one-third or if it consists of immovable properties, the value of which exceeds by one-half of the amount due from the prized subscriber". No other charges except penal interest on overdue instalments are col-

lected from borrowers.

23.5.6 Loan duration: The loan duration varies inversely with the period in which the subscriber is prized. The period of loan varies from a maximum of the chit period less one month (since the foreman gets the first month's prize) to a minimum of one month in a monthly chit. For example, in a 111 month chit, the loan period varies from 110 months in the case of the first prize winner to one month in respect of the last but one prize winner. Each member has a different loan duration. The Chit Funds Act 1982 fixes the maximum period of a chit at 60 months. The minimum loan period in all monthly chits is one month.

23.5.7 Bad debts/overdues: Seventy five per cent of the respondent institutions reported bad debts. 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.

23.5.8 Creditworthiness assessment procedure: As prize amounts are disbursed against security, creditworthiness of a member is rarely investigated by the foremen, although they give preference to persons known to be economically sound when they enroll members. But when they take security against prize amounts, foremen are cautious, sometimes extra-cautious, giving rise to delay in disbursement of prize amounts and complaints from prized subscribers. It is to prevent such delays that the Chit Funds Act has specified the value of security as mentioned above.

23.5.9 Complementarity/substitutability with formal finance: For subscribers, a chit fund is more than a bank because it combines savings and credit in one scheme. The unique nature of its operations distinguishes a chit fund from a bank. Upto the 1960s banks conducted chit funds in South India. In fact, "most of the banks in the erstwhile Travancore-Cochin State have grown out of the womb of chit and kuri funds that have been operating in the State since ancient times". (Travancore-Cochin Banking Enquiry Commis-

sion, 1956). Further, "the business conducted by banks was not limited only to the twin functions of acceptance of deposits and dispensing credit; the business of kuries or chitties formed a substantial portion of their total business which would be evident from the fact that as many as 116 banks were conducting kuries during the thirties (Ibid.). The Commission points out that of 136 banks they had examined in the Travancore-Cochin area, as many as 85 banks conducted kuries. "As on the 31st December 1955, the number of current kuries or chitties conducted by them was 480 of a total amount of Rs 27.45 crores" (Ibid). However, presently, banks are not allowed to conduct chit fund business and many subscribers who were served by banks switched to chit fund companies when the former closed their chit funds.

23.5.10 It is clear therefore, that chit funds were in competition with formal finance earlier. Should banking policy change, this will once more be the case, probably to the disadvantage of independent chit funds. However, as discussed in the survey of borrowers later in this chapter, most business subscribers join chit funds to ensure that liquid funds become available at short notice in case of need - by stepping up the bidding. Clearly, bank overdraft facilities would serve the same purpose if they were given and, in view of the high (expected) cost of borrowing from chit funds discussed below, preferred. Consequently, it can clearly be inferred that chit funds serve firms who have insufficient access to bank overdraft facilities. We may therefore conclude that the two are complementary given current banking practice.

23.6 Cost of intermediation and profitability

23.6.1 Here again, a distinction will have to be made between a chit fund institution and other financial intermediaries. A chit fund institution takes only a fixed commission from members. Other financial intermediaries pay interest for deposits and receive interest on loans and hence in their case the cost of intermediation can be worked out as the difference between the two.

23.6.2 As far as a chit foreman is concerned, he receives only a service charge. The bulk of funds is transacted between members who share among themselves the price paid by prized subscribers as discounts. The cost of intermediation, that is the cost of bringing borrowers and lenders together, is thus exactly equal to the foreman's commission which is typically 5 per cent of the chit capital. Thus, a striking feature of chit funds is the constant cost of intermediation to the borrowers regardless of the size of the chit business. Clearly for large chit fund firms there may be scale economies.

23.6.3 The details of income and expenditure of selected chit fund institutions for 1986 are given in Table 23.5. The bulk of income (79.48 per cent) came from commissions. On the expenditure side, about 43 per cent was spent on salary. Other major items of expenditure were rent (5.9 per cent) and printing (6.7 per cent). With a total income of Rs 6.39 lakh and a total expenditure of Rs 4.06 lakh, the sample chit funds showed a profit of Rs 2.3 lakh or about 36.5 per cent of income.

23.6.4 Profitability to members: The factors involved in assessing returns to members are the instalment in which the prize is taken, the discount offered on the prize, commission to the foreman, facility of fixed discount if any and whether there is a ceiling on bidding or not. Normally, in a long period chit, there will be heavy discounts in the early period, the prize winners who offer such heavy discounts expecting to recover the loss from the investment of prize amount in profitable avenues. Different methods for assessing returns have been tried by different banking enquiry committees (all India Rural Credit Survey, 1951-52, Travancore Cochin Banking Enquiry Commission 1956, Banking Commission 1971) and individual researchers (Nayar 1973, Radhakrishnan 1975) to arrive at a satisfactory measure of profit or loss.

23.6.5 Profiles of six terminated chits from the city of Madras, with amounts ranging from Rs 10,000 to Rs 1 lakh and

periods from 25 months to 50 months, are given in the Appendix to this chapter in Tables A23.1 to A23.6. We now turn to an estimation of rates of return for these chits. These are first calculated using a modification of the net present value approach. The ex post net present value for each chit member is computed and divided by the present value of the member's subscriptions. To this 'net present value per unit', the discount rate is added. Figures given are averages for 'borrowers' and 'lenders', where the former (latter) are defined as members whose net undiscounted receipts from the chit are negative (positive).

23.6.6 The net present value per rupee invested is worked out at an assumed rate of 11 per cent per annum for these six chits. The average 'borrowing rate' (that is the net present value per rupee invested) varies from 10.73 per cent per annum in one chit to 14.21 per cent per annum in another chit (Table 23.6). When the 11 per cent discount rate is added, the estimated borrowing rate varies between 21.73 per cent per annum and 25.21 per cent per annum respectively. Similarly, the average return on savings varies from -0.30 per cent per annum to 5.05 per cent per annum. The estimated return is thus between 10.70 per cent per annum to 16.05 per cent per annum. The position of different subscribers in different months in the six chits is shown in graph A23.1 to graph A23.6. Though by this method of calculating rates of return, both borrowing and lending rates exceed those in banks, the method itself has no rigorous justification. Calculations are also sensitive to the discount rate chosen. The assumption of who constitutes the borrower and who constitutes the investor is also open to question. However, no satisfactory method of finding implicit interest rates in a chit fund have been found (ex post internal rates of return are usually non-unique if they exist - and examples of nonexistence can easily be constructed).

23.6.7 A second, much more revealing, method of computing profits is now given even though no estimate of implicit returns results. Assume that members deposit net subscription amounts in bank fixed deposits (at 10 per cent compounded quarterly for com-

pleted quarters) instead of with the chit to the end of the chit period. Furthermore, assume that a bank loan is taken by subscribers in the same period as the prize is received (at 16.5 per cent compounded quarterly or on any part of an incomplete quarter) and repaid at the end of the chit period. If the net amount in hand after terminating bank deposits and repaying loan plus interest at the end of the period is positive, then the depositor makes a `loss` by joining the chit fund. If it is negative, then a `profit` is made by joining the chit fund. The method described here leads to the calculation of future values of the given cash flow when opportunity lending and borrowing rates differ. Previous use of an almost identical procedure is in Radhakrishnan (1975). The bank interest rates used reflect typical bank rates applicable for the 25 month and 30 month chits (corresponding to the chits given in Tables A23.3 and A23.4) for which calculations are reported in Tables 23.7 and 23.8. As can be seen from both tables, subscribers prized early (except the first case in Table 23.8) would prefer banks - which is indirect evidence of bank credit constraints - while subscribers prized late benefit from chits. Strikingly, on average, borrowers benefit from chits to the extent of 31 per cent and 63 per cent of the monthly subscription. This testifies to the relative efficiency of financial intermediation by chit funds.

23.7 Regulatory environment and impact

23.7.1 From the beginning, chit funds have been exposed to a variety of malpractices of which the serious one was delay in disbursement of prize amounts by foremen under one pretext or the other with consequent diversion of funds. Even when there was no default, some foremen delayed payments to prize winners on the plea that the security furnished by them for payment of future instalments was not sufficient. "The unpaid money of prize winners was seldom invested in banks" (Travancore Banking Enquiry Committee, 1930). By the time the prize winner brought additional security, two or three auctions would have taken place enabling the foremen to pay the prize amount of the person in question from

the subscriptions of subsequent instalments. Such adjustment of prize amounts was easy because there was no law stipulating that the prize amounts be paid before a particular date.

23.7.2 To regulate the working of chit funds and provide safeguards to subscribers, chit fund acts were introduced in Kerala (the Chitties Regulation, 1918, of Travancore, Cochin Kuries Act 1931-32, the Cochin Starting of Kuries (Restriction) Act, 1945, the Travancore Chitties Act, 1945 and the Kerala Chitty Act, 1975) and Tamil Nadu (the Madras Chit Funds Act, 1961). Subsequently other States and Union Territories (Andhra Pradesh, Maharashtra, Uttar Pradesh, Goa, Daman and Diu and Pondicherry) followed suit. Since there were still States without any chit acts, some foremen started chit funds from branches established in such States and extended their operations to States which had were chit fund acts. To plug this loophole the Chit Funds Act, 1982 (Act No. 40 of 1982) was enacted by Parliament. This Act extends the whole of India except the State of Jammu and Kashmir.

23.7.3 The Chit Funds Act 1982 is liberal in the matter of aggregate chit amounts of incorporated chit funds. Whereas an individual or partnerships can conduct chits at any time for an aggregate chit amount up to Rs 25,000 per individual or partner, a company registered under the Companies Act or a cooperative society can conduct chits upto an aggregate chit amount of ten times the net owned funds (paid up capital and free reserves) of the company or the cooperative society as the case may be. Thus a company with a paid up capital of Rs 1 lakh and reserves of Rs 25000 can start chits for an aggregate chit amount of Rs 12.5 lakh. At the same time, even a ten member partnership can conduct chits for a maximum chit amount of Rs 2.5 lakh only. Taking advantage of the favourable position for a company, many partnerships and individuals changed to the company form of organisation. This is the major reason for the spurt in growth of companies and chit subscriptions from 1984 seen in the RBI data presented in Table 23.1. With the passing of the Chit Funds Act 1982 and its adoption by the States (States have been given time to frame

necessary rules for the implementation of the Act which some of them are yet to complete) complaints against chit funds seem to have dwindled. However, some chit companies in Tamil Nadu have obtained a court stay on some clauses in the Act, such as on the aggregate chit amount, chit period, and maximum amount of discount. By making use of the stay order, many companies enroll members in 100 month chits (against the maximum period of 60 months in the Act) with no limit on the maximum amount of discount (the Act specifies a ceiling of 30 per cent).

23.7.4 Restriction of period and the ceiling on maximum bid in the Act are two clauses which make chit funds unattractive and non-profitable to subscribers. For businessmen, who are the backbone of auction chits, ceilings on the maximum bid comes in the way of taking the prize amount when they want it. The dividend per member will also be small and will not add up to give a reasonable return to investors who get the prize amount at the last few instalments. Again in a long period chit, the monthly subscription will be relatively small and therefore even small and middle income people can join chit funds with high chit capital. In long period chit of, say, 100 months, the discount offered under unlimited bids may reach 60 per cent to 70 per cent for about half the period. Subscribers need pay only 30 per cent to 40 per cent of subscriptions each month for about half the chit period and then at higher rates during subsequent months.

23.7.5 However, a long chit period with no limit on bids is preferred by businessmen especially under conditions of rising prices. A long period also means a relatively large number of subscribers in a monthly chit whose financial position, along with that of even the foreman, may deteriorate to the detriment of non-prized subscribers. Under such circumstances, a 60 month period seems reasonable provided the maximum amount of discount is left unspecified or at least raised.

23.8 Market structure

23.8.1 Size distribution of chit fund institutions in the sample:

Except for a large size chit fund company with 1191 running chits having a total monthly subscription of Rs 379 lakh, all selected chit fund institutions were medium or small size units. Details of sample chit funds are given in Table 23.10.

23.8.2 Market leadership and competition: Although there were some large units in many places, there was no evidence of market power for any unit. On the contrary, there was keen (non price) competition in securing business among various chit fund institutions, if we go by newspaper advertisements and other forms of canvassing. By the very nature of chits, price competition holds out limited scope. Competition mainly takes the form of product differentiation in the design of chits. Clearly, large chits are advantageously placed as they can offer a greater product range. Entry and exit barriers were also not observed in general.

23.8.3 The general impression, from the field is that older chit fund companies tend to specialise in big, long period chits with newer companies taking up smaller, short duration chits. This pattern is supported by grouped data (when one outlier is excluded) though not by the ungrouped data. Some support for the impression from the field that the reputation and ability to meet obligations of the chit company is important before large sums of money are entrusted to them over long periods has been found, though the evidence is weak. If true, this would demonstrate the existence of a barrier to entry (age, to the extent that it is correlated with reputation) into a segment of the industry.

23.9 Estimate of overall size

23.9.1 Different methods are applied to measure the volume of funds flowing through chit funds. It is argued that in monthly chits, a certain amount comes to the chit funds by way of chit subscription every month and the total chit subscription received

by the chit fund institution in a year is equal to twelve times the monthly figure. If we adopt this method (which was followed by the Report of the Study Group on Non-Banking Financial Intermediaries, Banking Commission, 1971, Nayar 1973 and Radhakrishnan 1975), the total annual chit subscriptions of the 37 selected chit fund institutions at the end of December 1986 would come to Rs 84.1 crore (Table 23.10). Using the RBI data given in Table 23.1, we may work out the annual chit subscriptions of 1066 chit fund companies in India at the end of March 1986 as Rs 8260 crore.

23.9.2 Another method of estimation of aggregate chit amount is through conversion of monthly subscriptions into rupee years per year as argued for in Chapter 8. According to this method, the average subscription of the 37 chit fund institutions in our sample comes to Rs 224.57 lakh. Thus, the total subscriptions of the 1066 chit companies mentioned in the RBI survey for 1986, would work out to Rs 2394 crore (Table 23.11). When the ratio of average chit subscriptions in rupee years per year to the average monthly deposit figure is used, the estimate works out to Rs 8163 crore. The wide discrepancy provides evidence of the variety in chit funds and chit types.

23.9.3 Trend in growth: The selected chit fund institutions showed a rising trend in annual chit subscriptions (Table 23.12) from 1981. Total chit subscriptions rose by about two and a half times during the five year period from Rs 349.9 million in 1981 to Rs 840.8 million at the end of 1986. The number of subscribers also rose (from 1.09 lakh in 1981 to 1.52 lakh in 1986) but not as rapidly as chit subscriptions (Table 23.13). One reason for the rapid growth of chit subscriptions of late was the starting of big denomination chits for periods of 100-110 months (with chit amount of Rs 3 lakh to Rs 5 lakh) by many companies in Tamil Nadu and Kerala.

23.10 Influence of formal sector lending rates and loan availability on business

23.10.1 Loan availability from the formal sector and its lend-

ing rates have influence only on one class of subscribers of chit funds, namely businessmen. All the businessmen who join chit funds have access to bank credit. But credit availability from banks is limited and conditional. When there is credit squeeze, and when business activity is brisk, they borrow from chit funds. Given the peak demand nature of borrowing from chits a slight change in the lending rates of banks has little consequence for bidding in chit funds. On the whole, the influence of formal sector funds availability and lending rates on subscribers of chit funds are negligible in the short run.

23.11 Profile of depositors and borrowers

23.11.1 We interviewed 42 subscribers of chit funds who may be grouped into 18 investors (late prize winners) and 24 borrowers (early prize winners). Investors includes 9 salary earners, five professionals, two housewives one agriculturist and one businessman. Borrowers included 9 businessmen, 7 salary earners, 5 professionals, 1 housewife and 2 self-employed.

23.11.2 The income range of subscribers is as follows:

Income Range (Rs)	Investors	Borrowers
Less than 500	-	-
501 to 1000	-	-
1001 to 1500	-	1
1501 to 2000	3	2
2001 to 2500	1	2
2501 to 3000	3	2
3001 to 4000	6	2
Above 4000	5	15
TOTAL	18	24

23.11.3 Two investors invested 90 per cent of their monthly

savings in chit funds. For others the share of savings in chit funds varied from 20 per cent to 60 per cent. The foremost reason mentioned by all the investors was the built-in provision for borrowing if the necessity arises. Advantages cited were saving in instalments to get a lump sum, few formalities in getting the prize amounts, familiarity with chit fund rules and the compulsion to reduce expenditure and effect savings.

23.11.4 A little more than one-third of borrowers were businessmen. Along with professionals (who use the prize money in clinics, construction work, engineering goods, etc.), and self-employed individuals, they accounted for two-thirds of borrowers with monthly income above Rs 4000. Other borrowers were salary earners. Borrowings by businessmen, professionals and self-employed varied from Rs 17,000 to Rs 1,10,000 giving a simple average of Rs 51,000 per borrower (Table 23.15). Borrowing by the salaried class varied from Rs 2,000 to Rs 10,000, while the lone housewife borrowed Rs 5,000. One agriculturist (plantation owner) took a prize amount of Rs 80,000. About 83 per cent of total borrowing by all categories of borrowers were for business and another 11 per cent for agriculture. Thus, about 94 per cent of total borrowing appeared to have flowed to productive purposes (even assuming the small loan of Rs 2500 in the case of one agriculturist and all the loans to the salaried class were used for consumption).

23.11.5 The security offered against future subscriptions by prized subscribers included personal guarantees signed by two salaried persons, title deeds of houses and real estate, life insurance policies and bank guarantees.

23.11.6 21 respondents replied that they were happy with their chit funds in the matter of dividend distribution and prize disbursement while 3 did not give a positive reply. This is in marked contrast to the usually negative opinion of bank clients in the case studies of credit using sectors elsewhere in the report.

23.12 Equity impact

23.12.1 A chit fund was traditionally considered as a small man's institution for savings and credit. Official data presented in Table 23.13 support this view for two major States which account for about 73 per cent of chit fund business. The table shows that in Kerala the average chit amount per chit was around Rs 10,000 upto 1970-71 whereas it was around Rs 5000 in Tamil Nadu. In the 1970's, it rose to above Rs 25000 in Kerala and Rs 10000 in Tamil Nadu.

23.12.2 After 1984, there appears to have emerged a tendency on the part of chit fund promoters, especially companies, to start big denomination chits of Rs 3 lakh to Rs 5 lakh. However, such chits were sporadic and confined only to a few cities in Tamil Nadu. But even in certain types of big and long period chits, there is a provision for fractional members as discussed above.

23.12.3 A distinction must be made between chit funds per se and chit fund companies. The former are to be found in almost every community and region and across income groups and represent truly 'informal' credit and self help groups. A few such chit funds are covered below and their numbers must clearly be large. These organisations can easily be seen to be welfare improving for the weaker sections. Chit fund companies do not, however, serve low income households (see the section on borrowers) though they do serve small business to the almost total inclusion of large business. Overall, one must conclude in favour of a positive distributional impact of chit funds, community chits helping to ease finance constraints of poor households and both community chits and companies helping small business.

23.13 Efficiency and allocative impact

23.13.1 Are chits efficient financial intermediaries? The community chit clearly is, provided defaults can be contained. In this event, financial intermediation is achieved at zero monetary

cost, with the entire savings going to borrowers. There are, of course, costs such as time costs, risk and liquidity costs and so on. For chit companies, there is a monetary cost of intermediation which is represented by the foreman's commission. As mentioned, this is typically 5 per cent of the chit capital. This 5 per cent covers both risk cost (due to the bad debts which were seen to be 7 per cent of transactions on average) and establishment cost. This cost of intermediation is certainly low compared to banks in India, whose establishment costs alone exceed 4 per cent of gross advances.¹

23.13.2 Secondly, auction chit funds have a mechanism which ensures that funds go to the borrower with the highest discount rate - presumably because the borrower has the best investment opportunity - of the unprized members. This would certainly contribute to allocative efficiency.

23.13.3 Regarding investment of prize amounts by the prize winners, the information is scanty. The recorded information on the subject based on data collected directly from 100 prize winners in the States of Kerala, Tamil Nadu and Maharashtra can be summed up as follows: "the utilisation of prize amounts by the prize winners varies from place to place and depends upon the size of the amount. When we take the country as a whole, we may conclude that the shares of prize money going to productive purposes in the three categories of big, medium and small prize amounts are roughly 90 per cent, 60 per cent and 33 per cent respectively, assuming that the amounts invested in legitimate trade and commerce are productive" (Nayar, 1973).

23.13.4 The composition of chit subscribers in our sample of 37 chit fund institutions given in table shows that about 46 per cent of the subscribers were businessmen. The chit fund institu-

1. Note that reserve funds are not intermediated - they do not find their way to borrowers. Thus, the ratio of costs to advances rather than to deposits is appropriate for measuring intermediation costs.

tions generally do not enquire into the purpose of bidding. However, we collected some relevant data from borrowers of chit funds. According to this data, about 94 per cent of total borrowings of the borrowers selected appeared to have flowed to the productive uses (Table 23.15).

23.13.5 Penultimately, chits in India clearly provide businessmen with a source of funds which banks are unwilling to provide - either because no credit is provided by banks or because of credit ceilings. This too is a positive feature.

23.13.6 Finally, chit rules are easily tailor-made to suit subscribers through combinations of lot, auction and discount rules.

23.13.7 Against this, however, the following negative features must be pointed out.

- i. Uncertainty to borrowers as to loan availability or loan cost.
- ii. Uncertainty to savers as to the rate of return on saving.
- iii. Limited economies of scale in financial intermediation.

23.13.8 On the whole, one must conclude in favour of allocative efficiency (para 23.13.2 and 23.13.3) and efficient intermediation - though chits clearly cannot become the sole financial intermediary in an economy.

23.14 Impact on savings mobilisation and investment

23.14.1 The unique feature of savings in a chit fund as against the savings in other financial institutions is that there is compulsion to effect 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 deposit. A recurring deposit can be discon-

tinued 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 regularly and compulsorily during the entire period of chit. If he discontinues after a few instalments, he will not get the amount subscribed before the end of the chit period (previously, before the enactment of any chit legislation, he used to lose it altogether). The obligation to pay subscriptions is so strong that, at times, a subscriber may postpone or even cancel other routine expenditures. He may even borrow to pay the subscription in time and repay the debt afterwards. Thus there is a self imposed obligation on the part of the subscribers of chit funds to save. It is thus likely that chit funds contribute additively to saving even if quantitative evidence is lacking.

23.14.2 Some of the attractions to savers of chit funds as given by the respondent chit fund institutions in our field survey (percentage of institutions reporting `yes` in the questionnaire) are: (a) in-built provision for borrowing (94 per cent), (b) savings in instalments (91 per cent), (c) compulsory savings (83 per cent) and (d) right to receive dividends (62 per cent).

23.15 Recommendations for a regulatory framework

23.15.1 Whatever defects in the working of chit funds exist can, we believe, be corrected by the existing provisions of the Chit Funds Act, 1982 if these are adequately enforced. However, certain difficulties experienced by the chit foremen and possible remedies for them are given in the following paragraphs.

23.15.2 The Chit Fund Act, 1982 stipulates that "Except with the general or special permission of the State government, no company carrying on chit business shall conduct any other business". Although mixing chit business with other businesses will give room for misappropriation of chit subscriptions, the prohibition on business limits the income of a foreman, especially of small

chits. This prohibition comes along with the restriction of commission of a foreman to 5 per cent of capital. When there is a temporary shortage of funds resulting from defaults, the foreman has to find alternative sources of funds to pay the prize amount. If he is prevented from doing other business, there must be some provision for temporary accommodation. All sample respondents stated that they borrow money at high rate of interest to pay prize amounts in time. In fact, it is such temporary shortages that cause some companies to fail, even though there is no misappropriation of funds.

23.15.3 To remedy the situation, one suggestion (Nayar, 1973) was the provision of refinance. The foreman receives from every prized subscriber some sort of security for the future payment of instalments. This security can be the guarantee for refinancing the prize amount. The foreman, according to the Chit Acts, can keep some amount with approved banks as security or furnish sufficient property as security to the Registrar of Chit Funds against each chit. This amount or property should not be released until the termination of the chit concerned. It can be considered as additional guarantee for the amount refinanced. Even though the chit fund is accepted as a viable and useful financial institution by various official commissions and committees, no alternative solution to this crucial aspect of temporary financial accommodation to chit companies has yet been suggested by them.

23.15.4 We referred the question of refinance to the respondent chit companies. More than two-thirds (67 per cent) of the companies liked the idea and said that they would conform to the specifications for security as required by the refinancing agency. Some chit companies have deposits of several lakhs of rupees with banks. These were security deposits given against running chits (As per the Chit Fund Act 1982). Banks normally do not extend any credit or overdraft facility to chit companies.

23.16. A Note on Community Chit Funds

23.16.1 Community chit funds: In all urban areas in India, chit funds or other self-help groups are wide-spread among various community groups. Such groups are to be found among people in various income groups and among people in many walks of life. For example, two popular types of chit funds are chits involving housewives (known as 'kitty parties' among middle to upper middle class matrons in Northern India) and office chits. While no systematic attempt to survey office chits, kitty parties and so on has been made, chits prevailing in one office in Delhi have been examined.

23.17 A case study of office chits in Delhi

23.17.1 The office chosen for study is a relatively large establishment in the service sector with over a hundred employees. Around half the staff (between 50 and 60 persons) are members of one or more chit funds and have been members of chits on a more or less regular basis. The percentage of staff members participating was inversely related to their income levels, with none of the highest paid staff members participating but almost all the lowest paid members participating. At the time of the case study, 5 monthly chits were reported to be in operation with subscription amounts ranging between Rs 100 per member per month and Rs 500 per member per month. Of these chits, 4 were 'middle income class' chits drawing their membership from clerical staff and junior professional/management staff. The fifth chit was started by blue collar workers though some clerical workers had later joined. Furthermore, the fifth 'chit' was not a chit in the pure sense of the term in that it was not close-ended but rather a continuing mutual self help group.

23.18 Middle income group chits

23.18.1 The middle income chits were all auction chits with fixed discounts and periods ranging from 10 months to two years

(ten to twenty four members). While the norm was one ticket per member, cases of members holding upto three tickets were reported. Furthermore, some individuals were members of more than one chit at a time with some individuals even participating in all chits. The monthly subscription of the chits taken together was Rs 1300, (totalling Rs 25,000) and the average monthly salary of office-going groups from whom the membership was drawn was Rs 2091. The percentage of monthly income contributed to chits works out, on average, to be 14 per cent of the earnings of both participants and non participants taken together. This percentage is worked out before accounting for auction and fixed dividends. Chit foremen were those who took the initiative in forming chits or, in some cases, consensus choices. They received no special benefits but were responsible for maintaining records. Chit members typically met on the day before the monthly salary disbursement for auctions and again on the day of salary disbursement for cash transactions. A feature of these chits was a late payment penalty applicable for those who did not contribute their subscriptions on 'pay day'. The penalty was reported to be 1 per cent per day. This penalty normally came into play if pay day happened to be a Friday and if members went home before paying their subscription dues. Penalty for two days would then accrue till Monday. No other cases of delayed payment or default were reported. The 4 chits found to be in operation were:

- i. Rs 500 subscription per member; 24 members.
- ii. Rs 500 subscription per member; 18 members.
- iii. Rs 200 subscription per member; 15 members.
- iv. Rs 100 subscription per member, 10 members.

23.18.2 Persons interviewed reported that, earlier, a different form of chit fund was in operation along with fixed discount auction chits. Under this alternative form, the auction discount was loaned to members wishing to borrow funds at a stipulated monthly interest. It was not distributed to members till the end of the chit. The maximum loan duration was 3 months with monthly interest at 2 per cent for the first month and 3 per cent for sub-

sequent months. Interest earnings were distributed as dividend to members. The foreman's job in these chits was more onerous as it was his responsibility to maintain loan accounts in addition to the chit account. Furthermore, unborrowed amounts were entrusted to his care till subsequent meetings. This type of chit was discontinued due to the cumbersome record keeping required.

23.18.3 Interviewees reported that many members borrowed to invest in businesses that they ran on the side, while others borrowed so as to obtain capital for the purchase of durables in a lump sum. One interviewee was of the opinion that such chits were superior to (commercial bank or post office) recurring deposits since only 70 per cent of the balance outstanding in a recurring deposit could be borrowed in case of need. Genuine loans from banks were, of course, unavailable.

23.18.4 In order to study the cost of borrowing and the return to shareholders, we requested and were supplied with information on four terminated chits. These chits are listed in the Appendix in Tables A23.7 to A23.10. Their ex post future value to members has been calculated according to the procedure outlined in section 23.6 and these are reported in Tables 23.15 to 23.18. As can be seen, members gain on average relative to bank opportunities though the average gain is small in view of the short durations of these chits.

23.19 The blue collar chit

23.19.1 This monthly chit has been in existence since 1985. The unique feature of this 'chit' is that it is non-terminating and has a mechanism by which the capital in the chit grows from month to month. The (currently 16) members contribute Rs 100 per month (6.5 per cent of the average monthly salary per participant), the capital then being loaned to one or more members depending on loan demand. The priority for loans goes to those who have genuine need, followed by others on a first come first serve basis with the lowest priority going to those who have an

outstanding loan that is not entirely paid back. Usually, in case more than one member wishes to borrow, mutual accommodation is reached as to the division of available capital before invoking tie breaking rules. Monthly interest at the rate of 2 per cent per month on the balance outstanding was collected from borrowers.

23.19.2 The growth of chit capital occurred due to the fact that loan repayments (plus interest) were made in addition to the normal monthly subscription at the rate of Rs 100 per month. Thus, a borrower's contribution would jump to Rs 200 plus interest from the month after the loan was taken and this level would continue (but with interest owed decreasing every month) till the loan was repaid - at which time the subscription would revert to Rs 100 per month. Since loans were taken to be net of previous subscriptions, the maximum possible amount of loan would stay equal to the initial chit capital but the amount of cash from subscriptions and loan repayments would mount to $(2n-1)$ times the monthly subscription (for an n member chit fund) exclusive of interest receipts. Interest would add a further $(n-1)^2 r$ time the monthly subscription at a monthly interest rate of r . Thus, for the chit under consideration the capital available for disbursement from the sixteenth month onward would be Rs 3650. However, the interviewees reported that interest was not distributed monthly but was held till an annual distribution which took place at the time of Diwali, a major North Indian festival. Furthermore, the increase in chit capital was also pruned down in some years by distributing the excess as dividend to all members during the annual meeting. Since at any given time in the chit history more than one member would be a net debtor to the chit, the chit has been in existence without a squaring of all loan accounts since 1985. An additional feature of the chit is that members are free to leave at any time but those leaving on any day except on the day of the annual meeting would have to forego interest accrued since the previous annual meeting. Finally, while interest was disbursed in cash to those who wished for it, bulk purchases of household durables (like pots and pans) were normally made by the chit organisers for distribution during the annual meeting.

TABLE 23.1

Growth of Chit Fund Companies in India

Year (March end)	Number of rep- orting chit compa- nies	Chit subsc- ription (Rs crore)	Percen- tage increase of chit subscri- ption over previous year	Aggre- gate schedu- led comm- ercial bank deposits (Rs crore)	Percen- tage incre- ase in bank depos- its over previous year	Chit subscrip- tion as a percentage of bank deposits
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1971	117	1.68		5906.00		0.03
1975	295	33.00		11827.00		0.28
1976	404	30.80		14155.00		0.22
1977	518	37.60		17566.00		0.21
1978	502	35.20		22211.00		0.16
1979	504	37.30		27016.00		0.14
1980	509	146.30		31759.00		0.46
1981	555	156.40	6.9	37988.00	19.6	0.41
1982	541	208.06	33.1	43733.00	15.1	0.48
1983	503	227.10	9.2	51358.00	17.4	0.44
1984	641	380.70	67.6	60596.00	18.0	0.63
1985	864	439.20	15.4	72244.00	19.2	0.61
1986	1066	688.30	56.7	85404.00	18.2	0.81

- Sources: 1. Columns 2 & 3, growth of deposits with Non-Banking Companies, RBI Bulletin, Various issues
2. Report on Currency and Finance, RBI, different volumes.

TABLE 23.2

**Borrowings of Chit Fund Companies
Outside Chit Business**

Year (March end)	No. of report- ting com- panies	Amount of de- posits (Rs lakh)	Net owned funds (Rs lakh)	Deposits as a % of net owned funds
1976	404	330.0	380.0	86.8
1977	518	360.0	300.0	120.0
1978	502	450.0	260.0	173.1
1979	504	450.0	250.0	180.0
1980	509	380.0	320.0	118.8
1981	555	1160.0	400.0	290.0
1982	541	210.0	460.0	45.7
1983	503	160.0	N.A.	N.A.
1984	641	150.0	580.0	25.9
1985	864	250.0	760.0	32.9
1986	1066	100.0	1060.0	9.4

Source: Growth of Deposits with Non-Banking
Companies, RBI Bulletin, Various
Issues.

TABLE 23.3

Distribution of Chit Subscribers By Occupation, 1986

(in per cent)

	Salaried class	House- wives	Agricul- turists	Self employed	Businessmen
Mean	27	9.9	7.6	9.3	45
S.D.	21	12	9.2	12	25

Source: Responses to questionnaires.

TABLE 23.4

**Distribution of Chits in the Sample by
Instalment and Duration**

Period intervals (months)	Instalment intervals (Rs)				Mean ¹	Coeffici- ent of variation (%)
	0-250	251- 800	801- 2000	2000		
0-40	236 ²	377	248	25	919	164.84
41-60	556	498	393	104	1402	114.40
61-200	71	74	16	9	791	125.03
Mean ³	42	56	49	70		
Coefficient of varia- tion (%)	54.76	57.14	67.34	871.4		

1 : Average instalment.

2 : Average duration of the chit.

3 : No. of running chits.

TABLE 23.5

**Details of Income and Expenditure of Selected Chit Fund
Institutions (1986)**

Income	Average (Rs.)	Coeffi- cient of variation of (1)	Average (percen- tage)	Coefficient of variation of percen- tages
	(1)	(2)	(3)	(4)
Entrance fees	3743.61	287.80	0.59	346.27
Documentation charge	4152.06	253.19	0.65	304.62
Penal charge	13960.36	275.42	2.18	331.38
Commission	508155.19	67.77	79.48	81.54
Others ¹	109354.92	237.36	17.10	285.58
Total income	639366.14			
Expenditure				
Rent	23885.36	75.91	5.89	77.40
Salary	172720.17	94.79	42.56	96.65
Commission to agents	30782.78	245.26	7.59	250.07
Advertisement	12958.75	154.40	3.19	157.43
Gifts	11347.11	352.88	2.80	359.81
Printing	27315.17	84.11	6.73	85.76
Registration fees	6253.39	93.31	1.54	95.14
Expenses on raising funds	7504.17	238.22	1.85	242.89
Legal expenses	4582.06	146.28	1.13	149.15
Others ²	108451.36	191.87	26.73	195.63
Total expenditure	405800.31			
Profit	233565.83			
Profits as a % of chit capital	2.18			
Profit as a % of income	36.53			
Expenses as a % of chit capital	3.78			
Income as a % of chit capital	5.96			

Notes: 1: Mainly bank interest received.

2: Main items are interest on borrowings, director's expenses, tour allowances and car expenses.

Data pertain to 36 chit fund institutions.

TABLE 23.6

**Net Present Value Per Unit of Six Terminated
Action Chits**

Chit number	1	2	3	4	5	6
Chit duration (months)	40	40	30	25	50	40
Number of borrowers	27	22	14	11	33	24
Average borrowing rate (% p.a.)	13.53	10.76	14.21	12.34	10.79	10.73
Standard Dev. (%)	28.45	22.38	28.89	24.81	21.79	21.72
Coefficient of variat- ion (%)	210.33	208.01	203.26	200.95	201.92	202.32
Number of savers	12	17	15	13	16	15
Average return to savers (% p.a.)	5.05	0.30	1.26	4.04	2.46	0.52
Standard deviation (%)	10.63	1.98	7.23	6.36	11.33	2.04
Coefficient of varia- tion (%)	210.36	655.81	573.43	157.44	461.17	394.98

Note: Average shows net present value per rupee invested at 11% per annum.

Interest rate = 11% + average rate

Assumption : A borrower is one who receives less than what he invests and an investor is one who receives more than what he invests in chit funds.

TABLE 23.7

Profile of a Terminated Commercial Auction Chit

A. Chit features

1. Number of months/members : 25
2. Monthly subscription : Rs 400
3. Foreman's commission : 5% (Rs 500 per instalment)
4. Foreman entitled to take first two instalments (foreman holds two subscriptions)
5. Fixed discount : 5% for non prized subscribers
6. Auction discount for all subscribers
7. Bidding ceiling : 30%

B. Instalment-wise details

(Figures in rupees)

Instalment	Prize amount	Net subscription of subscribers		Profit
		Prized	Non-prized	
1	10000	400	400	-
2	10000	400	400	-
3	7000	320	298.25	(361.68)
4	7000	320	297.30	(335.83)
5	7000	320	296.20	(692.04)
6	7000	320	295	(664.44)
7	7000	320	293.70	(635.45)
8	7000	320	292.25	(927.25)
9	7000	320	290.60	(941.52)
10	7000	320	288.75	(906.16)
11	7100	324	290.70	(1100.43)
12	7400	336	300.30	(696.47)
13	8050	362	325.55	138.52
14	9450	400	395.45	1434.10
15	9250	400	375.00	1203.90
16	9400	400	388.90	1407.15
17	9000	400	337.50	529.80
18	9000	400	328.60	596.66
19	9500	400	400	1235.14
20	9500	400	400	810.26
21	9150	400	312.50	430.79
22	9500	400	400.00	899.95
23	9500	400	400.00	492.32
24	9500	400	400.00	492.32
25	9500	400	400.00	492.32

Average profit: Rs 124.17

As a percentage of monthly subscription: 31.04

Notes: 1. Loss in parenthesis.

2. For basis of profit computation see section 6.

TABLE 23.8

Profile of a Terminated Commercial Auction Chit

A. Chit features

1. Number of months/members : 30
2. Monthly subscription : Rs 500
3. Foremans commission : 5% (Rs 750)
4. Foreman entitled to take first two instalments (foreman holds two subscriptions)
6. Auction discount to all subscribers

B. Instalment-wise details (alternative instalments)

(Figures in rupees)

Instalment	Prize amount	Net subscription	Profit
1	15000	500	-
3	10290	368	(979.60)
5	9240	333	(1141.83)
7	9780	351	(922.34)
9	10560	377	(155.46)
11	10500	375	(502.23)
13	9990	358	(1074.21)
15	11490	408	207.49
17	12750	458	1169.59
19	13200	465	1080.33
21	13050	460	904.00
23	13320	469	601.10
25	13950	490	688.43
27	14250	500	1013.69
29	14250	500	401.63

Average profit (30 subscribers) : 313.46
 As a percentage of monthly subscription : 62.69%

TABLE 23.9

**Year of Establishment and Details of Chits of Selected
Chit Fund Institutions at the End of December 1986**

(Rs lakh)

Chit fund	Location code	Year of establishment	Number of running chits	Monthly subscriptions	Number of subscribers	Yearly subscriptions
1	102	1970	26	7.05	920	84.60
2	101	1933	25	18.00	12090	216.00
3	101	1960	24	22.89	3500	265.08
4	101	1961	26	4.98	3610	59.76
5	201	1972	35	13.37	1200	160.44
6	201	1956	38	13.10	1482	157.20
7	201	1983	14	9.75	550	117.00
8	201	1983	37	5.99	1243	71.88
9	201	1962	11	1.06	290	12.72
10	201	1953	21	7.95	600	95.40
11	201	1951	91	19.65	5400	235.80
12	301	1962	1191	379.00	63046	4548.00
13	301	1982	66	16.60	2220	199.20
14	301	1983	26	8.80	1300	105.60
15	301	1984	39	8.60	875	103.20
16	101	1960	16	3.65	565	43.80
17	102	1970	25	4.00	910	48.00
18	102	1970	16	2.60	470	31.20
19	102	1950	30	2.00	570	24.00
20	102	1955	20	3.50	740	42.00
21	102	1958	30	6.50	1285	78.00
22	103	1942	12	2.75	900	33.00
23	103	1945	36	8.80	1405	105.60
24	101	1981	17	10.50	6349	126.96
25	101	1919	17	6.68	12600	80.16
26	101	1927	42	45.00	9800	540.00
27	101	1954	18	10.07	10400	120.84
28	104	1958	17	4.40	720	52.80
29	104	1965	21	5.20	910	62.40
30	205	1960	24	7.95	1020	95.40
31	102	1954	42	12.75	1820	153.00
32	401	1976	22	4.70	705	56.40
33	401	1978	20	5.90	635	70.80
34	207	1971	10	2.40	460	28.80
35	207	1952	18	7.40	780	88.80
36	204	1968	12	5.00	550	60.00
37	204	1974	14	2.85	375	34.20
Total			2149	700.67	152295	8408.04
Average of - 36 units (excluding No.12)			26.61	8.94	2479	319.32

Note: Key to location codes is in Table A23.11 in the Appendix to this chapter.

TABLE 23.10

Estimates of Chit Subscriptions in India (1986)

	Rs. million
Method I	
Monthly subscriptions of 37 running chits in our sample	70.07
Annual subscriptions of 37 running chits in sample (Twelve times the monthly figure)	840.84
Chit subscriptions of 1066 chit companies in March 1986 given by RBI survey ¹	6883.00
Annual subscriptions of 1066 chit companies given in RBI survey (6883x12)	82596.00
Method II	
Average subscriptions of 37 chit fund institutions in our sample (Rupee years per year) ²	22.46
Aggregate subscriptions based on number of companies (1066) in RBI survey (22.46x1066)	23942.36
Aggregate subscriptions based on deposits ³ of 1066 chit companies in RBI survey	81631.38
Notes	
1. Formula adopted is	
2. Total subscription = $A = \frac{(N-1)(N+1)x}{6}$ where, N = Number of periods (months) and x = Instalment per period. Average subscription = $A/37$.	
3. Total RBI Deposits x Average subscription of 37 chit fund institutions in our sample (Rupee years per year) / Average monthly subscription per running chit in sample.	

TABLE 23.11

Annual Chit Subscription Received by Selected
Chit Fund Institutions

(Rs lakh)

Chit funds	1981	1982	1983	1984	1985	1986
1	62.4	68.4	69.6	72.6	78.6	84.6
2	160.56	160.56	160.56	160.56	160.56	216
3	265.08	265.08	265.08	265.08	265.08	265.08
4	131.04	131.04	131.04	131.04	59.76	59.76
5	0	0	0	0	0	160.44
6	102.6	126.6	121.8	124.2	159	157.2
7	0	0	0	67.2	106.8	117
8	0	0	26.4	43.44	67.44	71.88
9	0	0	0	0	0	12.72
10	0	0	0	0	69	95.4
11	0	0	0	222	233.4	235.8
12	1692	2328	2880	3528	3876	4548
13	0	51.6	114	136.8	172.8	199.2
14	0	0	55.2	62.4	79.2	105.6
15	0	0	0	51.6	82.8	103.2
16	60	60	72	60	54	43.8
17	110.4	84	75	69	57	48
18	18	24	21	25.2	25.2	31.2
19	9	12	14.4	15.6	18	24
20	43.2	33	30	36	39	42
21	39	45	48	60	72	78
22	99	90	72	60	48	33
23	66	81	83.4	108.6	113.4	105.6
24	52.8	73.44	103.92	103.92	106.08	126.96
25	0	125.88	125.88	125.88	80.16	80.16
26	0	540	540	540	540	540
27	152.76	16.68	147.36	157.92	136.68	120.84
28	44.4	46.8	50.4	48	51.6	52.8
29	33.6	38.4	45.6	51.6	55.2	62.4
30	64.2	70.2	80.4	81	88.2	95.40
31	95.4	118.8	134.4	137.4	141	153
32	18	20.4	29.4	34.8	46.8	56.4
33	4.8	9.36	18.24	24.24	43.8	70.8
34	19.2	25.2	26.4	28.8	28.8	28.8
35	53.4	65.4	65.4	69	76.8	88.8
36	114	88.2	65.4	60.6	57.6	60
37	12	12	18	24	29.4	34.2
Total	3498.8	4955.0	5690.2	6786.4	7319.1	8408.0

TABLE 23.12

Number of Subscribers Served by Selected
Chit Fund Institutions

Chit fund	1981	1982	1983	1984	1985	1986
1	520	600	640	720	855	920
2	13941	13941	13941	13941	13941	12090
3	3500	3500	3500	3500	3500	3500
4	5590	5590	5590	5590	3610	3610
5	1200	1200	1200	1200	1200	1200
6	1248	1520	1200	1209	1521	1482
7	0	0	0	350	420	550
8	0	0	817	1176	1474	1243
9	0	0	0	0	0	290
10	0	0	0	0	500	600
11	0	0	0	3100	4500	5400
12	48780	53348	56231	58661	59434	63046
13	0	620	1110	1620	1890	2220
14	0	0	450	650	900	1300
15	0	0	0	500	675	875
16	725	725	725	725	685	565
17	1480	1250	1135	1085	985	910
18	350	410	350	430	430	470
19	195	335	375	400	420	570
20	490	500	500	600	715	740
21	500	625	700	855	1085	1285
22	3215	3130	2000	1600	1200	900
23	885	1010	1110	1320	1480	1405
24	3666	4486	5086	5086	5800	6349
25	0	18200	18200	18200	12600	12600
26	0	9800	9800	9800	9800	9800
27	17500	17500	17400	17400	12320	10400
28	520	560	640	600	680	720
29	570	620	700	770	800	910
30	600	650	755	780	920	1020
31	1250	1470	1600	1650	1770	1820
32	250	300	365	490	580	705
33	150	215	315	365	465	635
34	240	340	380	460	460	460
35	360	490	490	610	730	780
36	1050	850	700	650	625	550
37	175	175	225	275	325	375
Total	108948	143960	148280	156368	149295	152295

TABLE 23.13

**Average Chit Amount of Running Chits of Chit Fund
Institutions in Kerala and Tamil Nadu**

Year (April- March)	Kerala			Tamil Nadu		
	Number of run- ing chits at the end of year	Total chit amounts of run- ing chits at the end of year (Rs lakh)	Average chit amount of run- ing chits (3/2) (Rs)	Number of run- ing chits at the end of year	Total chit amounts of running chits at the end of year (Rs lakh)	Average chit amount of running chit (6/5) (Rs)
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1964-65	4203	368.40	8765	841	28.50	3389
1965-66	4498	472.7	10509	1359	68.00	5004
1966-67	4632	473.6	10225	2255	73.90	3277
1967-68	5247	531.5	10130	3043	120.16	3949
1968-69	6062	788.2	13002	4016	235.51	5864
1969-70	6181	527.5	8534	5795	269.16	4645
1970-71	6371	652.8	10246	12428	536.80	4319
1971-72	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
1972-73	6841	1559.4	22795	20821	851.80	4091
1973-74	7253	1397.7	19319	24650	1128.73	4579
1974-75	7784	1478.6	18995	26367	1443.86	5476
1975-76	8706	1509.8	17342	28501	1584.01	5558
1976-77	N.A.	N.A.	N.A.	17916	1269.38	7085
1977-78	6930	1019.2	14707	16315	1537.07	9421
1978-79	10032	966.6	9635	16214	1402.77	8652
1979-80	6747	1452.9	21534	16668	1429.32	8575
1980-81	7081	1782.2	25168	17423	1354.04	7772
1981-82	8013	1290.1	16100	18438	1529.30	8294
1982-83	N.A.	N.A.	N.A.	19315	2133.36	11045

Sources: 1. Administration Report of the Registration Department, Government of Kerala, Trivandrum.
2. Office of the Inspector General of Registration (Director of Chits), Government of Tamil Nadu.

TABLE 23.14

**Amount of Borrowings (Net of Discount) of
Sampled Borrowers of Chit Funds**

(in Rs)

	Businessmen/ profession- nals/self employed	Salary earners	Housewives	Agriculturists
1				2500
2		7000		
3	35000			
4		9250		
5	45000			
6	82000			
7	40000			
8	N. A.			
9	40000			
10		5000		
11	50000			
12	70000			
13		2000		
14				80000
15	30000			
16	40000			
17	17000			
18	N. A.			
19		4000		
20	N. A.			
21	55000			
22			5000	
23	110000			
(2 chits)				
24		10000		
Total	614000	37250	50000	82500
borrowings				
(% of total)	(83.11)	(5.04)	(0.68)	(11.17)

TABLE 23.15

PROFILE OF A TERMINATED COMMUNITY AUCTION CHIT

Discount distributed at the end of the chit
 Number of members/periods: 15
 Periodicity in months: 1
 Subscription in Rupees: 300

(Figures in Rupees)

Period	Prize	Discount	Net sub	Net prize	Deposit	Loan	Gain/loss
1	3675.00	825.00	300.00	3375.00	0.00	3375.00	-17.05
2	3640.00	860.00	300.00	3340.00	302.39	3037.61	-112.17
3	3795.00	705.00	300.00	3495.00	607.19	2887.81	17.48
4	3680.00	820.00	300.00	3380.00	914.43	2465.57	-165.67
5	3820.00	680.00	300.00	3520.00	1224.11	2295.89	-53.53
6	3840.00	660.00	300.00	3540.00	1536.26	2003.74	-77.70
7	3885.00	615.00	300.00	3585.00	1850.91	1734.09	-72.51
8	3930.00	570.00	300.00	3630.00	2168.06	1461.94	-66.35
9	4040.00	460.00	300.00	3740.00	2487.74	1252.26	10.93
10	4200.00	300.00	300.00	3900.00	2809.96	1090.04	140.67
11	4220.00	280.00	300.00	3920.00	3134.77	785.23	120.92
12	4255.00	245.00	300.00	3955.00	3462.15	492.85	118.38
13	4290.00	210.00	300.00	3990.00	3792.15	197.85	117.04
14	4350.00	150.00	300.00	4050.00	4124.78	-74.78	142.19
15	4350.00	150.00	300.00	4050.00	4460.07	0.00	107.86
Average gain per member:							Rs.14.03

TABLE 23.16

PROFILE OF A TERMINATED COMMUNITY AUCTION CHIT

Discount distributed at the end of the chit
 Number of members/periods: 12
 Periodicity in months: 1
 Subscription in Rupees: 200

(Figures in Rupees)

Period	Prize	Discount	Net sub- script.	Net prize	Deposit	Loan	Gain/loss	
1	1865.00	535.00	200.00	1665.00	0.00	1665.00	-135.75	
2	1925.00	475.00	200.00	1725.00	201.59	1523.41	-93.63	
3	2030.00	370.00	200.00	1830.00	404.80	1425.20	-1.37	
4	1895.00	505.00	200.00	1695.00	609.62	1085.38	-176.38	
5	2070.00	330.00	200.00	1870.00	816.01	1053.93	-7.33	
6	2100.00	300.00	200.00	1900.00	1024.18	875.82	1.73	
7	2270.00	130.00	200.00	2070.00	1233.94	836.06	160.54	
8	2195.00	205.00	200.00	1995.00	1445.37	549.63	58.33	
9	2200.00	200.00	200.00	2000.00	1658.49	341.51	42.58	
10	2250.00	150.00	200.00	2050.00	1873.31	176.69	74.18	
11	2300.00	100.00	200.00	2100.00	2089.84	10.16	105.79	
12	2300.00	100.00	200.00	2100.00	2308.10	0.00	87.40	
Average gain: Rs.9.68								

TABLE 23.17

PROFILE OF A TERMINATED COMMUNITY AUCTION CHIT

Discount distributed each period.
 Number of members/periods: 14/24
 Periodicity in months: 1
 Subscription in Rupees: 500

(Figures in Rupees)

Period	Prize	Discount	Net sub- script.	Net prize	Deposit	Loan	Gain/loss
1	6650.00	5350.00	277.08	6372.92	0.00	6372.92	-2182.22
2	7500.00	4500.00	312.50	7187.50	279.29	6908.21	-1164.23
3	7300.00	4700.00	304.17	6995.83	596.51	6399.32	-1543.13
4	7900.00	4100.00	329.17	7570.83	907.86	6662.97	-890.62
5	8900.00	3100.00	370.83	8529.17	1246.89	7282.27	259.71
6	8300.00	3700.00	345.83	7954.17	1630.62	6323.54	-627.55
7	8450.00	3550.00	352.08	8097.92	1992.22	6105.70	-561.75
8	10000.00	2000.00	416.67	9583.33	2363.00	7220.34	1219.13
9	9900.00	2100.00	412.50	9487.50	2801.83	6685.67	959.33
10	9900.00	2100.00	412.50	9487.50	3239.96	6247.54	826.37
11	9900.00	2100.00	412.50	9487.50	3681.58	5805.92	697.59
12	9700.00	2300.00	404.17	9295.83	4126.73	5169.10	339.92
13	9400.00	2600.00	391.67	9008.33	4567.03	4441.30	-122.87
14	9750.00	2250.00	406.25	9343.75	4998.24	4345.51	165.12
15	9650.00	2350.00	402.08	9247.92	5447.58	3800.33	-57.75
16	10050.00	1950.00	418.75	9631.25	5896.31	3734.94	279.58
17	10450.00	1550.00	435.42	10014.58	6365.42	3649.16	609.50
18	10650.00	1350.00	443.75	10206.25	6855.07	3351.18	716.39
19	11000.00	1000.00	458.33	10541.67	7357.02	3184.65	981.62
20	10850.00	1150.00	452.08	10397.92	7877.67	2520.25	715.29
21	11250.00	750.00	468.75	10781.25	8396.18	2385.07	1028.32
22	11350.00	650.00	472.92	10877.08	8935.62	1941.47	1027.05
23	11500.00	500.00	479.17	11020.83	9483.56	1537.27	1077.80
24	11500.00	500.00	479.17	11020.83	10042.17	0.00	978.66
Average gain per member: Rs.197.14							

TABLE 23.18

PROFILE OF A TERMINATED COMMUNITY AUCTION CHIT

Discount distributed each period.
 Number of members/periods: 12/15
 Periodicity in months: 1
 Subscription in Rupees: 100

(Figures in Rupees)

Period	Prize	Discount	Net sub- script.	Net prize	Deposit	Loan	Gain/loss
1	1000.00	500.00	66.67	933.33	0.00	933.33	-286.67
2	1000.00	500.00	66.67	933.33	67.20	866.13	-119.21
3	970.00	530.00	64.67	905.33	134.93	770.40	-168.09
4	1100.00	400.00	73.33	1026.67	201.19	825.48	-32.12
5	1100.00	400.00	73.33	1026.67	276.71	749.95	-46.61
6	980.00	520.00	65.33	914.67	352.84	561.83	-194.51
7	1105.00	395.00	73.67	1031.33	421.51	609.83	-68.34
8	1300.00	200.00	86.67	1213.33	499.12	714.21	131.98
9	1350.00	150.00	90.00	1260.00	590.46	669.54	171.03
10	1330.00	170.00	88.67	1241.33	685.88	555.45	134.80
11	1320.00	180.00	88.00	1232.00	780.73	451.27	110.29
12	1315.00	185.00	87.67	1227.33	875.66	351.68	91.89
13	1350.00	150.00	90.00	1260.00	971.00	289.00	115.29
14	1350.00	150.00	90.00	1260.00	1069.46	190.54	102.98
15	1350.00	150.00	90.00	1260.00	1168.71	0.00	91.29

Average gain per member: Rs.2.27

CHAPTER 24

DOCKYARD FINANCIERS IN CALCUTTA

24.1 Sample description, area surveyed and general description of the market

24.1.1 The case study of dockyard financing was conducted in Calcutta. The survey was confined to 6 borrowers and 10 principal lenders. Information was also obtained from discussions with senior Calcutta Port Trust officials and office bearers of the All India Clearing Agents Association.

24.1.2 It was found from our study that importers are the principal borrowers in this credit market. They need short term credit for the payment of cargo and container rent, wharfage rent and demurrage charges, of which demurrage charges are the most important and unpredictable element.

24.1.3 According to Calcutta Port Trust rules, goods are demurrage free for three clear working days after the date of landing or the date on which goods are made available for delivery in case of goods sold by public auction. Apart from this, when goods are landed on a day that is not a working day or in the second or third shift of a day, the next working day is treated as the landing date. Furthermore, demurrage charges are applied from the date of landing at double the rate specified in the list for goods classified as 'Hazardous I' in the hazardous list. A brief summary of the rates for demurrage charges is given in Table 24.1.

24.2 Sources of funds

24.2.1 It is found from our study that the borrowers prefer not to borrow from professional financiers. Professional finan-

ciers play an insignificant role in Calcutta though they are reputed to play a much greater role in Bombay and Madras and in the related markets of railway freight and air cargo finance. It is found that some financiers in this market have other occupations as their principal source of income. Nevertheless, importers normally do not take loans from them because they retain imported goods for which they provide dockyard finance till borrowers pay back the amount borrowed plus interest. Furthermore, their interest rate is reported to vary between 20 to 25 per cent per annum. There are mainly two ways in which importers meet their needs for dockyard finance. Firstly, some importers divert a certain percentage of total loans obtained from commercial banks for various purposes (mainly for working capital) to demurrage payment. The most important source of credit for this purpose is however loans given by clearing agents to their clients.

24.2.2 The major source of funds for clearing agents was claimed by them to be retained profits. They also claim that they never borrow from professional financiers, even though private individuals and professional financiers are reported to solicit loan business from clearing agents. But clearing agents have overdraft facilities with commercial banks, and occasionally take loans from commercial banks at a reported interest rate of 11 per cent per annum. It may be mentioned here that this interest rate is very low, the normal bank interest rate being 16.5 per cent. None of the agents interviewed or their Association consented to provide detailed financial statements.

24.3 Uses of funds

24.3.1 It has been observed in many cases that importers are unable to clear their goods within three working days due, inter alia, to the following reasons. Most important is disputes regarding customs duties. Importers are forced to pay demurrage charge for the period for which duties are in dispute. Although importers make a priori assessments of import and custom duties there is

usually a gap between the official assessment of customs duties, and their own assessment. In many cases it is found that customs duties amounted to nearly double the value of imports (C.I.F; see Table 24.2). Nevertheless, credit requirements for customs duties are normally met by commercial banks. However, banks do not advance loans to importers for payment of rent and demurrage charges which must therefore be obtained from informal sources. As mentioned earlier, clearing agents are the main source of funds. Funds are normally made available to importers by way of trade credit of upto 90 days. An Association official claimed that the practice of allowing trade credit is of recent origin. The reason for this is reported to be the increased competition between agents due to the decline in the cargo tonnage handled by Calcutta port. This is partially corroborated by the fact that official figures show that between 1958-59 and 1982-83 total cargo tonnage (imports and exports) handled at Calcutta port decreased by 33.06 per cent. Clearing agents advance credit to their clients without any collateral. However, a measure of security is provided by the fact that credit is advanced only to long standing customers. If importers are unable to partially or fully cover the amount required to pay rents and demurrage charges, clearing agents make payments on behalf of their clients to the Port authority and immediately deliver the cleared goods to their respective clients. It has been found from our study that loans may vary between Rs. 500 to Rs. 60,000. Table 24.3 gives the variation in loan amounts between 1985 and 1987 for a representative importer.

24.4 Cost of intermediation and profitability of intermediaries

24.4.1 Although clearing agents claim that they do not charge any interest, we found an implicit interest charge in their lending activities. It is found in our survey that they claim demurrage charges at rates greater than Calcutta Port Trust rates. Since importers cannot pay port charges directly to the Port Authority, and since most importers are relatively uninformed about Port Trust rules, this type of malpractice is reputed to be quite widespread. While importers do not find it easy to obtain

information on Port Trust charges, that they suspect malpractices on the part of agents may be inferred from the fact that one importer interviewed has recently gone to the courts to obtain relief. In one case, we found that a particular clearing agent charged demurrage for an item classified as Hazardous I at the rate of Rs. 45 per day per tonne, whereas the official rate, as stated in "The Calcutta Gazette" is Rs. 40 per day per tonne. Furthermore, it is also reported that this clearing agent was reluctant to show original Port Trust bills to his client. On the basis of information provided by this importer we calculated the mean interest rate (i) allowing for a "normal" return on capital employed of 100 per cent per annum for the agent and assuming that funds are indeed tied up for the maximum number of days during which his funds could have been employed in normal clearing activities.

24.4.2 i is estimated as

$$i = 1/n \sum_{j=1}^n (C(j) - (P(j)(1-a(j))))/P(j)$$

The variance of this estimate is given by

$$V = 1/(n-1) \sum_{j=1}^n [i - (C(j) - (P(j)(1+a(j))))]^2/P(j)$$

where C(j) and P(j) are the charges to the importer by the clearing agent and the actual demurrage charges calculated according to Port Trust rules respectively; n (=7) is the number of observations and a(j) is the rate of profit. Using this method we found an interest rate of 60.18 per cent per annum. The variance of the estimate was less than 0.0001.

24.5 Regulatory environment and impact

24.5.1 The impact of the government regulations in this market is felt in two major ways. Firstly, there is delayed assessment of customs duties and long disputes regarding customs duties and secondly, there is the unwillingness of (mainly nationalised) com-

mercial banks to advance loans for paying rent and demurrage charges. Because of delayed customs clearance, importers are forced to pay demurrage charges. Furthermore, since commercial banks do not advance loans for this purpose, firms meet their credit requirements in the two ways already discussed in section 3. For these two reasons costs of production for importing firms are driven up. Production costs could clearly be reduced if both these factors were ameliorated.

24.6 Market structure

24.6.1 It is very difficult to assess the nature of the market under consideration due to the various conflicting reports. An office bearer of the All India Clearing Agents Association claimed that they had started advancing credit to importers due to the declining business of Calcutta port and the resulting competition among clearing agents for shares of the shrinking market. However, our information shows that competition is absent in this market. The following evidence can be cited:

- i. High implicit interest rates.
- ii. Evidence of barriers to entry due to licensing of clearing agents by the Port Authority and the sole right of clearing agents to clear goods.
- iii. Stable and long term relationships between clearing agents and importers.
- iv. Imperfect information by clients of Port Trust charges.

24.6.2 While it may be true that clearing agents lose potential new clients to other agents due to declining business activities in Calcutta Port, they still manage to extract high profit margins in the short run from established clients by charging a high implicit interest on their loans and claiming high commissions for their clearing work. Currently, they charge 1/2 per cent to .6 per cent of total imports (C.I.F.) for their services. This is possible because clearing agents normally do not advance loans to the new customers forcing importers with funds constraints to deal with only the clearing agent with whom a long

term relationship has been established. If at all there is competition among clearing agents this is mainly for new customers. Hence, it is hard to believe that this market is competitive either in the sense of zero profits or free entry. Furthermore, it is difficult at this stage to predict the long term impact of the decline in tonnage handled by the Calcutta Port Trust on clearing charges.

24.7 Influence of formal sector lending rates and credit availability

24.7.1 The formal sector indirectly helps dockyard financing in Calcutta in two ways. As has been discussed, importers often divert a portion of loans obtained from the commercial banks to the financing of rent and demurrage charges. Secondly, clearing agents also advance loans to importers by using their overdraft facilities with commercial banks. Therefore, loosely speaking, commercial banks do indirectly assist dockyard financing, though the quantitative importance of this could not be assessed.

24.8 Efficiency and allocative impact

24.8.1 The financial assistance provided by clearing agents to importers clearly plays a role in improving the efficiency of functioning of this market. Since there is a gap between the demand for credit and supply of formal credit in dockyard financing, by channeling funds to businessmen, agents play a role in bridging the gap in financial requirements left uncovered by banks. Since most imported items are either raw material or machinery required for modernisation of factories, their services can clearly be considered as important to the efficient functioning of these organisations. Since the cost of borrowing from clearing agents, though high, must be less than the cost of borrowing from other financiers (taking into account the time factor), it can be said that their assistance to importers enables them to keep the cost of production below what it would have been without such assistance. Furthermore, it may be noted that clearing agents thereby mitigate the inefficiency engendered by the

regulatory environment, created by commercial banks, customs authorities and the Post Trust.

24.9 Recommendations for regulatory framework

24.9.1 Our first recommendation is that commercial banks should finance container, cargo, and wharfage rents and demurrage charges. In recognition of the important role that imports play in the Indian economy, special attention has to be given immediately to the provision of credit for this purpose. Since commercial banks advance loans partially for importing goods from abroad, there is no good reason why they should not grant credit for this purpose as well. Even if they give loans at the ceiling rate it would be cheaper to importers than borrowing from clearing agents and private financiers. Secondly, all Port Trust rules regarding different charges should be made available in a clearly written and easily accessible fashion to importers. This will undoubtedly reduce the costs arising from imperfect information. Furthermore, as we have noted already, delayed customs assessment and disputes regarding customs duties are the main contributory factors to the massive payment of demurrage charges. Customs authorities should look into the causes of delay and disputes to minimize the days required for customs clearance.

TABLE 24.1

Summary of Demurrage Rates

(Figures in Rupees)

S. No.	Description of goods		Charges per day		
			1-30 days	31-60 days	61 day onwards
1.	Foodgrains/ pulses, cereals, sugar, seeds of all kinds, timber.	Per tonne	20.00	30.00	40.00
2.	Glassware, porce- lain and sanitary wares, asbestos fibre.	Per Cu. metre	50.00	75.00	100.00
3.	Motor vehicle, chassis, etc.	Each	120.00	180.00	240.00
4.	Small parcels of hazardous goods	Each packet	10.00	15.00	20.00
5.	All other goods	Per tonne	40.00	60.00	80.00

Source: The Calcutta Gazette (1988).

TABLE 24.2

Import Values (C.I.F.) and Custom Duties
of an Importing Firm for 1986-87

(in Rs)

Quantity ¹	C.I.F. Value	Custom Duty
144 M/Tonnes	1,72,279.90	2,40,246.79
20 Tonnes	2,28,305.72	3,19,549.93
14.72 M/Tonnes	2,57,588.16	2,57,588.16

1 : ISOBUTYL ACETATE (Hazardous item).

TABLE 24.3

Variation in Loan Amounts

(in Rs)

Date	Loan amounts
06.06.1985	15,898
13.06.1985	25,147
05.07.1985	25,147
21.01.1986	1,800
29.07.1986	5,689
15.01.1987	14,950
01.08.1987	59,531

CHAPTER 25

THE INTERCORPORATE FUNDS MARKET

25.1 Introduction

25.1.1 When the supply of formal credit to economic units is constrained at prevailing interest rates, and when the return on saving through formal channels is fixed by regulation at below its market clearing level, some increments to the pool of loanable funds inevitably remain outside the formal credit system. Such funds, intermediated by a variety of informal intermediaries and markets, are attracted by the existing arbitrage opportunities: suppliers to better returns and buyers to cheap loans or additional finance. The intercorporate funds market (IFM) in India is, to an extent, one such market. Brief references to this market and its functioning are to be found in Timberg and Aiyar (1980) and Reserve Bank of India (1985). However, to our knowledge, no systematic attempt to study the working of this market has yet been made.

25.1.2 In this study we examine some of the organisational features of this market and try to evaluate its economic role. Besides describing the functioning of this market, the most important issue that must engage our attention is an evaluation of the hypothesis put forward by the Report of the Committee to Review the Working of the Monetary System, Reserve Bank of India (1985), better known as the "Chakravarty Committee". According to this report, "The loans are generally made by corporate units with seasonal surplus funds to other companies" and also "Evening out liquidity imbalances in the corporate sector through the development of the intercorporate funds market would provide a means of reducing the variability in the demand for bank credit and hence provide greater maneuverability to monetary regulation measures"

(RBI (1988), para 12.66). The hypothesis is, therefore, that the IFM helps to decrease fluctuations in credit availability around the trend determined by monetary measures.

25.2 Scope of the intercorporate funds market

25.2.1 Corporations have financial dealings with other corporations in three major ways: First, there are flows through their receivables account for value given. Secondly, there are flows through investment in the debt or equity of other corporations via capital markets, public issues, takeovers or the formation of subsidiaries. Finally, there are short-term loans made to other corporations and intercorporate deposits. By definition we exclude the first and second type of financial flows from the purview of this study. This corresponds with earlier usage of the term IFM. Certain external funds which flow to corporations through the same organisational channels as corporate funds are however also included in the market.

25.2.2 Exclusion of receivables is clearly appropriate since these simply represent delayed payments and have little or no relation with short term loans a priori. The exclusion of investment, especially at the short term end (represented for example, by public sector corporation bond issues with a functioning secondary market) may result in a somewhat misleading picture of the flow of funds through the intercorporate market, since both forms of corporate debt are clearly substitutable. However, even at the short-term end, the degree of substitutability is limited due to two reasons. Firstly, interest rates payable on public sector bond issues are subject to a ceiling and secondly, despite secondary markets, such investments are less readily liquidated, at least in principle, than intercorporate loans.

25.3 Organisation of the intercorporate funds market

25.3.1 This description is based on about 80 interviews with finance managers of corporations, bank officials and intercor-

porate brokers. Information from corporations was collected with the help of a structured questionnaire.

25.3.2 The IFM has two segments which have little or no interaction. One segment is the market for funds between public sector corporations. The other segment is the market for loans between private sector corporations. Both segments of the market are highly active and include among their participants the largest corporations in the respective sectors and in the latter case, blue chip companies. However, among intercorporate lenders in both segments, public sector financial institutions such as the Unit Trust of India, The Life Insurance Corporation and the General Insurance Corporation are to be found.

25.3.3 The flow of intercorporate loans is either directly negotiated between borrowers and lenders or intermediated through brokers. For public sector corporations, the portion of loans intermediated is relatively small.¹ Furthermore, the brokers for the public sector are themselves public sector banks or their subsidiaries (such as the State Bank of India's subsidiary, SBI Capital Markets). In the case of private sector corporations, the general impression is that the quantum of brokered transactions exceeds direct transactions.² Brokers are normally leading sharebrokers and are to be found in all the metropolitan cities.³ Recently, multinational banks such as Grindlays Bank, have selectively begun offering brokerage services. Nationalised banks are,

1. Exact figures are not available. According to the sample of firms studied, 22 per cent is brokered.

2. Based on claims made by persons interviewed.

3. In Delhi, leading brokers include (i) Bajaj Capital and Investments; (ii) Amrit Lal Bajaj; (iii) Rajeev Relan; (iv) Bishamber Dayal Aggarwal; and (v) Vijay Mehta. In Bombay the leading brokers include (i) Jagdish Dalal; (ii) Champaklal Investments; (iii) Bhupen Champaklal; (iv) C.J. Dalal; (v) DSP Financial; and (vi) J.M. Financial.

however, yet to make much headway in this market.

25.4 Brokerage, interest rates, loan duration, loan size and miscellaneous features

25.4.1 The brokerage charged by private brokers varies between 0.25 per cent and (in the case of one broker) 1.5 per cent. Multinational banks charge 0.5 per cent. The brokerage varies with the creditworthiness/reputation of the borrower given the added difficulty of finding willing lenders for less creditworthy borrowers. The brokerage also varies with the urgency of the loan demand.

25.4.2 Interest rates among public sector units vary between 12 and 15 per cent. These rates are bounded above by the commercial bank prime lending rate (16.5 per cent) and below by the relevant bank deposit rate (8 to 11 per cent). In the private sector, interest rates reportedly vary between 13 and 19 per cent.⁴ One broker in Bombay reported the following structure of interest rates.

	Call	3/6 month
A class companies	13.5-14	15-16.5
B class companies	13.5-14	16.5-18
C class companies	13.5-14	18-22

Another newspaper report⁵ maintained that the upper range of interest rates, 18 to 19 per cent, is applicable to companies with a low capital base facing liquidity problems due, for example, to sales fluctuations. The middle range, 16 to 17.5 per cent is for firms with strong sales who, due to a low capital base, cannot get bank accommodation. The lowest range is for companies who require short term accommodation and who have a very high credit rating

4. Business Standard, January 20, 1988 and conversations with brokers.

5. Business Standard, ibid.

due to frequent participation in the IFM. Some companies have reportedly offered interest at rates of upto 22 per cent but have been unable to find lenders at this rate which ties in well with asymmetric information based credit market models such as that of Stiglitz and Weiss (1981). Rates in the private sector are reported to vary with two factors. Firstly, the creditworthiness of the company comes into play. As can be seen from the example of the company offering 22 per cent, there appears to be an upper bound on the credit risk lenders are willing to face in making loans (Stiglitz and Weiss, 1981). The second feature is the extent of accommodation received by the firm from the banking sector. For this, the size of the capital base of a firm relative to its yearly sales is reportedly of relevance.

25.4.3 A second source of information claimed that loans fluctuated between a narrow level of 17 to 18 per cent for call loans and loans of upto 6 months duration. Our samples of companies, to be discussed further below, has revealed rates between 15 and 19 per cent.

25.4.4 Loans may be extremely short, call loans or may be for upto two years duration. The median loan in the private sector appears to be of three to six months duration, while the median loan in the public sector appears to be of six months to one year duration.⁶ Most loans in the private sector vary between Rs 25 lakh and Rs 1 crore, with a loan of as little as Rs 20,000 and another of as much as Rs 3 crore being observed. One broker claimed that blue chip companies who were frequent borrowers and/or lenders on the market had dealings of Rs 10 to Rs 15 crore per year in amounts ranging from Rs 25 lakh to Rs 1 crore. Assuming a median loan of Rs 50 lakh and dealings of Rs 13 crore, this would imply fortnightly transactions on the part of these companies. The broker in question confirmed that the market worked at a very fast pace.

6. Field interviews and survey. The Business Standard, June 15, 1988, cites a 3 year loan at 14.5 per cent per annum.

25.4.5 The average loan size in the public sector market is much larger at about Rs 10 crore though loans of Rs 100 to Rs 150 crore are not unknown. The total amount of loans outstanding at the year ending of one public sector company was as much as Rs 241 crore. In at least four other cases, total exposure exceeded Rs 100 crore. Among borrowers, one had borrowings of over Rs 1000 crore. In the private sector, one broker reported an average of about Rs 2-3 crore of loans at a time for large companies who account for about 50 per cent of loans; Rs 1-2 crore for medium companies of who account for about 30 per cent of loans and about Rs 50 lakh for small companies.

25.4.6 Loan negotiations between private corporations or arrangements negotiated by brokers are reportedly concluded extremely fast, the period varying between a few hours to upto three days. Public sector transactions are reportedly to take longer to negotiate at upto one to two weeks.

25.4.7 Bad debts in the private sector market are not unknown. At least three examples of bad debts of large loans, involving Rs 2.5 crore, Rs 2 crore and Rs 1.2 crore respectively have been cited by interviewees. The first mentioned loan had been overdue for over two years at the time of the interview. Brokers interviewed also claimed that somewhat delayed payments in the private sector were common and that their good offices were often sought to secure loan repayments. No bad debts were reported in the public sector market.

25.4.8 Loans are mostly unsecured, though a few cases of secured loans have come to light. One broker claimed that recently, companies have become more cautious in their lending in view of a series of defaults by some borrowers. He cited four instances of this in substantiation.

25.5 The size of the market

25.5.1 For public sector corporations, a sample of 13 large corporations with an aggregate paid up capital of Rs 9267 crore in 1986-87 were interviewed. The aggregate paid up capital of the 1053 existing government companies on March 31, 1987 was Rs 31,124 crore according to the annual report of the Department of Company Affairs. Thus, the sample covered 1.23 per cent of public sector companies representing 29.8 per cent of the aggregate paid up capital. The volume of intercorporate loans outstanding on March 31, 1987 for the sampled companies was Rs 1010 crore. The sample of firms included two companies which did not participate in the market, two pure borrowers, four firms that both borrowed and lent on the market and four pure lenders. The number of companies having dealings with these companies on the IFM was at least 27. If loans in the sample are scaled up proportionately by the total paid up capital of public sector companies (as on March 31, 1987), the aggregate size of the market works out to be Rs 3392 crore in 1986-87. This corresponds closely to the aggregate size of the IFM guessed at by a senior banker in Delhi, the main centre for the public sector IFM.⁷ For loans in the sample for which details were available, the (weighted) average loan duration was 8.2 months.⁸

25.5.2 The size of the private sector market has been estimated by one broker to be of the order of Rs 50 to Rs 100 crore in Delhi and Rs 300 to Rs 500 crore in Bombay at any one time. In Calcutta the market was estimated by another broker to be of the

7. Another banker felt that the size of the market at any one time would be about Rs 1000 crore. In view of the fact that the sample figure itself exceeds this - all firms sampled had the same year ending - this is clearly an underestimate.

8. The sample covered 2 to 4 years for each firm though only 1986-87 was common to all firms. The average loan duration is based on the total sample.

order of Rs 150 crore. The point in time estimate for the all India figure would therefore be between Rs 500 and Rs 700 crore giving a flow estimate of Rs 1500 to Rs 2250 crore if the average duration is taken to be four months. A sample of 47 private sector company with an aggregate paid up capital of Rs 134.84 crore in 1986/1987⁹ can be used as the basis for another estimate. Total intercorporate loans by the sample were Rs 111.69 crore. The all India figures as per the Department of Company Affairs (on March 31, 1987) were 1,37,133 companies with a paid up capital of Rs 9383 crore. Thus the point estimate of the all India size of the market on the basis of paid up capital is Rs 7772.08 crore. Even if intra-group loans amounting to Rs 4096 crore are netted out, the point estimate for the size of the market works out to Rs 4922 crore in 1986-87. These estimates are markedly different from the estimates given by the brokers, reflecting a bias in the sample towards large firms. Thus, for the private sector IFM we retain as our estimate the median estimate by brokers of Rs 600 crore.

25.6 Regulatory environment

25.6.1 The Chakravarty Committee has stated that, 'According to Tandon/Chore norms, companies with a current ratio of less than 1.33 are discouraged from making intercorporate loans but those with a better current ratio are permitted to make such loans'.(Para 12.66)¹⁰ However, the extent to which commercial

9. Unfortunately, firms in this segment had widely differing balance sheet dates. Credit balances with one firm are not matched by debit balances with correspondent firms due to this reason. We have followed the practice of considering the larger figure if exact loan details are available. Furthermore, we have, perforce, ignored the different year endings. The reported figure is, however, for year endings between July 1986 and June 1987.

10. 'Tandon' refers to the Reserve Bank of India's 'Study Group to Frame Guidelines for Follow-up of Bank Credit, 1974 which provides guidelines for assessing credit requirements for industry and proposes inventory norms.

banks monitor intercorporate lending at the time of sanctioning credit facilities to firms is open to question given that the Chakravarty Committee expressed dissatisfaction with current credit appraisal practices. Furthermore, these restrictions are only indicative. Their success, even if bank credit appraisal takes note of these norms, will be restricted to companies who find no substitute for bank credit and who are thereby forced to accede to these norms. A firm which has enough funds to lend on the IFM clearly will not be in severe need of bank credit unless it is channeling bank credit to the IFM.

25.6.2 A second item of regulation is provided by the Companies Act, 1956, Sections 369 and 370 relate respectively to loans (excluding book debts) by companies to their managing agents or to companies with the same managing agent and to loans (excluding book debts) to companies under the same management or other companies in general. The overall limit on such loan is fixed at 30 per cent of the subscribed capital plus free reserves of the company for loans to companies not under the same management (20 per cent for companies under the same management with no limits on loans from holding companies) unless prior approval of the Central government obtained. This limit is in the process of being revised. Furthermore, for loans in excess of 10 per cent of subscribed capital and free reserves, prior approval of the shareholders by special resolution is called for. Even here, the provisions of the Section 370 do not apply to private limited companies.¹¹ During the year 1986-87 only 22 applications were considered by the Department of Company Affairs of which 11 cases

`Chore' refers to the Working Group to Review the System of Cash Credit appointed by the Reserve Bank in 1977. This group recommended ways of encouraging firms to finance their own inventories. It also recommends methods of supervising borrowers.

11. Vide a judgement delivered in the Bombay High Court in Durga Prasad Mandelia versus Registrar of Companies (1987), 61, Company Cases, 479.

were approved. It is hard to see how these sections are enforced given the possibility of making and liquidating loans between financial year endings. At any rate, it is entirely possible that the loan figures given in the previous section, though extremely large, underestimate the true extent of the market.

25.7 Supply and demand for funds: qualitative aspects

25.7.1 Various facts have come to light as to the determinants of supply and demand for funds in the IFM. The most important finds are as follows. Firstly, public sector corporations interviewed reported that they resort to the IFM in view of the spread between bank deposit and lending rates and borrow mainly to even out short term fluctuations in cash flows not expected to continue over the long term. Thus borrowers go to the IFM mainly due to its speed and due to the lower cost of borrowing. In contrast, private sector firms are actively constrained for funds. The evidence for this is the fact that they are willing to pay rates of interest above the bank lending rate. Secondly, borrowers on the private sector IFM on occasion use IFM funds to finance fixed asset formation. At least two cases of this - and that too of blue chip companies - have come to light.¹² Thirdly, the aggregate availability of funds in the market responds to changes in bank credit availability and attempts by banks and the government to mobilise deposits. It has been claimed that the enhanced rates of return paid by government saving institutions in recent years, has caused the supply of funds to the IFM to decrease. Also, interest rates on the IFM display "seasonal" fluctuations. The tight season occurs towards the end of the calendar year since banks actively solicit deposits at that time to meet deposit mobilisation targets.¹³ Besides these major features, two other points may be

12. In the pharmaceutical and instrumentation sectors. A broker claimed that this practice was fairly common.

13. Both points in relation to bank/government influence are from the Business Standard, January 20.

mentioned.

- i. The public sector IFM reportedly has the blessings of the Finance Ministry.¹⁴
- ii. The following two features, both related to government policies or activities, have been cited as contributing to the financial tightness faced by some firms: (a) requirements for the advance payment of various levies and taxes; and (b) tardy payment of dues by government departments and by public sector companies (to each other and to the private sector) for goods bought on deferred terms. Cases of overdues for up to two years have been cited.¹⁵

25.7.2 Regarding specific instances of sources of surplus cash, the following relevant information has been gained.

- i. Manufacturers of vehicles, in both the public and the private sectors usually take advance payments, to be adjusted at the time of delivery, from customers who book orders for vehicles. These funds are often in excess of their needs especially when the vehicle manufactured is in high demand, so that bookings are in excess of production capacity. These funds are often deployed on the IFM. Since advance payments do not earn very high rates of interest, profitability of such firms is greatly aided by IFM loans.
- ii. One public sector corporation, with sales primarily to government departments and undertakings, receives most of its payments in the month of March/April. This is utilised to make IFM loans. However, during the lean season (around September), it occasionally has to borrow from the IFM.
- iii. Two large public sector trading firms get bank credit to pay for imports made by them. The credit period is 180 days. However, the resale of imported items is usually complete in three to four months, leaving the firms with surplus cash for two to three months. These funds are diverted to the IFM.
- iv. Two firms, one in the private sector and one in the public sector, claimed that their surplus funds were simply from retained earnings not channeled immediately to fixed investment.

14. Business Standard, June 15, 1988, op. cit.

15. Both points are taken from the Business Standard, ibid.

- v. It is reported that several finance corporations and other non bank intermediaries also lend large amounts on this market.
- vi. Directors and senior managers of corporations form investment companies to channel funds to intercorporate loans and investments. This has been reported in Nayar (1984).

25.7.3 With regard to demand for funds, the only important information gained, which has been mentioned earlier, is that some firms use funds to finance capital projects by rolling over loans. This has been claimed to be a fairly common practice.

25.7.4 The importance of such qualitative information lies in the fact that it provides indications of various factors affecting the cash flow of borrowers and lenders. Since the IFM is primarily a market for short term loans, it is most useful to have information about cash flows as this will ultimately determine which firms are borrowers and which lenders. Much of the evidence in this section provides support for the Chakravarty Committee's hypothesis. The rest of the evidence either has no bearing on the hypothesis or leaves open the door to contradicting it without actually doing so conclusively. Analysis of financial statements normally available is unlikely to prove as useful. Nevertheless, we now proceed to an analysis of selected financial ratios to examine differences between borrowers and lenders.

25.8. Analysis of financial ratios of participating and non-participating firms

25.8.1 We consider five financial ratios in this analysis:

- i. The equity-sales ratio (ES): The equity position of a firm has been cited as a key determinant of the extent of bank accommodation they can get. If equity is low relative to sales, then under this hypothesis, the quantum of bank finance would be inadequate. Thus, borrowers would be expected to have a lower ES than lenders. However, if the Chakravarty Committee is correct - in that the IFM meets temporary needs for finance not of a long term nature - then no pattern will necessarily be present.

- ii. The debt-equity ratio (DE): Since intercorporate loans are relatively expensive, at least for the private sector, borrowers could on average be expected to exhaust other sources of borrowed funds, including long term sources, before approaching the IFM. Bank credit should also be less readily forthcoming for highly leveraged firms. Both arguments suggest that borrowers would have a high DE. Once again, a lack of any pattern in the DE would tend to support the Chakravarty Committee (DE has been computed here as the rate of borrowed funds to owned funds).

- iii. The Net Current Ratio (NCU), Quick Ratio (QUI) and Current Ratio (CUR): All three ratios are measures of liquidity. The net current ratio gives the percentage of net current assets to total assets. A higher ratio would reflect a surplus liquidity position. Since current assets and current liabilities appear in the numerator, an intercorporate loan will not effect the value of the ratio.¹⁶ Borrowers should therefore be expected to have lower NCUs than lenders. In case the ratio is higher or the same for borrowers as for lenders, this may be taken as a sign of sticky "current" assets in borrower's portfolios. Once again, such a finding would support the Chakravarty Committee's position since sticky receivables clearly constitute a case of "temporary" tightness in cash flow which can usefully be ironed out by non bank sources of funds. However, the alternate hypothesis outlined earlier is not thereby rejected. The quick ratio (current assets less inventories as a ratio of current liabilities) should similarly be higher for lenders than for borrowers if the Chakravarty Committee thesis is to be contradicted. Finally, the current ratio (current assets to current liabilities) should also be lower for borrowers.

25.8.2 Table 25.1 presents the average ratios separately for public and private sector borrowers and lenders. For comparison, average ratios for non borrowers and for all firms are also presented.

25.8.3 In the case of private limited companies, ES provides

 16. The lender will have a decrease in one current asset, cash and bank balances and an increase in another current asset, loans and advances. The borrower will have an increase in a current liability, short term borrowings and either an increase in cash and bank balances or a decrease in dues payable.

evidence against the committee's view but the evidence is weak given that non-participants have the same ES as borrowers. The ratio DE tends to reject the Chakravarty Committee's position though the difference in means between borrowers and lenders is not statistically significant. However, the more important liquidity ratios NC and Q do not add their support to DE. Likewise, CUR has the opposite sign from that expected. The ratio CUR, being low for all private sector firms, goes to suggest that bank credit norms are irrelevant for the private sector IFM. Overall, the evidence does not permit us to reject the committee's hypothesis.

25.8.4 In the case of the public sector IFM, only the quick ratio has the right ranking between borrowers and lenders and even here, the difference in borrower's and lender's ratios is not significant. Thus, the analysis of ratios for the public sector also tends to support the committee's position¹⁷.

25.8.5 Overall therefore, both qualitative information and ratio analysis would tend not to reject the position of the Chakravarty Committee with regard to the public sector IFM. In the case of the private sector IFM, qualitative evidence suggests that long term credit constraints also play a role. We must enter the caveat that, the sample size being limited, the findings are ten-

17. To further examine the situation, net inter-corporate borrowings was regressed on ES, DE, CUR/NCU and QUI separately for private and public sector units. CUR and NCU were only tried separately due to their high correlation. One observation each per firm per year for which data were available was used. Thus there were 27 observations for the public sector and 81 observations for the private sector. While goodness of fit and specification diagnostics were uniformly poor for the private sector regression, CUR and DE were significant and contrary to the committee's position for the public sector regression. However, specification diagnostics were poor for this regression as well. The regressions are therefore not reported here.

tative.

25.9 Some omitted factors

25.9.1 Two factors which will clearly prove revealing in the study of the IFM have been omitted due to the limited data base for the study. The first is the sectoral pattern of intercorporate borrowings and the second is the influence of India's fast expanding stock market. The first item requires a large panel data set so that the fluctuating fortunes of different sectors over time can be captured. The second item requires time series data. Both items are presently beyond our resources since available data bases on the corporate sector do not give details of IFM transactions.

25.9.2 The influence of the interest rate and of the structure of returns on alternative assets has also not been addressed. Once again, this is because of the unavailability of a sufficiently large panel data set. The interest rate dispersion observed in the private IFM, it seems clear, is the result of differences in risk and convenience. While this could be tested with the aid of balance sheet ratios and other available data, the available qualitative information appears to be strong enough to make the exercise unnecessary.

25.10 Implications for monetary policy

25.10.1 The large size of the intercorporate funds market - at least 20 per cent of bank credit to companies - must give it the potential to destabilise monetary policy. While it is true that the evidence cited indicates that both the quantum and the cost of funds on the IFM respond to changes in bank credit and money availability, this does not give a complete picture of the impact of the market on monetary policy.

25.10.2 The first problem concerns the size of the money multiplier. While it is indeed likely that a tight credit policy will

be reflected in a tight IFM, the exactness with which the Reserve Bank can predict the impact of a given degree of credit tightening must necessarily be affected. Thus policies designed to counter a given level of inflationary overheating in the economy may either have a negligible impact or an overly restrictive impact. What is important is the greater uncertainty associated with the multiplier engendered by this market.

25.10.3 Secondly, it should be clear that selective credit controls, applied to different segments of the corporate sector will be seriously undermined. Thus, while the Chakravarty Committee may be right in saying that the IFM smooths over short term funds availability problems, it must be acknowledged that this works equally well when the cause of the credit tightness is a selective credit control.

25.10.4 Both these destabilising influences are likely to be aided by the fact that funds flow into this market from outside the corporate sector proper (through, as mentioned, other non bank intermediaries).

25.11 Summary of main points

25.11.1 The IFM has been defined to be the market for short term loans and deposits to corporations, usually between corporations, in accordance with earlier usage. It has two segments which are more or less compartmentalised. One segment consists of public sector companies and the other consists of private corporations. In the public segment, transactions are negotiated either directly or by nationalised banks and their subsidiaries. In the private segment loans are negotiated directly, through brokers and, in the recent times, by multinational banks. In the private segment, brokerage rates range between 0.25 and 1.5 per cent.

25.11.2 Interest rates vary between 12 and 15 per cent in the public sector segment and between 13 and 19 per cent in the

private segment. In the private segment rates vary with the urgency of the loan demand and with the credit rating of borrowers. Potential borrowers offering higher rates reportedly do not find lenders due to the adverse creditworthiness position such an offer signals. Loan durations are usually from 3 to 6 months in the private segment and 6 to 12 months in the public segment. The average loan size is Rs 10 crore in the public sector and Rs 25 lakh to Rs 1 crore in the private sector. The private sector market is reportedly very fast paced and fluid.

25.11.3 Lending on the market is regulated indicatively by banks who discourage firms with current ratios of less than 1.33 from lending on the market. Sections 369 and 370 of the Companies Act, 1956 also place a ceiling, in terms of net owned funds, on the quantum of loans to related and unrelated corporate bodies unless prior government approval is obtained. The effectiveness of the latter body of regulations is open to doubt.

25.11.4 Three important findings as to the supply and demand for funds in the IFM are:

- i. While public sector firms mainly enter this market to take advantage of better returns or cheaper loans than banks offer, private sector firms may borrow from the IFM to ease credit shortages.
- ii. Funds from the private sector IFM are demanded by some firms to finance fixed capital formation.
- iii. Bank credit availability and deposit mobilisation and government credit instruments influence the cost and availability of funds in the IFM.

25.11.5 A fourth feature influencing demand is compulsory advance payments of rates and taxes and tardy government payment for value received.

25.11.6 Advance deposits for vehicles, bunched payments by government departments for value received and extended bank credit for foreign trade finance are some of the sources of surplus funds identified.

25.11.7 Non bank intermediaries such as finance corporations are also known to lend on the IFM.

25.11.8 From the analysis of financial ratios, the Chakravarty Committee's hypothesis cannot be rejected.

25.11.9 Three potentially important factors not studied due to lack of data are the sectoral pattern of IFM participation; the influence of capital markets; and the influence of interest rates both in the IFM and for alternative assets.

25.11.10 A priori, the IFM has the potential to destabilise monetary control by enhancing the uncertainty of the money multiplier and rendering selective credit controls ineffective though this is not testable with available information.

TABLE 25.1

Selected Financial Ratios

FIRM GROUP		equity- sales	debt- equity	current	net current	quick
All Firms	mean	0.57	2.06	0.56	-0.19	-0.03
	st. dev.	1.02	1.43	0.38	0.42	0.42
Public Sector						
All firms	mean	1.12	2.57	0.44	-0.23	-0.05
	st. dev.	1.86	1.86	0.32	0.50	0.52
Borrowers	mean	1.57	2.32	0.39	-0.21	-0.11
	st. dev.	2.27	2.03	0.22	0.53	0.58
Lenders	mean	1.19	2.89	0.40	-0.25	0.05
	st. dev.	2.09	1.96	0.23	0.53	0.42
Others	mean	1.01	1.65	0.74	-0.12	0.29
	st. dev.	0.49	0.77	0.57	0.22	0.16
Private Sector						
All firms	mean	0.38	1.89	0.60	-0.18	-0.01
	st. dev.	0.34	1.21	0.39	0.17	0.40
Borrowers	mean	0.28	2.42	0.62	-0.16	-0.11
	st. dev.	0.15	1.36	0.35	0.18	0.43
Lenders	mean	0.47	1.81	0.51	-0.19	-0.16
	st. dev.	0.38	1.26	0.25	0.12	0.26
Others	mean	0.28	1.94	0.76	-0.14	0.16
	st. dev.	0.23	1.21	0.50	0.19	0.45

PART G

Financing of Credit Using Sectors

CHAPTER 26

FINANCE FOR FEATURE FILM PRODUCTION IN MADRAS

26.1 Introduction

26.1.1 Feature film production has not been recognised as an industry though film producers have been making representations to the Government for industry status. If such a status is given, this will improve the accessibility of bank funds for film producers. Currently, banks lend only to a limited extent, to established and reputed film producers, not for film production as such, but as overdraft facilities fully secured by immovable property. The reason is that film production is a highly risky business.¹ Finance of feature films has earlier been briefly described in Aiyar (1979).

26.2 Dispersion of the sector

26.2.1 There are over 5000 film producers in the country. Except for a few institutional producers, the bulk of producers are individuals, who float proprietorship or partnership concerns. Some of them act on behalf of individuals who wish to use their unaccounted money and who, understandably, wish to remain anonymous. Government servants, public sector officials, political party members are among those who engage in film production either openly or covertly. In the last five years, an average of 818 films have been produced and released in all Indian languages. Of them, Hindi, Telugu and Tamil films account for about 60 per cent. While about 800 films are released every year about the same number of films are in different stages of produc-

1. The information for this study was collected mainly through personal interviews with film producers, studio managers, film financiers and artistes.

tion, at any time of the year. The language-wise breakup of films certified by the Censor Board for 1982 to 1986 is in Table 26.1.

26.3 Area surveyed, general description of area

26.3.1 The metropolis of Madras, selected for this survey, is the second largest film producing center in terms of investment after Bombay which has been described as the Hollywood of India. In terms of numbers, however, Madras, which is the centre for production and processing of South Indian (Tamil, Malayalam, Telugu and Kannada) films, is ahead of Bombay which is the centre for production and processing of Hindi and Marathi films. Besides this, film financiers for films in South Indian languages are generally from Madras. Regarding the number of films produced in 1986, South Indian films accounted for 63.7 per cent of the total number of films produced in India with Hindi films coming next with 18.9 per cent. However, in terms of investment in film production, Bombay easily stands first because almost all big budget films are produced there. The combined investment of four South Indian language films on a rough estimate, is less than a big budget Hindi film. Table 26.1 shows that between 1982 and 1986, the number of south Indian language films exceeded the total number of films in all other languages except Hindi.

26.3.2 Organisation of film production: Film producers do not own facilities like shooting equipment, shooting floors etc. but hire them to suit their specific needs. Various production facilities are available with small business units which are hired out at standard rates. Between the producers at one end and the cinema viewing public at the other, there is a system for providing facilities for shooting, music, dubbing, processing, financing, distributing and exhibiting. Before examining the sources of working capital and the method of financing, it is necessary to understand the various stages involved, all of which require financing.

26.3.3 Production: When a producer decides to take a film, he

has to select a story for which he has to pay story writers. The other persons to be selected and paid are the director, cameraman, script writer, lyricists, music director, singers, editor and the artistes. The choice of artistes depends on the ability and popularity of artistes and they are paid fees ranging from Rs. 5 lakh to Rs. 20 lakh. This is in fact, the major item of expenditure in film production.

26.3.4 Until a decade ago, shooting was done in studios which erected the required sets, with the assistance of art directors. This method has changed over the last ten years. A major part of the shooting is now carried out on location. Quite a few private bungalows in metropolitan cities are hired out for shooting purposes and the hiring charges per day are between Rs. 1,000 and Rs. 3,000. The producer has also to select a song recording studio, and the selection is influenced by the credit facilities offered by studios. He has also to make travel arrangements and hotel accommodation for artistes, director, cameraman and the crew of the production unit. The production period varies from two months to over one year. Each of these items described requires working capital.

26.3.5 Distribution: Once the picture is ready for release, the producer orders the required number of copies with the laboratories and hands them over to distributors, as per prior agreement, for exhibition in theatres. It is the responsibility of the distributors to book theatres with producers supplying necessary publicity material. Most established producers have regular distributors. Distribution rights are normally assigned to distributors for a specified period at an agreed price. The distributor is free to sub-distribute films within his jurisdiction. The distributors have to make arrangements with theatres in their respective areas for exhibition. There are a little more than 6000 theatres in India.

26.3.6 Exhibition: In metropolitan cities and leading towns, distributors normally book the theatres for a specified number of

weeks, by making advance payment of between Rs.15,000 to Rs.50,000 per week for 21 shows. In smaller towns, however, the practice is for the theatre owners to pay an advance to distributors to have their film exhibited. For old pictures, there is an arrangement by which the weekly collections net of taxes, are shared by the distributor and the theatre owner in a descending ratio - 50:50, 45:55, 40:60 - in succeeding weeks.

26.4 Sources of funds and characteristics of finance

26.4.1 The necessity for liquid funds and credit at different stages of production of films has been highlighted in the preceding paragraphs. What are the sources of funds and what are the shares of the formal and informal financial sectors?

26.4.2 The sources of finance for film production are (a) producer's own funds, (b) finance from distributors, (c) individual film financiers/finance corporations, (d) credit facilities from studios, (e) credit facilities from laboratories, and (f) subsidies of Rs. 50000 to Rs. 1 lakh from Governments in some States for shooting the entire film in their States. The proportion of these finances is not the same for all producers.

26.4.3 Own capital: In most cases, own funds of small producers constitute only a small percentage of total production cost. Instances of only 5 per cent own investment have come to light. A few established producers who have institutionalised their operations may however contribute upto 25 per cent from own funds.

26.4.4 Distributors as financiers: There are hundreds of film distributors in the country. Many of them bid for distribution rights of films in specified areas at the commencement of film production. Some distributors also act as agents for well to do persons for a consideration. There are also films where distributors hesitate to come forward because they are not satisfied with the cast or the story. Many films have not been released at all for want of distributors since most producers do not have the

resources to distribute films by themselves. When a distributor shows his readiness to take up distribution rights, a formal written agreement is entered into and an advance is paid to the producer. There are clauses in the agreement for periodical payments and a final payment before delivery of prints. The agreement provides for distribution rights to the distributor for a specified time in a specified area. The number of prints and the price depend on the area covered. When top stars and directors are involved, films get a premium price, fetching as much as Rs. 50 lakh to Rs. 70 lakh in Tamilnadu and Andhra Pradesh and upto Rs. 3 crore for Hindi films.

26.4.5 Film financiers: The major source of finance for the majority of film producers is private film financiers and finance corporations. According to Aiyar (1979), Shikarpuri bankers are prominent among financiers active in film finance. These financiers usually provide 50 per cent to 60 per cent of production costs. The practice in such financing is to transfer film negative rights to financiers. A letter from the processing laboratory, known as a "Lab Letter", has to be obtained from the film laboratory engaged by the producer to irrevocably confirm that prints will not be delivered to the producer until the financier gives a letter of clearance that dues have been settled.

26.4.6 Credit facilities from studios: Recording studios and studios which have facilities for shooting extend credit facilities for set erection, supply of cameras and other equipment. Their dues are expected to be settled before release of pictures.

26.4.7 Credit facilities from laboratories: Processing laboratories, in order to remain competitive, extend credit facilities to film producers. They undertake to supply film negatives, make 'rush' prints and the censor copy. On average, such credit for each film, will be around Rs. 1 lakh to Rs. 2 lakh. Here too, the understanding is that all dues will be settled at the time of release of the film.

26.4.8 Thus the entire film production costs are financed by informal sources - studios/laboratories, distributors, financiers and producers. Film production does not receive financial assistance for its working capital needs from any formal sector financial institutions except for the limited exceptions mentioned earlier.

26.4.9 Period and amount of credit: The period of credit varies from supplier to supplier depending on the stage of production at which it is extended. Generally, financier's credit does not exceed six months. The size of credit also varies, depending on the budget of films. In small budget films of Rs. 10 lakh to Rs. 20 lakh, the entire period of production may be around six months and the size of credit may be about 50 per cent from financiers, 20 per cent from studios/laboratories and the rest from distributors and own sources. In big budget films, the share of distributors will be higher and that of financiers lower.

26.4.10 Loan interest rates: Most financiers charge interest at compound rates of 67 per cent to 99 per cent per annum, payable quarterly, with the first quarter's interest taken in advance. Studios and laboratories do not charge explicit interest for facilities offered. Their charges are paid when the print is delivered to the producer.

26.4.11 Security for loans: The financiers lend against demand promissory notes with the additional guarantee of the "Lab Letter". No collateral is demanded by any source of finance. However, all creditors ensure that they are in a position to prevent the release of the film unless their dues are settled.

26.4.12 The main reason for the dependence of film producers on the informal financial sector is the practice of unaccounted cash payments for each major activity and service in film production. Recorded payments and expenditures are 50 per cent or even less of total expenses incurred.

26.4.13 Unaccounted and cash payments: As gathered from informal discussions with knowledgeable persons, the various unaccounted payments in film production may be listed as follows:

- i. Film stars: About 60 per cent to 80 per cent of their fees (which range between Rs 2 lakh and Rs 20 lakh) are unaccounted.
- ii. Film and music directors: 50 per cent to 60 per cent of their fees (which are between Rs 1 lakh and Rs 3 lakh) are unaccounted.
- iii. Musicians: 50 per cent of their fees (Rs 2000 to Rs 20000 per song) are unaccounted.
- iv. Distributors pay 30 per cent to 40 per cent of distribution charges in cash.
- v. Film financiers show only 24 per cent interest, as compared to the 48 per cent to 60 per cent actually charged by them, in their books.
- vi. Outdoor equipment suppliers, theatre owners and film laboratories also make or receive part payment off the books.
- vii. Producers commonly show personal expenses as production costs.

26.5 Estimate of informal finance in this sector

26.5.1 The data in Table 26.1 can be used along with the information we have on the cost of film production to derive an approximate idea of the annual expenditure on film production. Approximately 10 per cent of films are big budget films, 40 per cent are medium budget films and 50 per cent are small budget films in all languages. The average cost of each type of film can be taken to be Rs 1 crore, Rs 50 lakh and Rs 20 lakh respectively except for Hindi films where these would be Rs 3 crore to Rs 6 crore (say Rs 4.5 crore), Rs 1 crore and Rs 25 lakh respectively. Furthermore, approximately 5 per cent of films are never released so that films actually financed can be taken to be 5 per cent higher than in Table 26.1. Thus, for 1986, the total expenditure on film production can be calculated at Rs 440 crore. The calculations are exhibited in Table 26.2. Allowing a 25 per cent error margin, upper and lower bounds can be given as Rs 550 crore and Rs 330 crore. Ninety five per cent of these production costs are financed by informal credit (50 per cent from financiers, 10 per

cent from studios and laboratories and 35 per cent from distributors and others). Since the average duration of credit for small and medium budget films can be taken to be six months and that for big budget films 1 year, the total informal credit in rupee-years is Rs 279 crore with an error margin of Rs 70 crore.

26.6 Distributional impact of film finance

26.6.1 Since financiers prefer to spread their risk by lending small amounts to several borrowers, the extent of finance going to small film producers is proportionately greater than that to large film producers. Secondly, the number of small and medium budget films is much higher than the number of big budget films. This gives an indication of the distribution of informal finance between small and large firms. The indirect distributional impact through employment generation, since film production and exhibition are labour intensive, may also be mentioned.

26.6.2 There are three categories of persons in film production: (a) artistes, the director, cameramen, the music director, script writers and their assistants; (b) technicians including stage erectors, electricians and make-up men; and (c) labourers, who move shooting paraphernalia from place to place, cooks, caterers, etc.

26.6.3 Direct employment: We may roughly estimate the total number of persons employed under the three categories above in a medium budget film which takes 6 months to produce at 400 (100 artistes and 300 others). Two such films give employment to 400 persons a year. Thus the total employment attributable to the 840 films censored in 1986 would be $(840 \times 200) = 1,68,000$ persons.

26.6.4 Indirect employment: Besides this direct employment, there are two types of indirect employment arising from film distribution and film screening at theatres. Further employment is created near the 6000 and odd cinema theatres for the thousands of small shops selling refreshments, beedis, cigarettes, etc.

26.6.5 The point to note here is that this employment generating activity is made possible due almost entirely to informal finance. Formal finance plays next to no role in this sector.

26.6.6 On the negative side it should however be noted that the structure of gains from film-making disproportionately favours the few stars, producers, distributors, theatre owners and financiers.

26.7 Efficiency and allocative impact

26.7.1 Besides the employment generation discussed above, the film industry contributes disproportionately to public sector resource mobilisation through various levies like the income tax (on artistes and producers), entertainment tax and the theatre tax. The former accrues to the Central government and the latter to State and local bodies. To the extent that enhanced public revenues improve the allocation of resources, this can be taken as a gain in the allocation of resources attributable to the film industry and indirectly, informal finance for films. Employment and revenue gains must however be weighed against the diversion of funds to unaccounted uses.

26.7.2 Realising the influence of films on people and their potential for providing employment and income and with the object of promoting good cinema in the country, the Central Government established the National Film Development Corporation, (NFDC) in 1980 by merging the erstwhile Film Finance Corporation and Indian Motion Picture Export Corporation.

26.7.3 The NFDC finances and produces films. Upto 1986, it financed 157 feature films. NFDC financed films have won 116 national and 28 international awards. The NFDC extends financial assistance for the construction of cinema theatres and has, upto March 1986, sanctioned loans for 111 theatres. It also organises international and national film festivals in order to popularise

Indian films. This State-run corporation is a good source of help to film producers including new entrants and in a modest way, it enables a few talented producers to avoid private financiers. However, the extent of finances is small relative to the total.

26.7.4 A partial solution to the problem of black money generation and circulation is the expansion of activities of the NFDC - more direct production by it, more finance to talented producers and directors and credit for the construction of theatres.

26.8 Summary of main points

26.8.1 Feature film production is an expensive affair. If a producer is able to organise some finance on his own, he is able to obtain the rest from informal sources. Formal finance is limited.

26.8.2 In 1986, South Indian films accounted for 63.7 per cent of the total number of films produced in India; Hindi films came next with 18.9 per cent. However, in terms of investment in film production, Bombay is first. At a rough estimate, the combined investment for four South Indian films is less than that for a big-budget Hindi film.

26.8.3 Film producers do not own facilities like shooting equipment and studios. Production facilities are available on hire.

26.8.4 Producers must provide finance for the director, cameraman, script writer, lyricists, music director, singers, artistes etc., and also for travel and stay of people in different places.

26.8.5 Sources of finance for film production are (a) producer's own funds, (b) finance from distributors, (c) individual film financiers/finance corporations, (d) credit facilities from studios, (e) credit facilities from laboratories,

and (f) (in a few cases) subsidies of Rs. 50,000 to Rs. 1 lakh from State governments. Banks do not directly finance film production while the NFDC supports only selected films.

26.8.6 Credit facilities are made use of at different stages of production and therefore, the period of credit varies from supplier to supplier. Generally, financier's credit does not exceed six months.

26.8.7 Financiers who are the major credit source charge interest at 67 per cent to 99 per cent per annum.

26.8.8 The main reason for the dependence of film producers on informal finance is the practice of unaccounted cash payments in film production.

26.8.9 Total investment in film production in India is estimated to be Rs 440 crore in 1986. Total informal finance for this is estimated at Rs 279 crore rupee-years.

26.8.10 The evidence suggests that informal finance is skewed in favour of small producers. There may also be significant distributional gains through direct and indirect employment generation. Efficiency gains arise due to employment creation and government revenue generation. These must be weighed against the generation of black money.

26.8.11 With a view to helping film business, the Central Government established the National Film Development Corporation (NFDC) in 1980. The NFDC finances and produces films. It also extends financial assistance for construction of cinema theatres. It is a good source of assistance to film producers.

26.8.12 A partial solution to the problem of black money generation and circulation by film business is the expansion of activities of NFDC.

TABLE 26.1

Number of Indian Feature Films Certified by Censor Board

Language	1982	1983	1984	1985	1986
1. Telugu	155 (20.31)	131 (17.68)	171 (20.53)	198 (21.68)	192 (22.86)
2. Tamil	140 (18.35)	128 (17.27)	148 (17.77)	190 (20.81)	154 (18.34)
3. Malayalam	117 (15.33)	112 (15.11)	121 (14.52)	137 (15.00)	130 (15.48)
4. Kannada	51 (6.68)	72 (9.72)	80 (9.60)	70 (7.67)	59 (7.03)
5. Hindi	148 (19.40)	132 (17.81)	165 (19.81)	187 (20.48)	159 (18.94)
6. Bengali	49 (6.42)	49 (6.61)	35 (4.20)	28 (3.06)	47 (5.60)
7. Bhojpurī	3 (0.39)	11 (1.48)	9 (1.08)	6 (0.66)	19 (2.26)
8. Oriya	9 (1.17)	12 (1.62)	14 (1.68)	17 (1.86)	17 (2.02)
9. Marathi	24 (3.15)	20 (2.70)	25 (3.00)	16 (1.75)	17 (2.02)
10. Gujarati	39 (5.12)	27 (3.64)	30 (3.60)	22 (2.40)	13 (1.54)
11. Assamese	5 (0.66)	-	5 (0.60)	10 (1.09)	11 (1.30)
12. Punjabi	6 (0.79)	19 (2.56)	10 (1.20)	8 (0.87)	7 (0.83)
13. Others ²	17 (2.23)	28 (3.80)	20 (2.40)	24 (2.67)	15 (1.78)
TOTAL	763 (100)	741 (100)	833 (100)	913 (100)	840 (100)

Notes: 1. Figures in brackets indicate percentage to total.

2. Others include Bodo, Garhwali, Manipuri, Urdu, Maithili, Avadhi, Nimadi, Sindhi, Dimasa, Karli, Rajasthani, Haryanvi, Nepali, Konkani, Sanskrit and English.

Source: South Indian Film Chamber of Commerce, Madras.

TABLE 26.2

**Estimated Cost of Film Production in 1986
and Informal Credit for Film Production**

(Rs. Crore)

	Number of films	Cost per film	Total cost	75 % of col. (4)	125% of col.(4)
(1)	(2)	(3)	(4)	(5)	(6)
A. Hindi films	166.45	-	-	-	-
1.1 Big budget (10% of A)	16.70	4.5	75.15	56.36	93.94
1.2 Middle budget (40% of A)	66.78	1.0	66.78	50.09	83.48
1.3 Small budget (50% of A)	83.48	0.25	20.87	15.65	26.09
B. Other language films	715.05	-	-	-	-
2.1 Big budget (10% of B)	71.51	1.0	71.51	53.63	89.39
2.2 Middle budget (40% of B)	286.02	0.5	143.01	107.26	178.76
2.3 Small budget (50% of B)	357.53	0.175	62.57	46.93	78.21
C. Total	882	-	439.89	329.92	549.86
Finance					
D. Finance required	-	-	293.28	219.96	366.59
E. Own funds (5% of D)	-	-	14.66	11.00	18.33
F. Film Financiers (50% of D)	-	-	146.64	109.98	183.30
G. Studios & laboratories (10% of D)	-	-	29.33	22.00	36.66
H. Distributors & others (35% of D)	-	-	102.65	76.99	128.31
I. Total informal credit (F+G+H)	-	-	278.61	208.96	348.26

Notes: 1. Figures for finance required are in crores of rupee-years.
 2. Credit for big budget films is required for one year on aggregate.
 Credit for other films is required for 6 months on average.

CHAPTER 27

GARMENT EXPORTERS IN DELHI

27.1 Description of salient features and geographical dispersion of sector

27.1.1 Garment exports are emerging as India's leading export industry and have been growing at a phenomenal rate. For such an important sector, what is surprising to the outsider is the lack of statistics on even such basic items as the number of export firms or the total employment in the sector. There reportedly exists a large number of dummy companies due to the method of assignment of export quotas by the government and due to tax reasons. However, the Apparel Export Promotion Council had 6250 merchant exporters/ manufacturing exporters of ready-made garments in India on its register in April 1986.

27.1.2 **Sudden rise of the industry:** India's garment exports amounted to an insignificant Rs. 9 crore in 1969-70. It is a remarkable feature in the history of garment exports that these soared to Rs. 1323 crore in 1986 - a compound annual growth rate of 33.6 per cent. By 1975, India had established a firm presence in world markets, when it exported garments worth over Rs. 119 crore. By 1981-82, exports reached the level of Rs. 670 crore and in 1987 exports of ready-made garments reached an all time high of Rs. 1863 crore (estimated) contributing as much as 12 per cent to the total export basket of the country. The growth rates of exports during the most recent two years have been 25 per cent and 40 per cent respectively. For 1990 garment export target has been fixed by the government at Rs. 2500 crore.

27.1.3 The major market for Indian ready-made garment is the U.S.A. which accounted for exports totalling Rs. 595.20 crore during 1987 (32 per cent of total garment exports). The second biggest importer is West Germany which imported goods worth Rs.

257.87 (13.8 per cent) crore during 1987 followed by the U.K. with imported goods worth Rs. 196 crore (10.5 per cent). West Europe and the EEC accounted for exports of about Rs. 850 crore (46 per cent).

27.1.4 A large part of the credit for the rapid growth of Indian garment exports goes to State Trading Corporation (STC) and to the concerted efforts made by the Apparel Export Promotion Council (AEPC), the Cotton and Woolen Textile Promotion Council (CWTPC) and the Trade Fair Authority of India (TFAI). Today, Indian garments are competing successfully with other apparel exporting nations of the world such as Hongkong, Taiwan, Korea and Singapore.

27.1.5 The multi-fibre agreement (MFA): The Multi-Fibre Agreement, a major irritant in North-South relations, is the main external factor affecting Indian garment exports. The Agreement has been specially designed to protect the textile industries of developed countries from competition with developing countries. First signed in 1973 and renewed four times since then by all major textile importing and exporting countries, the MFA is a significant departure from the General Agreement on Tariffs and Trade. The MFA allows quantitative restrictions rather than tariffs on imports from specific countries. As a result, there are no restrictions on trade in textiles among developed countries but the MFA has been used as weapon to cut imports from developing countries. The main trade inhibiting points are to be found in articles 3 and 4 of the Agreement. Under these articles, any importing country can cut the import of any specific item from a specific source if it feels that its market is being disrupted by such imports.

27.1.6 The garment export entitlement policy, 1987 (quota policy): The policy for allocation of export entitlements for garments and knitwear, popularly known as the quota policy, is based on bilateral agreements between India and various importing countries. Every year the Government of India issues a public

notice laying down policies within which allotments are to be made. The quota is administered by the Apparel Export Promotion Council. Over the years, a large numbers of changes have been introduced in the policy based on feedback from the trade. The Government of India has, most recently, agreed to meet the long outstanding demand of exporters for the issue of quotas to garment exporters who succeed in exporting garments to non quota countries.

27.1.7 The major features of the new policy are a shift from quantity to value in determining entitlements based on past performance, larger quotas for manufacturer-cum-exporters and quota tendering open to all for certain country quotas where utilisation has been over 90 per cent in the previous three years. Under the new policy, in most categories, 65 per cent of the quota is based on past performance. The reason for the shift in past performance entitlement (PPE) from quantity to value is that Indian exports are hitting the limits of the quotas for most countries. The only way out is therefore by increasing the value of exports. A further 10 per cent of the quota will be distributed to manufacturer-cum-exporters (i.e., those who have at least 100 workers and 150 machines). The main reason for increasing the quotas for manufacturer-cum-exporters is to attempt to boost the quality of manufactures. Most exporters feel that the failure of the government to establish investment criteria in value terms makes the move meaningless.

27.1.8 Another two and three per cent of the quotas will be given to Centre and State corporations and those who develop exports to non-quota countries respectively. The last twenty per cent of the quota is provided under what is called the first come, first served (FCFS) system so that new comers and small exporters get a share of the pie. The fact that 65 per cent of the quota is reserved for past performance and 10 per cent for large firms clearly constitutes an entry barrier as pointed out by Law (1981) in the context of Hongkong.

27.1.9 According to a recent study by the State Bank of India (1987) the region-wise distribution of firms is as follows:

Northern Region	3600
Western Region	1750
South Region	800
Eastern Region	100
Total	6250

The garment industry was born in Bombay but labour conflicts, coupled with the high prices of real estate drove many organised manufacturers out of the city. Though, initially, Delhi was thought to be an easier area to work out of, labour continues to be a thorny issue in these centres. In spite of this, Delhi and Bombay are the main centres for apparel exports and they alone account for more than 80 per cent of total exports made from India. City-wise shares in the value of exports made from India during the year 1985 according to the State Bank study are:

	Percentage
Delhi	42.03
Bombay	39.06
Madras	10.84
Bangalore	5.38
Trichur	1.75
Calcutta	0.47
Jaipur	0.47
Total	100.00

27.1.10 There are more than 3600 registered members in and around Delhi. However, the number of active garment exporter cum manufacturers is estimated to be around 400 only. Generally, exporters have as many 3-4 firms under different names to get more quota allotments from the Apparel Export Promotion Council.

27.2 Description of sample

27.2.1 Sample characteristics: The sample selected consisted of 40 units previously surveyed by the State Bank, Delhi Circle. Only 19 of these units cooperated with field staff, and that too not to the fullest possible extent.

27.2.2 42 per cent of firms were partnerships. Private limited companies and sole proprietorships were each 26 per cent of the sample. Information on one firm was not available. The average firm was 14 years old while the oldest was 37 years old. The newest firm was one year old. Most firms (26 per cent) were manufacturers cum exporters. 16 per cent each were merchant firms and silk exporters. 26 per cent of firms reported working on a seasonal basis. On average, 69 workers were employed by a firm and the minimum and maximum number of workers were 1 and 400 respectively.

27.2.3 Table 27.2 provides details of profitability of firms with respect to own capital employed and income. Small firms may be seen to be less profitable than large firms by both indicators of profitability. This shows that, if corrections are made for the imputed wages for owner's labour time, small firms will be even less profitable. However, the sample return on capital is absolutely high compared to other industries. It is likely that both the differential profitability of large and small firms and the high profitability in absolute term are due to the administration of the export quota policy and the quota itself. We now turn to an analysis of sources of funds.

27.3 Sources of funds and salient features of sources

27.3.1 Own funds, formal and informal borrowing: Of the total sample, all firms except one were getting bank credit facilities in one form or another, while 68.4 per cent received informal credit in addition to formal credit. Out of formal borrowers, 79 per cent were getting finance against export orders in the form of

‘packing credit’ while 48 per cent received packing credit and also enjoyed export bill discounting facilities. Only one firm had received a long term loan from a bank.

27.3.2 Table 27.3 gives details of the average percentage of total liabilities from various sources. The average firm may be seen to depend mainly on informal credit (41.04 per cent). Bank credit also plays a significant role and contributes 24.92 per cent of total funds. Owed funds contribute only 29.96 per cent. Informal credit includes both trade credit and other informal borrowings. If trade credit is excluded, then informal credit falls to only 7.04 per cent of total funds. Of these other informal sources, 37 per cent of firms borrowed from friends and relatives. Directors, shareholders and partners lent to a further 21 per cent of firms. Only 10 per cent borrowed from informal intermediaries (chit funds and finance corporations).

27.3.3 Table 27.3 shows that own capital is significantly more important as a source of funds for large firms than for small firms when firms are classified by total assets. The reverse is true for formal credit. It is of interest that formal credit is the least important source of funds for both categories of firms. Trade credit, contributed 29.15 per cent and 35.75 per cent of funds for large and small firms respectively. Informal credit was the main source of funds in the case of small firms (42.60 per cent). The comfortable own funds position of large firms reflects, in this industry, the combined operations of quotas and export promotion described earlier and not credit constraints.

27.3.4 The current financial structure of firms is likely to move increasingly in the direction of reliance on own finance. In the two years for which data was available, reserves and surplus increased at an average rate of 160.58 per cent, the ratio of growth of reserves being similar for both small and large firms. However, 66 per cent of large firms but only 50 per cent of small firms showed growth in this category (58 per cent overall). Only one firm showed a decrease in reserves and surplus. If we add

to these figures growth in loans from directors, shareholders, partners, friends and relatives, then, no firm for which data is available shows a decrease in the combined position from these two sources. Since it is known that many partnership and proprietary concerns show their own funds as loans from friends and relatives in order to launder black funds from concealed profits, it is possible that such "informal credit" is primarily illegal wealth. That this could be the case is made more plausible by the nature of the quota policy discussed further in section 5.

27.3.5 Purpose, duration and cost of loans: Both formal and informal sector credit was mainly for working capital finance. Only one formal borrower received a term loan from the banking sector. Due to non availability of data, the exact term structure of loans could not be ascertained. Large firms had to pay marginally more interest as compared to small firms (see Table 27.5). While firms receiving both formal and informal credit had a lower cost of borrowing than firms receiving only formal credit, this appears to be due to the fact that the former were better credit risks and not because informal credit is cheaper than bank credit. In fact, larger firms, who are more dependant on informal borrowing (Table 27.4) have the higher cost of credit.

27.3.6 Table 27.5 also reveals that trade credit is received on average for ten weeks in this sector. Smaller firms are, however, able to get credit for longer terms as compared to large firms. This position is made even better for small firms since they provide less credit to their customers. The overall impression is that small firms receive more credit than large firms and are better served by banks, primarily because large firms are in little need of borrowings.

27.3.7 Reasons for approaching the informal sector and respondent's opinions of bank credit facilities: 40 per cent of those firms who received informal credit were interested in informal credit because, in their opinion, informal credit was easily available; 30 per cent cited less formalities as compared to bank

credit; 25 per cent complained of inadequacy of bank credit; and a further 5 per cent cited the cheapness of informal credit as the reason for approaching informal credit markets.

27.3.8 In the sample, all but one unit had credit facilities with a bank. 63 per cent of firms were generally satisfied with their banker. Out of those firms which were not satisfied, 57 per cent were dissatisfied due to both delays in service and inadequacy of credit. 14 per cent cited only delays in service as the reason for dissatisfaction and 29 per cent cited other reasons for dissatisfaction. Only three firms out of the total sample felt that banks were not fair to them as compared to their treatment of other customers. Only one firm felt that more satisfactory services could be obtained from private moneylenders or other informal intermediaries. Five firms had received special services from their banks and this related to both financial aspects and management aspects. Table 27.6 gives the statistics for customer service arranged according to the concerned nationalised bank.

27.4 Uses of funds

27.4.1 Table 27.7 provides information about the uses of fund by garment export firms. Use of funds is divided into four components: fixed assets, inventories, loans and advances and other uses. The main feature as to uses of funds visible in this table is the low proportion of funds devoted to fixed assets. Looking at the distribution by size of firm, the striking feature revealed by this table is that small firms hold inventories four times as large relative to the number of days of production compared with large firms. The reason for this is to be had in the organisation of production. While small firms rely mainly on job work done by independent cutters and tailors, larger firms have their own work force and machines. To cope with the uncertainties in securing the services of cutters and tailors, who are in high demand, small firms must maintain large inventories. This acts as a buffer in case a time bound order is received. Along with the earlier evidence, this suggests a greater reliance of small firms

on credit markets.

27.5 Impact of regulatory environment

27.5.1 While the regulatory environment prevailing has no impact on the availability of informal credit to this sector, it does affect the total funds position greatly. Three items come into play here.

- i. For established firms, obtaining cheap bank credit to finance confirmed export orders is routine and relatively obstacle free. In fact, there is evidence that nationalised banks actively compete with one another to increase their business in this market.
- ii. Export incentives (cash compensatory support and duty drawback) against the customs levies, designed primarily to offset internal taxes on inputs, are normally paid to firms soon after they export a consignment (usually within, 30 days). This reduces the average waiting period between the shipping of goods and receipt of payment thus improving the cash flow of firms.
- iii. The higher unit value which firms have to realise on export orders to qualify for allotments in subsequent years is a possible third factor. This may be explained as follows. The quota under the MFA leads to a position of excess demand for Indian garments in developed countries at free market equilibrium prices. Thus the goods tend to be sold at higher prices with a correspondingly large surplus for producers. However, to escape taxation, exporters may under-invoice their consignments with the connivance of importers overseas. The extent of under-invoicing possible decreases whenever a unit value stipulation is made for the assignment of quotas with the floor price being increased every year provided export performance does not suffer.

27.5.2 The result of the three factors described above is that firms, especially large firms, are becoming 'cash rich' and have little need for outside credit. Evidence for this was presented earlier (in that reserves and surplus had shown a phenomenal growth rate). Indirectly, this also provides further evidence on the likelihood of black funds in the industry since, otherwise, it is difficult to understand why a cash rich firm would borrow at the high average rates (especially for large firms) given in Table 27.5.

27.5.3 The other, non financial, impact of government is through the quota policy. That 65 per cent of the quota is allotted on the basis of past performance and 10 per cent is allotted to large firms rather than by open tendering, shows that there is a clear barrier to entry engendered by regulation. This, of course, has an important indirect effect on the funds position of incumbent firms since their profits are thereby greatly augmented.

27.6 Estimate of total value of informal credit to garment export activity

27.6.1 The figures in Table 27.1 can be used to shed light on the total size of the informal and formal credit markets serving garment exports. Formal and informal credit respectively make up 20 per cent and 25 per cent of the total production of sampled firms. If we assume that this ratio prevails at the aggregate level as well, then informal and formal credit in 1987-88 to the sector would be Rs. 259.05 crore and Rs. 207.60 crore respectively.

27.7 Efficiency and allocative impact of informal finance

27.7.1 Since data are not available on the quantity of output, value of production has been used as the indicator of production. An examination of the capital output and labour output ratios shows two things: small firms (who get more finance through the informal market inclusive of trade credit) use less capital per unit of output but get a lower return on sales (Table 27.8).

27.7.2 Secondly, table 27.8 shows that small firms are more labour intensive than large firms in that they have a lower capital output ratio but a higher labour output ratio than large firms. This is as expected given that total finance available to them is less in quantity but more costly. We tentatively conclude that informal finance is associated with firms using more labour intensive methods of production in this sector.

27.8 The main distinguishing features

27.8.1 The main points that have emerged in the analysis may now be summarised.

- i. Most loans to both small and large firms are for working capital
- ii. There appears to be evidence to suggest that what appears to be informal credit, apart from trade credit, is, to a large extent, unaccounted funds.
- iii. Firms in the sample have shown a high growth rate (161 per cent) of retained earnings. The reason for this can be traced to the quota policy followed by the Government.
- iv. A large proportion of firms expressed dissatisfaction with bank credit facilities even though the credit facilities they receive are better than that received by many other productive sectors.
- v. The quantum of informal credit (excluding trade credit) to the sector is marginal.
- vi. The informality of informal credit was the reason cited most often by respondents for taking such credit.
- vii. The quota policy and the prevailing export incentives make this sector very cash rich.

Regarding differences between the small and large firms we see that

- i. Small firms are less profitable.
- ii. Small firms receive trade credit for longer durations than large firms and also give credit for shorter durations.
- iii. Trade credit had equal importance for both types of firms, though it makes up a larger chunk of borrowed funds for small firms.
- iv. Small firms rely more on informal credit (including trade credit) than large firms.
- v. Small firms are more labour intensive than large firms even though their borrowing cost is lower than the cost of large firms.

27.9 Recommendation for reform and regulation

27.9.1 In a capital poor economy it is indeed remarkable that one sector, however much it helps the export drive, should receive concessional finance to the extent that this sector does. The question that needs to be asked is how effective this concessional finance is in boosting exports at the margin. This policy needs careful examination. Secondly, the operation of the quota system as it is run by the AEPC and other related councils clearly creates barriers to entry for new firms. This too is worth a second look. However, both these points are beyond the strict purview of this study.

27.9.2 Besides recommending more expensive bank finance to lower the social opportunity cost of the export drive or, as an alternative, recommending open bidding for a larger part of the quota, it is clear that the discrimination in favour of large firms needs to be removed in so far as the relative extent of finance is concerned. Given that this sector is cash rich and therefore not dependant to any great extent on informal finance aside from trade credit (nor even formal finance) little scope exists for further improvements in credit facilities.

TABLE 27.1**Aggregate Garment Export Activity in India**

(Rs. crore)

1. Estimated formal credit to sector (All India) in 1986-87	207.60
2. Estimated informal credit to sector (All India) in 1986-87	259.05

- Notes: 1. Total export of ready-made garments is:
1038 crore. (1986-87 provisional)
2. Ratio of informal credit to production: 0.02
Ratio of formal credit to production : 0.20

TABLE 27.2**Profitability of Firms**

(in percentage)

Category	Pat/Capital	Pat/Income
Large firms	54.89 (97.53)	9.89 (15.94)
Small firms	26.97 (51.91)	5.72 (9.93)
All firms	34.36 (68.20)	6.86 (12.02)

- Notes: 1. PAT : Profit after taxes.
Capital: Equity/owners capital.
Income : Gross income.
2. Figures in parentheses are standard deviations.

TABLE 27.3

Sources of Funds of Garment Export Firms

(All figures in percentage)

Category	Own capital and equity	Formal credit	Informal credit		
			Trade credit	Other	Total
Large firms	37.76 (38.15)	22.74 (18.59)	29.15 (23.32)	7.57 (9.24)	36.72 (16.28)
Small firms	27.16 (24.05)	25.71 (22.34)	35.75 (15.05)	6.85 (9.89)	42.60 (12.47)
All firms	29.96 (29.14)	24.92 (21.46)	34.00 (17.86)	7.04 (9.73)	41.04 (13.80)

Notes: 1. Figures are percentages of total capital employed.
 2. Figure in parentheses are standard deviations.
 3. Other liabilities (unclassified), if added to row totals would result in them adding to 100 per cent.

TABLE 27.4

Pattern of Borrowing of Garment Export Firms

(percentage of total borrowing)

Category	Formal credit	Formal credit		
		Trade credit	Other credit	Total informal
Large firms	32.53 (24.48)	40.65 (25.67)	26.82 (37.34)	64.47 (31.51)
Small firms	32.60 (26.19)	56.72 (24.20)	10.68 (16.57)	67.40 (20.39)
Only formal borrowers	40.04 (18.57)	59.96 (18.57)	0.00 (0.00)	59.96 (18.57)
Informal and informal borrowers	30.28 (27.17)	50.16 (26.99)	19.55 (26.89)	69.71 (26.94)
All firms	32.58 (25.75)	52.47 (25.60)	14.95 (24.93)	67.42 (25.27)

Note: Figures in parentheses are standard deviations.

TABLE 27.5

**Interest Cost of Borrowing and Duration of
Trade Credit Received and Given**

Category	Interest cost of borrowed funds	Trade credit received (in days)	Trade credit given (in days)
Large firms	13.20 (9.47)	62.67 -	80.00 -
Small firms	12.45 (9.77)	76.88 -	45.67 -
Formal borrowers only	16.48 (10.25)	37.50 -	60.00 -
Formal and informal borrowers	11.34 (9.11)	80.89 -	53.10 -
All firms	12.67 (9.69)	73.00 -	54.25 -

Notes: 1. Interest cost is interest paid as a percentage of total borrowing.
 2. Standard deviations for (2) and (3) not computed due to missing data resulting in few observations.

TABLE 27.6

Bank-Wise Statistics

	Total no. of account holders	Percent- age get- ting need based finance	Percent- age sat- isfied with bank	Percent- age fee- ling bank is un- fair to them	Percent- tage availing of other credit as well
(1)	(2)	(3)	(4)	(5)	(6)
Number of loan accounts					
1. All Banks	19	79	63.16	10.53	47.37
2. Punjab National Bank	4	25.0	25.0	50.0	75.0
3. Indian Overseas Bank	3	66.67	66.67	0.0	66.67
4. Canara Bank	2	0.0	0.0	100.0	100.0
5. Not available/ others	13	92.3	69.2	8.3	30.8

TABLE 27.7

Uses of Funds of Garment Export Firms

(percentage of total assets)

Category	Fixed assets	Inventories	Loans and advances	Inventories in days
Large firms	16.87 (12.25)	14.57 (12.66)	32.32 (25.42)	22.01 (23.07)
Small firms	10.91 (12.12)	37.17 (24.50)	41.77 (26.51)	82.31 (100.39)
Formal borrowers only	13.71 (10.31)	33.29 (32.84)	41.40 (37.08)	114.35 (170.89)
Formal and informal	12.11 (12.99)	30.54 (20.71)	38.61 (22.30)	51.62 (49.18)
All firms	12.49 (12.43)	31.19 (24.15)	39.27 (26.55)	65.56 (95.14)

Note: Other assets, not reported, include investments (less than 1 per cent) and cash and bank balances.

TABLE 27.8

Efficiency Indicators for Garment Export Firms

Category	Capital/output ratio	Labour/output ratio
Large firms	0.35 (0.46)	0.33 -
Small firms	0.23 (0.21)	0.56 -
All firms	0.28 (0.34)	1.15 -

Notes: 1. Capital: Inventories plus fixed assets in Rs.lakh.
 2. Labour : Total employment.
 3. Output : Value of production
 4. Figures in parentheses are standard deviations.

CHAPTER 28

INFORMAL CREDIT TO THE POWERLOOM SECTOR

28.1 Introduction

28.1.1 The decentralised powerloom sector occupies an important place in textile production, particularly in manufacturing cheaper varieties of cloth for mass consumption. The production of cloth in 1985-86 in the mill sector, powerloom sector and handloom sector put together was 12998 million metres. Out of this, powerlooms in the decentralised sector produced 6222 million metres, which amounts to 48 per cent of the total cloth production. (See Table 28.1).

28.1.2 Apart from composite mills, fabric production in India takes place in separately organised handloom and powerloom weaving establishments and in hand or power operated processing and printing establishments. As opposed to composite mills which centralise spinning, weaving and finishing activities under one roof, the parallel form of production decentralises the constituent activities into separate entities. The types of activities described above, taken together, constitute the decentralised sector. During the last two decades there has been a six fold increase both in the number of powerlooms working in the decentralised sector and in the production of this sector according to a recent task force of the Ministry of Textiles which examined credit requirements for powerlooms (Government of India, 1988). Even though there was, at one time, a ban on establishment of new powerlooms, unauthorised powerloom were established. The Government has regularised such unauthorised powerlooms from time to time. During 1986-87, production in the decentralised sector was 75 per cent of composite mill textile

production whereas, in 1951, it was only 25 per cent.

28.1.3 Weaving activity in this sector is predominantly organised under the master weaver and entrepreneurial systems. In the master weaver system loom owners are provided yarn by master weavers and are required to convert the same into specified "sorts" or types of woven cloth for which fixed conversion charges are paid. Looms are largely run with family or hired labour. The entrepreneurial system, on the other hand, requires the owner to not only invest in fixed assets but also in raw materials. Fabric may be woven by entrepreneurs on a job order basis or for direct sale. The distinguishing mark of the entrepreneurial system is the involvement of owners in the business to earn commercial profit. A third type of system, less prominent and found in Uttar Pradesh is the household or cottage enterprise. In this system producers sell their output mainly to the local market. The master weaver system is dominant in Maharashtra, Madhya Pradesh and Uttar Pradesh. In Tamil Nadu it exists side by side with the entrepreneurial system.

28.1.4 Government and policy: The Government of India have laid consistent emphasis on the development and promotion of decentralised industry to satisfy the key objectives of creation of employment and income generation in rural areas within the framework of the country's economic and social development policies. The government's role has been articulated through a structure of enabling measures aimed at supporting small producers. For instance, filament fabric production was earlier reserved for powerlooms. Their dominance has been hard to break even after the introduction of complete fibre flexibility. In cotton fabrics, excise concessions were weighted in favour of production of superior varieties by powerlooms. Much government intervention has been motivated by the need to minimise capital investment in the manufacture of this mass consumption good, so that cloth could be made available to the consuming public at affordable rates. The government has increasingly turned to powerlooms as events have shown that the mill and handloom sectors

are unsuited to the task under prevailing conditions. However Little (1987) expresses the view that mill production has higher social benefits than powerloom production at plausible shadow wage rates.

28.1.5 Again, this industry could not have progressed so fast were it not for the rapid opening of the rural market during the seventies and after. Here again the role of government has been pre-eminent. Massive public investment in infrastructure improvement and in the enhancement of rural productivity has led to income generation and consequent generation of demand for clothing. In effect, the policy position has been that the technology represented by the powerlooms and related processing activity is suited to Indian conditions.

28.1.6 However, not all is well with the government's approach to powerlooms. Though some attention has been given to the question of financial arrangements for the powerloom sector, with a government committee examining the issue as early as 1964,¹ the level of funding from state agencies and formal credit agencies is still very poor in the opinion of a more recent government task force. Secondly, as recognised by the task force, decentralised cloth production entails repeated transportation of intermediate goods between units, a situation that does not occur in integrated mills. This and the weaker market position of small decentralised units entails a cost disadvantage for powerloom units with regard to yarn prices. This disadvantage is exacerbated in most cases by state and local levies resulting in an estimated 8 per cent to 10 per cent cost disadvantage for powerloom units compared to integrated mills. This disadvantage, is of course, more than compensated for by the lower overheads in powerloom production as compared to integrated mills. However, complaints by associations of powerloom entrepreneurs regarding 'step-sisterly' tax treatment for powerlooms have not, so far, been heeded. It is to be seen if the situation regarding both

1. Ashoka Mehta Committee, Ministry of Textiles.

credit and taxation improves in the light of the recent task force report.

28.1.7 Geographical dispersion: The decentralised sector is located in a range of urban places from small towns to big cities. Most locations are well connected by rail or road transport to other urban centres. Upto the mid-sixties powerloom and processing activities were concentrated in the western part of the country. Prominent locations were Bhiwandi, Ichalkaranji, Malgaon and Bombay in Maharashtra, Surat and Jetpur in Gujarat and Burhanpur in Madhya Pradesh. In 1964, the Ashoka Mehta Committee estimated the total number of powerlooms manufacturing silk and cotton cloth at 1.5 lakh looms. During the last two decades there has been a rapid growth in existing locations in these States, the establishment of new locations and the spread of powerlooms to most other States as well. There are now more than 8 lakh powerlooms operating in the country in over 2.2 lakh establishments. The loomage is distributed in more than 60 centres of weaving activity. The loom population varies from a few hundreds in some centres to 1.75 lakh in Surat and 2.5 lakh in Bhiwandi (Shanbhag, 1987). Table 28.2 lists important powerloom weaving centres.

28.2 Description of the sample

28.2.1 Data for this study of informal credit was collected with the assistance of the State Bank of India from 18 powerloom units and master weavers in Surat. Though 25 units were initially selected only 18 units cooperated. Of these, one unit did not furnish complete information. Furthermore, though an additional centre, Ahmedabad, was included in the sample design, no data could be collected there. Of the 17 units, 12 units are powerloom units and five are master weavers. Detailed discussion was also had with managers of commercial and cooperative banks, weavers associations and government officials.

28.2.2 Four powerloom units were sole proprietorships and 8 were partnership concerns. Also, 4 master weavers were proprietary and 1 was a partnership. The average powerloom unit was 10 years old, while the oldest was 22 years old. In the case of master weavers, the average unit was 5 years old. 10 powerloom units were entrepreneurial units and 2 worked under the master weaver system. On average, there were 9 workers in powerloom units and 5 in master weaver establishments. The average investment in plant and machinery was Rs 3.58 lakh for powerloom units and Rs 2.24 lakh for master weavers. The smallest powerloom unit had 6 looms while the largest had 33 looms, the average being 16. The average size of units in the sample is larger than the average for the population (8 looms). The consequence of this bias is that sampled units, being large, have more ready access to credit, especially formal credit, than is generally the case due to their superior ability to offer collateral.

28.2.3 To determine the profitability of powerloom units and master weavers, two ratios are calculated: Profit after tax as a percentage of own capital employed and profit after tax as a percentage of income. By the first ratio, it can be seen that powerloom units in the sample have a greater return to capital than master weavers (See Table 28.3). However the ratio of profit after tax to sales is higher for master weavers than for powerloom units. When corrections are made for the imputed value of family labour, the return on capital (Table 28.3, column 3) is, on average, between 5 per cent and 6 per cent for both powerlooms and master weavers.

28.2.4 In recent years many traders in related sectors have plunged into processing activity and established processing units. Processing activity has thus grown very rapidly and earns much higher profits than powerloom weaving. A decade ago, due to less competition, the average powerloom earned a profit of 10-20 per cent on turnover even with job work (Mehta and Gandhi, 1987).

28.3 Sources of funds and salient features of finance

28.3.1 General description of credit markets for the textile sector in Surat and informal credit for powerlooms: The report of the Task Force on Credit Requirements for Powerlooms contains replies to a questionnaire sent by them to associations of powerloom units. All respondents expressed dissatisfaction with formal credit availability if an opinion was expressed at all. The common complaint was that the total quantum of bank finance was small or nonexistent. Some respondents went further to say that even units getting bank finance (usually larger units) did not receive finance commensurate with their requirements. Others mentioned cooperative finance as important. In a very few centres, marginal finance from other financial institutions was available. Among informal sources, "private parties/mahajans", moneylenders, yarn merchants and master weavers were mentioned. The incidence of pure informal lenders appears to be extensive in Maharashtra (Bhiwandi/Ichalkaranji), Kanpur and Amritsar from these responses. Master weavers are important in Surat and also in Maharashtra. In Ahmedabad, own finance appears to be the most important source of finance for powerlooms. Since, in Ahmedabad, powerlooms are primarily entrepreneurial, the impression was gained from field enquiries that units were net suppliers of credit with credit being given for up to 150 days with a discount of 11 per cent to 12 per cent on cash sales. Unfortunately, more extensive field work could not be carried out.

28.3.2 In Surat, our enquiries revealed a wide variety of financial arrangements serving the textile sector which includes yarn merchants, powerloom units, master weavers, processing units and wholesale traders. Surat contains about 50 large buildings (locally called 'markets'), each containing several hundred textile outlets and offices of powerloom and processing units, aratiyas and wholesalers, the oldest being the multi-storey Surat Cloth Market. These markets, as well as powerloom and processing units in the area, are served by several commercial banks and at least 3 cooperative banks. Furthermore, there is a well developed

credit market where "private parties" give credit at between 2.5 per cent to 4 per cent per month (35 per cent to 65 per cent per annum) for 30 to 90 day periods. According to several persons interviewed, doctors, lawyers and even government officials lent in this clean bill finance market. The size of this market was variously felt to be between Rs 100 crore and 600 crore per month. Furthermore, for those with prior acquaintance with borrowers, the risk of outright default was reported to be small. The major beneficiaries of these markets were reported to be aratias and wholesalers with processing houses with powerloom units having lesser access to this credit. Even among such units, small units are reported to be the most disadvantaged. However, an office bearer of one association of powerloom owners reported that upto 70 per cent of association members had to depend on such loans for the finance of capital equipment purchases.

28.3.3 A recent phenomenon is the rise of equipment leasing companies in the area, predominantly serving processing houses but also powerloom units.

28.3.4 The general consensus of opinion of persons interviewed was that bank credit was only available to larger units with adequate collateral and also that credit for working capital was particularly inadequate. The same was true for credit from cooperative banks. Cooperative banks charge 15 per cent interest on loans for capital equipment purchases but usually require collateral in the way of immovable property in order to sanction loans.

28.3.5 Leasing companies finance acquisition of new capital equipment over one to four year term (with an additional delay in transfer of title to take advantage of tax provisions for depreciation). The average amount financed was reported to be 3.5 lakh per customer at an effective annual interest rate of 28 per cent per annum. The total business is estimated at between Rs 5 and Rs 10 crore annually and is growing rapidly. Equipment leasing companies give great importance to the reputation of the

borrower and lend only to known parties. Since leasing companies operating in Surat raise much of their capital from formal capital markets including commercial banks, this is a case of funds being channeled from the formal to the informal credit market. We now turn to an examination of the credit experience of sampled units.

28.3.6 Own funds, formal and informal borrowing: Funds available to powerloom units and master weavers in the sample have been divided into own capital and borrowing from formal and informal markets. For both types of units informal credit has equal importance. For powerloom units, 49.09 per cent of funds is from informal sources while 46.27 per cent of master weaver's funds is from this source. Within informal credit, trade credit is more important to powerloom units (See Table 28.4). Own capitals also plays a significant role for both types of units contributing 40.90 and 44.52 per cent respectively. Formal credit has the least importance to both type of units. Table 28.4 shows the pattern of borrowings for both types of units. Informal credit contributes 82 per cent of total borrowings in the case of powerloom units, while banks provide more credit to master weavers as compared to powerloom units (See Table 28.5). Turning to the number of units financed, all units surveyed receive trade credit while about two thirds receive bank credit. Bank credit is mainly for working capital. One master weaver had received a term loan.

28.3.7 Formal sector finance was entirely from banks for sampled units whereas informal credit from other sources was either from friends and relatives or deposits from partners and directors. For powerloom units, 83.82 per cent of funds comes from friends and relatives and only 16.18 per cent from directors and partners. For master weavers, 56.18 per cent comes from friends and relatives the balance coming from directors and partners. The near absence of borrowing from money lenders and shroffs in Surat is not replicated in other centres (Shanbhag, 1987 and Government of India, Ministry of Textiles, 1988).

28.3.8 Purpose, duration and cost of loans: Both formal and informal sector credit was mainly for working capital finance. Six units had, however, received long term loans from the formal sector (forming 40 per cent of formal credit to the total sample), while only one unit received a long term loan from the informal market. The term loan formed less than 1 per cent of total informal credit in the sample. The average interest rate for formal credit is 14.56 per cent whereas the average interest rate for informal credit is 12.03 per cent (Tables 28.6 and 28.7). Powerloom units had marginally higher interest cost compared to master weavers (Table 28.8). While powerlooms and master weavers getting credit from formal as well as informal market had lower interest cost compared to units receiving only credit from the informal market (See Table 28.8), given that the average informal interest rate is lower than that of bank credit, the reversal of the finding in terms of interest cost is of interest. Since banks have stringent scrutiny procedures and collateral requirements the difference in interest cost tends to suggest differential credit worthiness of borrowers having access to bank credit. This could not be directly confirmed though evidence presented below, on credit classified by firm size, supports this hypothesis.

28.3.9 Table 28.8 reveals that powerloom units received trade credit equal on average to 53 days of sales as compared to master weavers which received credit equal on average to 51 days of sales. Even though there is not very much difference between these figures, the position is better for powerloom units since they provide less credit to their customers (Table 28.8). Powerloom units getting only informal credit received trade credit for longer than average which is, of course, a reflection of their disadvantaged status since the interest rate for trade credit exceeds their return on capital even though it is the low relative to market rates of interest.

28.3.10 Reasons for approaching informal sector and respondents opinion of bank credit facilities: 70 per cent of informal borrowers cited the ready availability of finance and lack of

borrowing formalities as the main reasons for preferring informal credit. 12 per cent mentioned inadequacy of bank finance. Both cheapness and ready availability was mentioned by a further 12 per cent of respondents and 6 per cent cited cheapness, inadequacy of bank credit, ready availability of finance and fewer formalities as their reasons for taking recourse to informal credit. **Thus for 18 per cent of respondents, informal credit was not only easily available but also cheap.**

28.3.11 65 per cent of units sampled had credit facilities with a bank. Also, 75 per cent of formal borrowers were generally satisfied with their banks. Of the dissatisfied units, one third cited delay in service and inadequacy of credit as the main reason for dissatisfaction. A further third were not satisfied because banks did not provide finance for further expansion. The remaining 33 per cent did not mention any reason for their dissatisfaction though one powerloom unit felt that the bank was "not fair to it". Two units felt that more satisfactory service could be obtained from other agencies such as private moneylenders, shroffs and cooperative banks. Two units received special services from their banks related to sales, marketing and purchase. Even this fraction is high compared to other sectors sampled by us. Finally, seven units felt that banks delay processing loan applications inordinately.

28.4 Uses of funds

28.4.1 Uses of funds have been classified into four major components: fixed assets, inventories, loans and advances and investments. For powerloom units most funds are tied up in fixed assets (43.24 per cent). They hold less inventories in relative terms compared to master weavers (Table 28.9).

28.4.2 Turning to the classification by borrowing status, both powerlooms and master weavers who were fully dependent on informal credit, devoted more resources to inventories compared to those units receiving credit from both formal and informal

markets, but their investment in fixed assets was less. This ties in well with the relatively short duration of informal loans observed.

28.4.3 The average master weaver held inventories equal to thrice the number of days of sales as compared to powerloom units.

28.4.4 Credit sales by both master weavers and powerloom units tie up about 25 per cent of total capital (Table 28.9), though the average period tends to be variable. The discount on cash sales averages 13.5 per cent and varies between 12 per cent and 14.5 per cent.

28.5 Estimate of total volume of informal credit to powerloom activity

28.5.1 The data in Table 28.1 can be used along with sample information to make a rough estimate of total informal credit to the powerloom sector. Informal and formal credit equalled 14.69 per cent and 4.03 per cent of the total value of production of the sampled firms. Estimates are calculated by taking the same proportion of total production for the whole of India. Informal credit to the powerloom sector is thus estimated at Rs 914.61 crore and formal credit at Rs 250.75 crore in 1986-87.

28.5.2 These estimates cannot be viewed as more than order of magnitude estimates. Furthermore, this credit is to both weaving units proper and master weavers. According to the Ministry of Textiles Task Force, credit requirements for the powerloom sector are between Rs 500 crore and Rs 700 crore given the current distribution of independent units and units under the master weaver system.² If this is turned around and taken to be the current level of credit from all sources to the sector, then our estimate is seen to exceed the task force estimate by about Rs 450 crore keeping in mind that we also include master weavers.

2. The actual figure given by the task force is Rs. 500 crore. But the basic figures given by them can be used - following their methodology - to get the Rs 700 crore figure.

Finally, it should be recalled that the size of the clean bills market in Surat alone is thought to be between Rs 150 crore and Rs 600 crore, though processing units and wholesalers receive the bulk of this credit. Consequently this estimate is to be treated with great caution allowing for up to a 100 per cent error margin - especially in view of the sampling bias.

28.6 Efficiency and allocative impact of informal finance

28.6.1 Capital output and labour output ratios are calculated to assess the impact of informal finance on efficiency. For both powerlooms and master weavers those receiving credit from both formal and informal sectors are found to be more labour intensive than firms relying only on informal credit. Also, master weavers receiving both formal and informal credit, have a higher return on sales than those relying only on informal credit. Since, on average, units getting both formal and informal credit were larger (18 looms) than units receiving only informal credit (12 looms), economies of scale may provide the explanation for these findings with respect to both the capital output ratio and the profitability statistics. The difference in the labour output ratio would then reflect the omission of family labour from the figures used to calculate labour output ratios. Of course, the ratios though not the profitability figures are also consistent with deliberate choice of capital intensive techniques given lower informal interest rates. In either event, informal credit would appear to be associated with less productive firms or firms having relatively inappropriate production techniques in the sample of firms studied. Against this however, the fact that informal credit is available to finance second hand machines must be kept in view. No firm conclusion can therefore be drawn.

28.7 Equity impact of informal finance

28.7.1 According to the opinions of most persons with whom we have had discussions, the following conclusion appears warranted subject to the caveat that the evidence for the conclusion is not

survey based: if at all smaller powerloom units receive credit, it is from the informal sector. This and the reported importance of collateral for loans from commercial and cooperative banks tend to support the view that informal credit has a positive impact on the resource position of relatively disadvantaged units. The fact that second-hand machines are financed by informal credit is also evidence that favours this view.

28.8 Conclusions

28.8.1 This study of informal credit for powerlooms in Surat, while fairly rich in evidence from discussion with knowledgeable persons, uses a biased sample of respondents for statistical analysis and verification. Nevertheless, it would appear that the role played by informal credit to the powerloom sector in its continued growth is crucial given the relative paucity of formal credit. It may tentatively be concluded that informal credit reduces the gap in credit availability to disadvantaged units. Recommendations for reform of formal credit norms are limited to just two, given that the Task Force of the Ministry of Textiles has already made a detailed examination of the situation:

1. **Credit disbursal:** Targets in terms of units with few (say, less than 8) looms should be set.

2. **Used machines:** The formal sector should consider ways of financing the purchase second hand machines in addition to financing their modernisation.

TABLE 28.1

**Aggregate Powerloom Activity in India and Estimated Credit
to the Powerloom Sector**

	1984-85	1985-86	1986-87
1. Aggregate powerloom production (million metres)	5445	5886	6222
2. Estimated aggregate value of powerloom production in India (Rs crore)	5260	5886	6179
3. Total formal credit based on responses to Task Force Question- naires (Rs crore)	11.22	13.56	9.12
4. Value based estimate of working capital - requirements (Rs crore)	-	-	717
5. Estimate of working capital require- ments based on total number of looms (Rs crore)	-	-	500
6. Estimate of formal credit: This study (Rs crore)	219.43	257.21	250.75
7. Estimate of informal credit: This study (Rs crore)	799.87	864.65	914.61

Notes: 1. Rows (1), (2), (3) and (5) from Report of the Task Force on Credit Requirements for Powerlooms, 1988.
2. Row (4) computed from figures given by the Task Force.
3. Rows (6) and (7) based on ratios of formal credit/informal credit to value of production in the sample (ratios are 0.0403 and 0.1469 respectively).

TABLE 28.2

**Production of Cloth and Salient Features of Powerloom
Weaving Centre in India**

(In Million Metres)

		1984-85	1985-86	1986-87
I¹				
i.	Mill sector	3432	3376	3317
ii.	Powerloom sector	5445	5886	6222
iii.	Handloom sector	3137	3236	3449
State	Name of centre	Estimated loomage	Fibres	Varieties
II²				
Gujarat	Ahmedabad	16,000	Cotton, PC	Poplin, long cloth shirtings, sarees, shirtings
	Surat	1,75,000	Nylon, Polyester viscose	Sarees, shirtings, dress fabrics, suitings
Maharashtra	Bhiwandi	2,50,000	Cotton, PC, PV, polyester	Mulls, cambrics, suiting, shirtings
	Ichalkaranji	45,000	Cotton	Dhoties, cambrics, poplins
	Malgaon	40,000	Cotton	Dhoties, voiles, poplins, cambrics
Tamil Nadu	Pallipalayam	28,000	Cotton	Shirtings, check shirtings
Uttar Pradesh	Meerut	20,000	Cotton, PC	Tapestry, shirtings

Source: 1. Report of the Task Force on Credit Requirements of Powerlooms.

2. "Perspectives for Growth of Powerloom, Power Processings and the Decentralised Sector" - Dr. V. Shanbhag, C.L. Centre for Management, ATIRA.

TABLE 28.3

Profitability of Firms

(All figures in percentage)

	PAT/ capital	PAT/ income	EPAT/ capital	EPAT/ income
Powerloom units	28.01 (23.41)	2.55 (1.95)	5.60 (4.68)	0.53 (0.43)
Master weavers	27.15 (17.12)	5.54 (3.53)	5.43 (3.42)	1.13 (0.61)
Borrowing status wise				
<u>Powerloom units</u>				
Informal only	29.15 (14.77)	2.64 (1.41)	5.83 (2.95)	0.55 (0.32)
Both informal & formal	27.43 (26.68)	2.50 (1.95)	5.49 (5.34)	0.52 (0.48)
<u>Master weavers</u>				
Informal only	28.52 (4.09)	4.54 (1.28)	5.70 (0.82)	0.96 (0.18)
Both informal & formal	26.24 (21.80)	6.21 (4.31)	5.25 (4.36)	1.24 (0.86)

Notes: Figures in parentheses are standard deviations.

PAT : Profit after taxes.

EPAT : Estimated profit after taxes after adjusting for the imputed value of family labour by considering only 20% of gross profits as true profits.

TABLE 28.4

Pattern of Borrowing

(All figures in percentage of total borrowings)

	Formal credit	Informal credit		
		Trade credit	Other	Total
Powerloom units	18.04 (24.61)	49.97 (23.15)	31.99 (19.96)	81.96
Master weavers	23.84 (25.23)	28.02 (27.82)	48.15 (28.47)	76.17
<u>Powerloom units</u>				
Informal only	-	53.79 (24.76)	46.21 (24.76)	100.0
Both formal & informal	27.06 (25.78)	48.06 (22.060)	24.88 (11.81)	72.94
<u>Master weavers</u>				
Informal only	-	36.08 (35.61)	63.92 (35.69)	100.0
Both formal & informal	39.73 (20.72)	22.64 (19.20)	37.63 (15.02)	60.27

Note: Figures in parentheses are standard deviations.

TABLE 28.5

Sources of Funds

(All figures in percentage)

	Own capital & equity	Formal credit	Informal credit		
			Trade credit	Other	Total
Powerloom units	40.90 (28.19)	9.95 (13.62)	30.91 (17.81)	18.18 (12.23)	49.09
Master weaver	44.52 (34.72)	10.07 (9.95)	17.08 (20.59)	28.19 (24.10)	46.27
Powerloom units					
Informal only	42.00 (16.45)	-	32.12 (16.82)	25.87 (15.84)	57.99
Both informal & formal	40.36 (20.21)	14.92 (4.29)	30.30 (18.25)	14.34 (7.38)	44.64
Master weaver					
Informal only	40.21 (18.55)	-	17.80 (22.47)	42.00 (30.63)	59.80
Both informal & formal	47.41 (31.91)	16.79 (7.22)	16.61 (19.21)	18.98 (11.44)	35.59

Note: Figures in parentheses are standard deviation.

TABLE 28.6

Details of Bank Credit

	Cash credit		Term loan		All loans			
	A	D	A	D	A	B	C	D
I. Number of loan accounts								
1. All banks	11	1.58	11	1.56	22	11	64.70	1.57
2. State Bank of India	4	2.12	3	1.84	7	3	17.65	3.96
3. Bank of India	2	0.70	Nil	-	2	1	5.88	0.70
4. Bank of Baroda	1	1.50	Nil	-	1	1	5.88	1.50
5. Cooperative bank	Nil	Nil	8	1.46	8	4	23.53	1.46
6. Not available/others	4	1.50	Nil	-	4	2	11.76	1.50
II. Average Rate of interest		14.68		14.51				14.56

	Total no. of account holders	Percen- tage getting need financed	% satis- fied with banks	% feel- ing bank is un- fair to them
Number of loan accounts				
1. All banks	11	63.64	72.73	9.09
2. State Bank of India	3	66.67	66.67	0.0
3. Bank of India	1	100.0	0.0	10.0
4. Bank of Baroda	1	0.0	0.00	100.0
5. Cooperative bank	4	50.0	100.0	0.0
6. Not available/others	2	100.0	100.0	0.0

Notes: A: Number of accounts.

B: Number of firms.

C: B as a percentage of total sample.

D: Average (Rs. lakh).

TABLE 28.7

**Salient Features of Informal Credit Received by the
Powerloom Industry**

	Friends and re- latives	Partners directors & share- holders	Multanis and shroffs	All informal sources
1. Number of firms	12	6	1	17
2. Average rate of interest (%)	12.00	Nil	16.00	12.03
3. Percentage of short term loans	100.0	100.0	-	95
4. Percentage of long term loan	-	-	100.0	5
5. Average loan amount (Rs lakh)	1.17	1.08	0.15	1.09
6. Percentage of loans for working capital finance	92	100.0	100.0	95

TABLE 28.8

Interest Cost of Borrowing and Duration of
Trade Credit Received & Given

	Interest cost (%)	Trade credit received (in days)	Trade credit given (in days)
A: By Group			
Powerloom units	14.79 (15.12)	53.58 (42.110)	40.03 (28.71)
Master weavers	13.52 (8.11)	51.0 (0.00)	56.00 (46.47)
B: By Borrowing Status			
<u>Powerloom units</u>			
Informal borrowers	18.78 (18.03)	73.50 (57.10)	43.50 (32.14)
Formal & informal borrowers	12.79 (12.97)	43.63 (27.05)	38.25 (26.57)
<u>Master Weavers</u>			
Informal borrowers	17.64 (10.75)	51.00 (0.00)	33.05 (18.0)
Formal & informal borrowers	10.77 (3.71)	51.00 (0.00)	72.33 (52.58)

Note: Figures in parentheses are standard deviations.

TABLE 28.9

Uses of Funds

(Percentage of total assets)

	Fixed assets	Invento- ries	Cash	Loans & advances	Invest- ment	Inventory holding in days
A: By Group						
Powerloom units	43.34 (24.22)	23.90 (15.36)	4.82 (6.09)	23.98 (17.46)	3.76 (6.33)	23.19 (13.36)
Master weavers	25.00 (25.56)	38.88 (32.32)	6.09 (4.95)	27.36 (16.36)	1.96 (1.45)	67.46 (73.45)
By Borrowing Status						
B: Powerloom units						
Informal only	37.97 (36.83)	27.28 (15.65)	8.16 (8.96)	24.40 (23.21)	2.19 (4.22)	27.00 (15.54)
Both informal & formal	46.02 (13.42)	22.21 (14.94)	3.16 (2.67)	23.78 (13.71)	4.54 (7.03)	21.28 (11.67)
Master weavers						
Informal only	1.40 (1.61)	68.49 (11.16)	10.04 (4.05)	18.74 (14.55)	0.80 (0.92)	133.53 (68.17)
Both informal & formal	40.73 (21.65)	19.13 (26.14)	3.45 (3.53)	33.55 (14.73)	2.73 (1.21)	23.42 (32.32)

Note: Figures in parentheses are standard deviations.

TABLE 28.10

Efficiency Indicators for Powerloom Units and Master Weavers

	Capital output ratio	Labour output ratio	Return on sales (%)
A: By group			
Powerloom units	0.106	0.41	2.55
Master weavers	0.087	0.35	5.54
B: By borrowing status			
<u>Powerloom units</u>			
Informal only	0.130	0.36	2.64
Formal and informal	0.096	0.43	2.50
<u>Master weavers</u>			
Informal only	0.151	0.24	4.54
Formal and informal	0.074	0.37	6.21

CHAPTER 29

ROAD CONSTRUCTION IN DELHI AND WESTERN UTTAR PRADESH

29.1 Size of sector

29.1.1 Investment in road construction is undertaken almost entirely by the Central and State governments. Contractors tender for work contracts and winning bidders execute the contracts as per the terms of the contract. Table 29.1 (Row 1) provides details of the total expenditure on roads and bridges for the most recent years for which data were available. The table (Rows 2 and 3) also provides these details for surveyed regions.

29.2 Description of area surveyed and sample

29.2.1 **Area surveyed:** Firms of contractors in three major cities of western Uttar Pradesh and in Delhi were surveyed. Table 29.2 provides some descriptive feature of these cities and the surrounding areas.

29.2.2 **Sample characteristics:** Contractors are classified into four groups, A, B, C and D, by the Central Public Works Department according to the size of contracts for which they are eligible to bid. Category A firms include the largest contractors. The classification is done by taking into account the contractor's total assets, a bank solvency certificate and the past contract record. Firms in one category may apply for upgradation to the next higher category after accumulating sufficient assets and establishing a good contract execution record. Table 29.3 gives the distribution of the randomly selected sample firms. Despite a sample design in which cell-wise samples were proportional to the population total (with extra firms included in case of non response by initially selected firms), due to non-cooperation by

some firms or other difficulties in the actual sample. Delhi is marginally under-represented, with the incidence of non-response is inversely correlated with firm size. Since, in our analysis, no significant differences were found between different centres in the sample, only aggregate estimates of credit for the sector as a whole should be affected by this shortcoming.

29.2.3 55 per cent of the sample firms were sole proprietorships. Of the remainder, 2 category A firms (5.7 per cent) were private limited companies and the rest were partnerships with two to eight partners. The average firm was 13 years old while the oldest was 40 years old. The newest was only 2 years old. Firms engaged only in road construction with four exceptions. Of these four, two also undertook bridge building, one was also a supplier of raw materials for road construction to the Public Works Department and one had diversified into the unrelated area of hire purchase of consumer durables. One firm (excluded from sample) had not been functioning for 3 years due to lack of finance and another was in the process of winding up its business. Smaller firms were, in general, pessimistic about their future prospects in the sector while larger firms were satisfied with their prospects or were actually planning further purchases of capital equipment.

29.2.4 The average turnover for the most recent year of operation is given in Table 29.4.¹ For the sample as a whole, the average annual value of contracts executed was Rs. 13.13 lakh. The disaggregated figures reveal that the turnover of firms in any category is roughly double that of firms in the immediately preceding category. Wide variations in turnover are, however, visible on further disaggregation. Firms in category D in Uttar Pradesh claimed that they were unable to bid successfully for con-

1. Due to incomplete responses even among cooperating firms, averages, where given, may not pertain to all firms. Figures given are averages for firms with usable responses in the appropriate group.

tracts against larger firms with a better stock of equipment and one firm, in category C in Dehradun, claimed to be winding up its operations on this account. The greater "capital intensity" of large firms is reflected in Table 29.5, which gives crude estimates of capital-labour ratios, partially support this claim. It may be added that several smaller firms did not own any machinery but executed contracts with equipment hired from the local public works departments.

29.2.5 The return on own capital employed and on sales (Table 29.6) shows that firms in category D may in fact be less profitable than larger firms. Though the ratio of their profit after tax to sales is the highest of the four categories (column 2) the return on own capital employed is less than that of firms in categories B and C (column 2). Since profits after tax also include an implicit wage component for small firms, as proprietors or partners also work for the firm, columns (3) and (4) are based on the assumption that 80 per cent of distributed profits constitute wage income. With this assumption the return on capital for category D firms falls to below the interest rate on two year commercial bank fixed deposits. This is despite the fact that their profit margin (return on income: column 4) is the highest.² The difference in estimated profitability is statistically significant as compared to B and C category firms while the mean estimated profitability for A category firms is itself not significant due, possibly, to the relative overestimation of wage income for these large firms.

2. From Table 29.6 onwards, sample standard deviations are given. The mean for the entire sample may be taken as significant at the 90 per cent level if it is at least 27 per cent of the sample standard deviation. Likewise, for individual cities, categories or borrowing statuses the mean should be at least 77 per cent of the group standard deviation. These figures are based on one tailed t-tests for the minimum group-wise sample size taking into account missing values.

29.3 Sources of funds and salient features of sources

29.3.1 Own funds, formal and informal borrowings: All firms for which information is available received trade credit. For large (A and B category) firms, a part of 'trade credit' is sometimes in the form of advances for works contracts from public works departments. However, advances are given only in exceptional cases and small contractors do not receive advances. Instead, they are paid in stages on completion of specific portions of contracted work. The breakup between supplier's trade credit and advances from the government is not available for any firm. We therefore treat all trade credit as informal credit since the bias is unlikely to be large. Clearly, since government advances go only to large firms, supplier's trade credit helps small firms more than our results below suggest. Besides, trade credit, 27 per cent of the sample received formal credit in one form or another, 24 per cent received informal credit and an additional 21 per cent received credit from both informal and formal channels. 27 per cent received only trade credit. Of those who received only trade credit, 12 per cent were unaware of bank credit facilities or had been turned down by banks and a further 9 per cent were uninterested in bank credit. Table 29.7 gives details of the average percentages of total assets/liabilities from different sources.³ The average firms in the sample relies mainly on own funds (61.54 per cent) with informal credit, contributing another 32.15 per cent to their funds. Of this however the bulk was trade credit which accounted for a quarter of the funds available to them. Thus bank loans and other formal credit contributed only 6.31 per cent of the total funds. The total credit made available by formal sources referred to here does not include bank guarantees.

3. While we have qualitative evidence that 2 firms in Delhi were bank borrowers, their financial statements were not made available. Thus, figures for own and informally borrowed funds for Delhi and all firms are biased upward. However, if Delhi is excluded from the sample, figures for the remaining firms are higher than those given for "all firms" in Table 7.

Bank guarantees were 7.8 times as large as total direct lending mainly on account of a bank guarantee of Rs. 3 crore enjoyed by one category A firm in Delhi (see Table 29.8). When this is excluded from total bank guarantees, total accommodation via bank guarantees reduces to 87 per cent of other bank credit. Nevertheless, when guarantees are taken into account, formal credit emerges as a more important source of finance than informal finance excluding trade credit.

29.3.2 The category-wise figures in Table 29.7 reveal no marked differences in reliance on trade credit. However, own capital is significantly more important as a source of funds for smaller firms. Correspondingly, both banks and informal lenders serve large firms more than small firms though the pattern is much less marked for informal credit. Furthermore, the extent of reliance of small firms on informal finance is much larger (at 4.17 per cent excluding trade credit and 29.21 per cent including trade credit for firms in category D) than their reliance on formal credit. A much clearer picture of this pattern is to be had in Table 29.10 which gives the break up by borrowing status.

29.3.3 Own funds employed by firms getting both formal and informal credit is significantly lower (at 49 per cent) than for those relying either solely on formal finance (62 per cent) or informal finance (61 per cent). Correspondingly (see Table 29.10) firms borrowing from both sectors are marginally less dependent on trade credit.

29.3.4 Except in one case, formal sector finance meant commercial bank finance. The exception was a category firm A in Agra which had received a term loan from the Public Works Department for the purchase of machinery. However, two firms were contemplating approaching the Public Works Department or a State financial institution for term loans. Informal finance was mainly from friends and relatives (80 per cent of informal borrowers) or from partners. Only one firm, a C category firm in Agra, had approached an indigenous banker for a loan. Most B, C, and D

category firms were aware of the availability and cost of informal loans. Some claimed that many other contractors borrowed from indigenous bankers, though, with the exception discussed, the sample studied did not reveal any evidence of this.

29.3.5 One component of funds not separately reported in financing figures of road construction firms is known to be sales by them of excess cement, bitumen and steel supplied by the government against work orders. This is reported to be a major source of funds for the contractors and has been reported by some interviewees to equal 10-15 per cent of the value of the material supplied or about 5-7 per cent of the value of the work order. However, no details of this source were revealed by sampled firms. This may be a factor explaining the large owned funds position of contractors.

29.3.6 **Purpose, duration and cost of loans:** The bulk of loans from both formal and informal sectors was for working capital finance. Three formal borrowers had received term loans (two from banks, one from the public works department) though this made up a small fraction of total formal finance. While only one informal borrower had received a long term loan (from friends/relatives) with an explicit pay back period, most claimed to have received loans which, while formally repayable on demand, were outstanding for over one year (in one case for 4 years) and were expected to continue to be available. If these loans are treated as long term loans, then the percentage of long term loans from the informal sector is seen to exceed that from the formal sector (See Table 29.8 and 29.9). The average cost is lower than that from the formal sector (15.89 per cent versus 16.20 per cent: see Tables 29.8 and 29.9). However, this was due to two interest free loans from friends and relatives in the sample. The median cost of credit in the informal sector was 18 per cent as against 16.5 per cent from commercial banks. The cost of borrowings from informal financiers was 24 per cent for the one case in the sample and also according to information gathered from other respondents. These cost figures are obtained as a weighted average computed over all loans for

which information was available. An alternative figure is the ratio of interest paid over the year to outstanding loans at the end of the year. By this method (Table 29.11) the difference in borrowing cost is even more striking. However, there are obvious timing difficulties with this method. Also, these calculations exclude bank guarantees. When the charges on bank guarantees are considered, the average bank cost falls to 2.5 per cent.⁴ There was no evidence that the cost of borrowing fluctuated in the informal sector over time. However, significant inter-city and inter-group differences in the interest average cost of borrowing existed (see Table 29.11). The most striking finding is that firms borrowing from both sectors had the lowest cost of funds followed by informal borrowers.

29.3.7 Turning, finally, to trade credit, Table 29.11 reveals that trade credit is received on average for five weeks. Also, (i) category A firms receive credit for more than twice the duration of firms in category D; (ii) the number of days of credit is monotonically increasing with firm size; (iii) firms getting both formal and informal credit also received credit for longer than average; (iv) older firms also received trade credit for longer periods than newer firms (the simple correlation of date of establishment with days of credit received is -64 per cent); and (v) formal borrowers received less than average trade credit. While not much information could be obtained on the implicit interest rate on trade credit, two firms in Agra claimed discounts for cash purchases of 8 per cent -10 per cent. This however appears to be an exaggeration since the annualised cost of such credit, given an average borrowing period of 41 days (from Table 29.11) would then be between 97 per cent and 133 per cent. Trade credit would then be more expensive than 90 day loans from in-

4. Since a bank guarantee leads to a part of the owners funds being left free for other uses, in terms of foregone opportunities it is appropriate to club bank guarantees with other formal loans even though no money changes hands. Margin and collateral issues are treated later.

digenous bankers!

29.3.8 Collateral, security and margin: Informal credit for the sample was, without exception, unsecured and without any margin requirement. However, borrowers in all cases had personal and/or long standing associations with lenders which may be looked upon as implicit security. Likewise, the fact that older, established firms received more trade credit than newer firms is a manifestation of the same phenomenon. The average margin for bank credit was 25 per cent for both guarantees and other credit (Table 29.8). This varied between 0 per cent and 100 per cent. In the latter case, of course, net credit extended was zero. In at least two other cases, loans were given against bank fixed deposit receipts for larger amounts than was lent, in which case the bank only acted as a source of emergency loans which were more than 100 per cent secured. Of the remaining bank loans for which information was available (other than guarantees), 46 per cent were secured by hypothecation of stocks of raw materials, book debt or (in one case) motor vehicles. In addition, in the case of one term loan, secondary collateral by way of a land mortgage was taken. Three firms claimed to have been unable to obtain loans due to lack of collateral, and two firms were refused enhancement of their credit limit for the same reason. Finally, one firm was asked to provide 100 per cent margin for the issue of a bank guarantee.

29.3.9 Availability of credit in relation to working capital employed: A striking feature of the credit picture in this sector is that fully 58 per cent of firms are net providers of credit.⁵ The corresponding figures for formal borrowers, informal borrowers, borrowers from both sectors and those who rely solely on trade finance are 75 per cent, 17 per cent, 38 per cent and 71 per cent respectively. Figures for firm-wise averages by the three groupings being considered are to be found in Table 29.12 where

5. Net credit received is calculated from balance sheets as total borrowings plus trade dues less loans and advances and other debtor balances.

columns (2) and (3) give net credit received and number of days of sales covered by net credit received averaged across firms in different groups. Column (2) reveals that while the sector as a whole is a net receiver of credit, on average this credit is equal to only 32 days turnover (though this figure is not statistically significant). The standard deviations in both columns (2) and (3), being large, show that the experience is quite varied. An ordinary least squares regression of the number of days of credit received showed the following:

$$\begin{aligned}
 \text{Net credit in days} = & -82.87 + 67.85(\text{IB}) + 65.85(\text{FB}) \\
 & (1.815) \quad (2.802) \quad (2.932) \\
 & + 109.90(\text{BB}) + 56.28 (\text{A category}) \\
 & (4.140) \quad (3.429) \\
 & + 6.8468 (\text{Interest cost}) - 1.741 (\text{own capital}) \\
 & (5.210) \quad (4.674)
 \end{aligned}$$

t- statistics in parentheses.

Number of observations: 62; Regression F statistic: 17.2549, R Squared: 0.6531; R-bar-squared: 0.6152; (Heteroscedasticity, and mis-specification (Lagrange multiplier test for residual serial correlation; Ramsey RESET test using squares of fitted values) rejected at the 10 per cent level). Own capital = own capital to total equity ratio. IB: Informal borrower; FB: formal borrower; BB: borrower from both sectors. (Dummy Variables).

29.3.10 The regression confirms the observation that only those obtaining credit from both sectors and A category firms who are also borrowers are net receivers of credit as a general rule. In relation to funds used for extending credit (by way of unpaid bills or security deposits) or in holding inventories, the average shortfall was for 124 days (Table 29.12). Furthermore, the worst affected firms were the smallest (D category) firms. In fact, the shortfall is related inversely to firm size. Finally, it may be added that the average period for which trade credit is given exceeds that for which trade credit is received (Table 29.11), the

situation being worst for small firms. This further strengthens the findings of this section.

29.3.11 Before leaving this section, it must be recalled that the absolute position of contractors may not be as bad as has been made out due to cash inflows from the sale of cement and steel mentioned earlier. However, the relative positions of small and large firms are likely to be as indicated

29.3.12 Reasons for approaching informal sector and respondents opinion of bank credit facilities: 65 per cent of informal borrowers cited informality as one reason for approaching informal lenders. 35 per cent cited ready availability of funds (without collateral requirements). 29 per cent cited inadequacy of bank credit and 12 per cent cited lower interest rates.⁶

29.3.13 Since all firms surveyed were at least deposit account holders with banks, responses were sought from all firms as to their evaluation of banking facilities. 58 per cent of the sample felt that bank finance was not commensurate with their needs. Among borrowers, this figure was 57 per cent. 52 per cent of firms were dissatisfied with their bank branch managers. 10 per cent cited tardy bank service as the reason for dissatisfaction and 23 per cent cited inadequate credit availability. Only one borrower had received any special service or advice from his branch manager, and this too on a matter unrelated to the business.⁷ 17 per cent of firms, and not necessarily the same firms that had been refused credit facilities or credit enhancement, felt that they had received unfair treatment from their bankers relative to other customers. As shown in Table 29.8, of the banks with the greatest market share among sample firms, the most satisfactory performance was by the Punjab and Sind Bank. 4

6. Percentages add up to over 100 per cent since some respondents cited more than one reason.

7. The borrower expressed complete satisfaction with his banker. The public sector bank in question was the Punjab and Sind Bank.

banks shared the bottom rank in serving the needs of clients and the worst branch managers were those of the State Bank of India. While evaluating these findings, the small sample size should be kept in view.

29.3.14 Overdues and penalties: In only one case did any respondent admit to having an overdue loan and even this was claimed to be temporary. The loan was from a commercial bank. Where field staff performed cross-checks with banks, no contradictory evidence was forthcoming. No information as to penalties for overdue loans from the informal sector was available.

29.4 Uses of funds

29.4.1 Table 29.13 gives details of use of funds by contractors in the sample. Use of funds has been divided into 4 groups: fixed assets, inventories, loans and advances and investments. The most striking feature of the use of funds available to firms in this sector is that they lend heavily to the Government by way of forced loans (security deposits and unpaid bills). More than 43 per cent of their funds are tied up in this fashion. Therefore, given the meagre net credit received by these firms, it can be said that, de facto, contractors act as intermediaries (or suppliers on their own account) of loans to the Government sector. Besides constituting a clear case of funds flowing from the informal sector to the formal sector, this also provides a case of where the Government uses its monopsony position to, in effect, interlock loan and goods markets (the 'good' in this case is the service of road construction contractors). If, to this, is added the fact that banks found to be lending to the sector are all public sector banks, then, since bank lending is not a very major source of finance to this sector, a bleak picture emerges. It almost appears as if different arms of the Government come together to forcibly extract credit from firms in the sector.

29.4.2 However, not all firms are equally affected. The ratio of investments to assets is inversely related to firm category

showing that large firms have a less constrained funds position. Since such investments - almost entirely in Government securities in order to benefit from saving incentives - reduce the tax burden of firms (and further add to lending to the Government by the sector bringing the total to almost two-thirds of total assets) and increase their profitability, the inability of small firms to undertake greater investments adds weight to their claim of being squeezed out of the sector.⁸

29.4.3 Turning to the classification by borrowing status, two features stand out: firms receiving credit from both formal and informal sectors hold more inventories and invest more of their funds in other assets than any other group of firms. This could be taken to suggest that a portion of the inventory was for speculative purposes and that the quantum of credit received by these firms was more than the minimum comfortable level required for their operations. Caution must be used in accepting this hypothesis since, equally, the large inventories and investments may simply be the efficient levels (given the tax code and supply delays) made possible by their access to sufficient credit.⁹ The second feature which stands out is the unusually low level of investments by informal borrowers. One explanation possible is that firms who borrow from informal markets have relatively poor information not just about bank finance but also about other legal and institutional features. This hypothesis, however, could not be verified.

29.4.4 Finally, the relation between inventories and sales may be assessed. While the average firm held 75 days of inventories, this was highly variable and showed no pattern for any group of

8. A ratio of two stocks really cannot reflect the flow of fresh investments. The growth rate in investments as shown during the two years for which data was available was roughly the same for all categories of firms.

9. For further discussion see section 29.7 below.

firms. It may be worth mentioning that much of the inventory consists of food items to feed hired labour. The only other feature that is worth mentioning is that firms receiving credit from formal and informal sources had the highest average inventory level (with however a high standard deviation). Thus no corroboration or contradiction of hypotheses outlined in paragraph 4.3 is to be found.

29.5 Impact of bank regulations and the government sector on credit availability

29.5.1 As described above, the combined effect of various government arms - bank, income tax authorities and civil works authorities - is to turn road construction contractors into involuntary creditors to the government. No particular impact on informal sector credit availability to road construction contractors can be discerned.

29.6 Estimate of the total volume of informal credit to road construction activity

29.6.1 The figures in Table 29.1 can be used to derive crude estimates as to total size of informal and formal credit to road construction. However, these estimates should be treated with extreme caution, especially the estimates at the all India level. Since formal and informal credit is 2.91 per cent and 10.07 per cent respectively of the total value of production of sampled firms,¹⁰ estimates are arrived at by taking the same proportions of total production for U.P. and Delhi and for the whole of India. On this basis informal credit is estimated to be of the order of Rs. 25 crore in Delhi and U.P. and Rs. 454 crore at the all India level as compared to formal credit of Rs. 7.11 crore and Rs. 131.04 crore respectively. Correspondingly, estimates can be obtained for the total funds outstanding with the government sector, both in gross terms and net of bank credit. From Table 29.1 these figures can be seen to be Rs 593.12 crore and Rs 440.65 crore

10. Unlike the tables, these figures are the ratios of totals across firms rather than average firm-wise ratios.

respectively at the all India level and Rs 32.16 crore and Rs 21.21 crore respectively for Delhi and Uttar Pradesh.

29.7 Efficiency and allocative impact of the informal finance

29.7.1 No physical indicator of output being available, value of production has been used as the indicator of production. If capital output and labour output ratios are examined to assess the impact of informal finance on efficiency, the tentative conclusion which emerges is that such finance, despite its higher cost, finances relatively inefficient firms. Table 29.14 gives these ratios for firms by borrowing status. Firms relying solely on formal finance, it can be seen, have lower ratios than all other firms. No clear ranking of other categories of firms can be given. Since these ratios show a weak positive correlation (16.36 per cent) the presumption is that firms with higher ratios are inefficient even after capital - labour substitution is accounted for unless scale economies are reflected in the trend. As against this return on sales has exactly the opposite rank order as labour-output ratio. The finding that the average bank interest cost (on balance sheet borrowing) exceeds informal sector interest takes on significance in this context.

29.8 Complementarity/substitutability of formal and informal finance

29.8.1 In one respect, bank finance has no substitute even though it is not available to the bulk of firms. This is in the giving of bank guarantees, since guarantees by other parties are not acceptable for earnest money and security deposits. Likewise, the near uniformity of figures for trade credit (Table 29.7) and their low standard deviations suggest that trade credit is not easily substituted by other means of finance. With these two exceptions, informal finance appears to be, by and large, substitutable for bank finance insofar as the purpose of borrowing is taken as the criterion.

29.8.2 The distinguishing features of informal credit - speed,

informality and absence of collateral requirements - are normally cited as reasons for their complementarity to bank funds. Informal finance is then seen as ideal for short term and unforeseen financial needs. However, given pre-existing overdraft facilities with banks - which many sampled firms had - this need not be the case. Thus, no overall conclusion can be drawn on the relative position of these credit sources.

29.9 Overall assessment of credit availability and distinguishing features

29.9.1 The picture that emerges of this sector is that of an archetypical financially repressed sector relying primarily on own funds and facing a formal sector credit constraint as postulated by Shaw (1973) or McKinnon (1973). There is, however, one significant difference between the McKinnon - Shaw model and firms in the sector. Since firms in the sector operate in a monopsony market (with the government as the sole buyer), firms are not simply constrained, on average, to operate within their own funds constraints but are 'forced' to extend credit to the government in tied contracts for purchase of services. Thus, it is not simply the banking sector that contributes to the financial repression of firms by restricting credit availability to them but also other arms of the government.

29.9.2 In comparing formal and informal credit availability, two striking findings, contrary to the bulk of writings on the subject, emerge. Firstly, informal credit is on average cheaper than formal credit, though informal rates are more widely dispersed than formal rates and have a higher maximum and lower minimum. Secondly, the duration of informal loans (excluding trade credit) is, de facto, longer on average than formal credit. It is possible that the interest free informal loans encountered in the sample are spurious loans reflecting deployment of 'black funds' by the owner of the business with the connivance of friends and relatives.¹¹ If so this would explain the controversial

11. This was pointed out in conversation by Dr. Amaresh Bagchi.

findings.¹²

29.9.3 Other points of similarity and dissimilarity are as follows:

- i. Banks - as the example of the bank which demanded a 100 per cent margin for an almost risk free bank guarantee shows - are overly conservative in their loan policies. Informal lenders may or may not be more risk averse since a high level of implicit security is available to them through personal relations with borrowers.
- ii. Most loans by both groups are for working capital.
- iii. Informal lenders do not require any margin as compared to an average margin of 25 per cent from banks.
- iv. Both banks and informal lenders favour larger and older firms, though the absolute level of informal lending to small firms is higher.
- v. Bank guarantees are a relatively risk free form of bank accommodation to the sector for which no substitute form of credit exists.
- vi. Trade credit, due possibly to the ease with which it is available, is the most important single source of credit to the sector and appears to have no substitute.
- v. The efficiency of firms financed by banks appears to be much higher than informally financed firms.

29.9.4 From the point of view of firms, two findings are of importance. Firstly, the adverse situation of the smallest firms seems to suggest that they are below the minimum size necessary to take advantage of scale economies including the provision of collateral. To recapitulate the main findings for firms in category D:

- i. They are less profitable (in the sense of return on own capital employed).

12. However, it may be mentioned here that bank credit in some southern States, such as Kerala, is reported to be non-existent. Furthermore, informal credit from a group of financiers is reported to be much more important.

- ii. They receive trade credit for relatively short durations.
- iii. Their inventory holding is large relative to sales suggesting indivisibilities in the purchase of raw materials.
- iv. They are most dependant on internal finance and have the greatest credit shortfall.

29.9.5 Secondly, firms receiving credit from both formal and informal sectors are in a privileged minority. The main findings are:

- i. They are far less dependant on own funds than other firms.
- ii. Their cost of borrowing is the least.
- iii. They are able to hold larger inventories relative to total assets and can use a larger part of their funds in purchasing government securities to save on taxes.
- iv. The average period of trade credit received by them is the longest.

No particular exogenous characteristic of these firms could be discerned that would explain their favoured status.

29.9.6 Turning to other features of the sector worth highlighting, three items stand out. First, several firms were found to lack information as to credit facilities available from banks and perhaps, as to tax concessions and tax incentives. This contrasts with the information about informal loans volunteered by several respondents. Secondly, the near absence of professional informal financiers as suppliers of credit to this sector, deserves to be noted. Finally the wide variation in the cost of borrowing across categories of firms and cities may be taken as weak evidence of the fragmentation in credit markets which is made so much of in the literature.

29.9.7 Before leaving this section it is worth repeating that all these findings should be evaluated in the light of the relatively small sample size available for analysis.

29.10 Recommendations for reform and regulation

29.10.1 While the main thrust of this section is on ways in which banks can better serve the sector, at the outset it must be pointed out that a coordinated approach by the public works authorities and commercial banks is needed if the credit restrictions faced by the sector are to be eased. In line with the suggestions of respondents - which we endorse - the following activities may be considered by banks for enhancing credit availability to the sector.

29.10.2 First, banks in consultation with public works departments should provide bank guarantees to contractors. The scope for such guarantees is large. 25 per cent of the respondents expressed an interest in such a facility. Since bank guarantees are relatively risk free - especially if there is appropriate coordination with public works departments - the margin requirements should be kept to a reasonable level.

29.10.3 Secondly, providing credit by way of overdraft facilities or cash credit against work orders may be considered. Once again, routing of payments made by the authorities for completed work through banks should reduce the risk of default. About 20 per cent of the respondents felt the need for such a facility.

29.10.4 Thirdly, discounting of government cheques which need to be sent for outstation clearance or immediately crediting customers accounts on receipt of such cheques would also ease the financial strain on firms.

29.10.5 While the first measure above would counter-balance funds blocked in security deposits, the second and third would reduce the net period of involuntary credit extended to the government. Both would result in improved cash flow for firms.

29.10.6 The rate of interest charged on loans and bank guarantee charges should however be at the maximum prescribed. In view of the suspected inefficiency of small firms, high interest rates would act as a partial weeding out device for inefficient firms. No special characteristic of the sector makes them eligible for interest subsidies.

29.10.7 Working capital accommodation and term loans should be given as at present on a case by case basis. However, given adequate security, efficient operating characteristics and a willingness on the part of firms to pay the maximum rate of interest, no limit on the credit facilities granted to firms need be laid down a priori.

29.10.8 Efforts on the part of branches to disseminate information on available bank credit facilities - and efforts to monitor the performance of contractors on a continuing basis - seem to be essential if the credit needs of the sector are to be better served.

29.10.9 Finally, the complaint by some firms that a record of prompt payment of loans and prudent financial management has no impact on their credit rating needs to be looked into and, if true, corrected.

TABLE 29.1

Aggregate Road Construction Activity in India

(Rs. Crore)

	1982- 83	1983- 84	1984- 85	1985- 86	1986- 87	1987- 88
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1. Gross capital formation in public sector (roads and bridges)	2555	2834	3206	3591 (P)	4023 (P)	4507 (P)
2. Capital expenditure on roads & bridges in Uttar Pradesh		98.42	157.30	140.10 (RE)	174.35 (P)	216.97 (P)
3. Capital expenditure on roads & bridges in the Union Territory of Delhi			15.30	14.90	24.22	27.38 (P)

Estimates of Credit for 1987-88

4. Formal credit to sector (All India)	131.04
5. Informal credit to sector (All India)	454.06
6. Formal credit to sector (U.P. & Delhi)	7.11
7. Informal credit to sector (U.P. & Delhi)	24.62
8. Gross loans to Government sector (All India)	593.12
9. Loans to Govt. sector Net of Bank Credit (All India)	440.65
10. Gross loans to Government sector (U.P. and Delhi)	32.16
11. Loans to Govt. sector Net of Bnk Crdt (U.P. and Delhi)	21.21

- Notes: 1. Estimates calculated by proportionate scaling up of figures in Note 2 below.
2. Total value of production of firms in sample (average of 2 years): Rs. 396.54 lakh
 Ratio of non formal credit to production : 10.0746%
 Ratio of formal credit to production : 2.9089%
3. P : Projected on the basis of data for latest available 3 years.
 RE : Revised Estimate.

- Sources: 1. National Accounts Statistics, 1988.
 2. State Government Budgets.
 3. Annual Reports, Ministry of Surface Transport.

TABLE 29.2

Descriptive Statistics for Sampled Areas

Item	Population	Delhi	Dehradun	Agra	Meerut
1.	Population of city (1981 census) in lakh	51.67	2.21	6.94	4.17
2.	Annual growth rate 1971-81 (per cent)	2.69	2.09	1.38	2.87
3.	Population of district union territory (1981 census) in lakh	62.20	7.62	28.53	27.67
4.	Annual growth rate 1971-81 (per cent)	4.34	2.81	2.14	2.28
5.	Urban population (1981 census)(per cent)	92.7	48.9	38.1	31.2
6.	Area of district/ union territory (sq.km.)	1483	3088	4805	3911
<hr/>					
Length of roads		Delhi		Uttar Pradesh	
		Surfaced	Total	Surfaced	Total
6.	<u>Highways (km)</u>	<hr/>			
	1980-81	336	297	52,436	89,353
	1982-83	326	311	54,777	91,494
7.	<u>Urban roads (km)</u>	<hr/>			
	1980-81	6,806	13,581	16,266	20,614
	1982-83	8,359	15,464	16,322	20,688
8.	<u>6 plus 7 (km)</u>	<hr/>			
	1980-81	7,142	13,878	68,702	1,09,967
	1982-83	8,685	15,775	71,099	1,12,182

Source: Central Statistical Organisation, Government of India: Statistical Abstract of India, Various Issues.

TABLE 29.3

Sample Description: Numbers Surveyed

Category	City				Total
	Delhi	Dehradun	Agra	Meerut	
A	3	3	3	1	10 (23.26)
B	2	3	Nil	4	9 (16.96)
C	1	2	5	2	10 (10.53)
D	3	1	Nil	2	6 (6.06)
TOTAL	9 (4.81)	9 (25.0)	8 (25.0)	9 (25.71)	35 (12.07)

Notes: 1. In Delhi categories are actually I, II, III and IV.

Category A: No limit on contracts

Category B: Contracts up to Rs. 15 lakh

Category C: Contracts up to Rs. 5 lakh

Category D: Contracts up to Rs. 2 lakh

2. One firm from Category A in Delhi is omitted since data were for the years 1984 and 1985. Sample thus dropped to 35 from 36.

3. Figures in brackets are percentages of population sampled.

TABLE 29.4

Average Turnover of Firms Surveyed

(Rs. lakh)

Category	City				
	Delhi	Dehradun	Agra	Meerut	All centres
A	36.65	6.63	24.82	50.0	26.38
B	10.5	13.38	-	13.25	12.68
C	6.5	1.75	8.78	4.0	6.43
D	1.0	4.0	-	5.0	3.2
Overall average	14.69	8.61	14.80	14.63	13.13

- Notes: 1. 'Current' year and 'previous year' vary depending on accounting year of firms. 80% of firms had the same accounting year.
2. Number of firms with increased turnover:19
 Number of firms with unchanged turnover:5
 Number of firms with decreased turnover:7

TABLE 29.5

Employment and Capital/Labour Ratios of Firms

	A	B	C	D	All
E	47	21	23.1	22.8	28.7
K/E	65.05	28.78	10.3	6.05	28.78

- Notes: E : Average number of workers employed.
 K/E : Average total assets (in Rs.) divided by E.

TABLE 29.6

Profitability of Firms

(All figures in percentages)

	PAT/ capital	PAT/ income	EPAT capital	EPAT/ income
(1)	(2)	(3)	(4)	(5)
A: Category-wise				
A	20.41 (14.71)	5.39 (3.24)	11.69 (18.84)	2.69 (1.84)
B	35.94 (21.34)	5.83 (2.02)	17.72 (11.15)	2.87 (1.35)
C	47.22 (51.64)	7.14 (1.74)	23.41 (27.52)	3.12 (1.19)
D	29.56 (12.05)	15.51 (17.29)	9.56 (5.78)	3.86 (3.19)
All firms	34.78 (32.99)	7.66 (8.08)	16.58 (17.69)	3.13 (1.89)
B: Borrowing Status-wise				
Formal only	38.37 (2.31)	5.53 (1.39)	21.62 (14.26)	3.03 (1.27)
Both formal and informal	21.11 (17.69)	5.91 (3.12)	11.96 (12.02)	3.04 (1.99)
Informal only	39.00 (50.73)	6.98 (2.52)	18.31 (26.04)	2.79 (1.25)
Self financed	36.51 (20.42)	11.82 (14.53)	13.97 (9.23)	3.66 (2.61)
All Borrowers	33.37 (36.32)	6.21 (2.54)	17.51 (19.76)	2.94 (1.51)

- Notes: 1. PAT : Profit after taxes.
 Capital : Equity/owners capital.
 EPAT : Retained earnings plus 20% of dividends/drawals.
2. All firms including 'self financed' received trade credit.
3. Figures in parentheses are standard deviations.

TABLE 29.7

Sources of Funds of Road Construction Firms

(All figures in percentage)

	Own capital and equity	Formal credit	Informal credit		
			Trade credit	Other	Total
(1)	(2)	(3)	(4)	(5)	(6)
A: By Category					
A	49.67 (20.14)	11.09 (16.44)	27.43 (18.68)	11.80 (13.69)	39.23 (24.01)
B	62.13 (15.360)	7.71 (10.75)	25.86 (16.06)	4.30 (8.99)	30.16 (19.42)
C	65.73 (15.75)	4.46 (12.67)	21.81 (13.13)	8.01 (11.48)	29.82 (15.78)
D	69.78 (12.49)	1.01 (2.03)	25.04 (12.94)	4.17 (8.54)	29.21 (13.17)
B: By Borrowing status					
Formal only	60.09 (15.62)	15.27 (14.62)	22.64 (16.590)	N.A.	22.64 (16.59)
Formal and informal	18.54 (18.00)	13.97 (17.45)	20.29 (12.81)	17.20 (13.15)	37.49 (24.25)
Informal only	60.82 (19.03)	N.A.	24.22 (16.96)	14.96 (11.53)	39.18 (19.03)
All borrowers	58.19 (18.51)	8.84 (14.26)	22.69 (15.69)	10.28 (12.42)	32.97 (21.12)
Self finance	69.90 (13.02)	N.A.	30.10 (13.62)	N.A.	30.10 (13.62)
All firms	61.54 (17.920)	6.31 (12.69)	24.80 (15.54)	7.35 (11.48)	32.15 (19.20)

- Notes: 1. Figures are percentages of total capital employed.
2. Standard deviations in parentheses.
3. All firms including 'self financed' receive trade credit.

TABLE 8

Details of Bank Credit

		Type of facility												
		Cash credit		Overdraft accounts		Term loans		Bank guarantees		All loans				
		A	D	A	D	A	D	A	D	A	B	C	D	E
I	Number of loan accounts													
	1. All banks	5	6.71	10	0.98	2	6.4	6	56.29	23	16	45.7	3.50	18.35
	2. State Bank of India	1	1.6	3	1.25	1	0.8	Nil		5	4	11.4	1.23	
	3. Canara Bank	1	25.0	1	NA	1	12.0	2	152.5	5	2	5.7	18.5	152.5
	4. Punjab and Sind Bank	1	0.05	2	None	Nil		Nil		3	2	5.7	0.05	
	5. Corporation Bank	Nil	1	1.0	Nil	1	5.0	2		1	2.9	1.0	5.0	
	6. Oriental Bank of Commerce	Nil	Nil		Nil	2	1.38	2		2	5.7		1.38	
	7. Punjab National Bank	1	0.2	Nil		Nil		Nil		1	1	2.9	0.2	
	8. Syndicate Bank	Nil		1	0.1	Nil		Nil		1	1	2.9	0.1	
	9. Not available/others	1	N.A.	2	2.0	Nil		1	25.0	4	3	8.6	2.0	25.0
II	Margin (Average %)	25.0		20.0		25.0		27.40				25.0	24.33	
	Rate of interest (average)		16.49		15.35		12.5		1.0				16.20	2.49
III	Amount outstanding as a percentage of limit sanctioned	71.62		103.15		65.0		NA			75.42		NA	
IV	Primary security (Number of accounts)	None/personal (1)		None/personal (6)		Hypothecation of vehicle (1)		None (4)						
		Hypothecation of stocks (3)		Hypothecation of stocks (1)		NA: (1)		NA: (2)						
		Hypothecation of Bad debts (1)		Fixed deposit receipt (1)										
		Fixed deposit receipt (1)		NA: (2)										
V	Collateral security	None/personal (4)		None/personal (7)		Mortgage & Land (1)		None/personal (4)						
		NA: (1)		NA: (3)		NA: (1)		NA: (2)						

Table 8 (Contd.)

	Total No. of account holders	Percentage getting need based finance	Percentage satisfied with banker	Percentage feeling bank is unfair to them	Percentage availing of other credit as well
Number of loan accounts					
1. All banks	35	42.86	51.7	5.7	52.9
2. State Bank of India	16	30.8	25.0	6.0	53.3
3. Canara Bank	5	60.0	40.0	0.0	60.0
4. Punjab & Sind Bank	3	100.0	100.0	0.0	33.3
5. Corporation Bank	2	50.0	100.0	0.0	100.0
6. Oriental Bank of Commerce	3	0.0	66.7	0.0	66.7
7. Punjab National Bank	1	0.0	100.0	0.0	0.0
8. Syndicate bank	1	0.0	100.0	0.0	100.0
9. Not available/ others	10	50.0	50.0	10.0	70.0

- Notes: 1. Rate of interest for all loans including bank guarantees.
 2. "Interest rate" for bank guarantee is the annual change.
 Interest rates do not net out interest paid on security held with banks, if any.
 3. All averages are with respect of firms for which data is available.
 4. A: Number of Accounts
 B: Number of Firms
 C: B as a percentage of total sample
 D: Average excluding Bank guarantees (Rs. lakh)
 E: Average including bank guarantees (Rs. lakh).

TABLE 9

**Salient Features of Informal Credit Received by
Road Construction Firms**

	Friends and re- latives	Partners & share- holders	Multanis & shroffs	Source not avail- able	Total informal credit
1. Number of firms	12	1	1	4	17
2. % of firms in sample	34.3	2.9	2.9	11.4	48.57
3. Average rate of interest (%)	15.03	15.0	24.0	N.A.	15.89
4. Minimum rate of interest (%)	Nil	15.0	24.0	N.A.	Nil
5. Maximum rate of interest (%)	18.0	15.0	24.0	N.A.	24.0
6. Percentage of short term loans	33.3	Nil	100.0	N.A.	35.7
7. Percentage of long term loans	66.7	100.0	Nil	N.A.	64.3
7a. of which demand loans	58.3	Nil	Nil	N.A.	50.0
8. Average loan amount (Rs. lakh)	3.55	1.64	0.25	N.A.	3.55
9. Collateral & security	Nil	Nil	Nil	N.A.	Nil
10. Percentage of loans for working capital finance	83.3	0.0	100.0	N.A.	71.4

- Notes: 1. Figures are with respect to loans for which data is available.
 2. Long term loans (7) : Loans outstanding for more than one year.
 3. Demand loans (7a): Outstanding for more than one year.
 4. Interest rates were found not to vary with duration or purpose.

TABLE 29.10

Pattern of Borrowing of Road Construction Firms

(All figures in percentage of total borrowing)

	Formal credit	Informal credit		
		Trade	Other	Total
(1)	(2)	(3)	(4)	(5)
A: By Category				
A	21.19 (28.63)	52.11 (34.47)	19.57 (21.85)	78.81 (28.63)
B	22.71 (27.46)	69.50 (27.57)	7.78 (15.51)	77.29 (27.46)
C	8.61 (24.36)	71.82 (32.41)	19.57 (28.18)	91.39 (24.36)
D	5.96 (12.03)	83.62 (22.30)	10.42 (21.83)	94.04 (12.03)
B: By Borrowing Status				
Formal only	38.65 (28.43)	61.36 (28.43)	N.A.	61.36 (28.43)
Formal and informal	28.83 (29.70)	49.34 (29.64)	29.24 (20.25)	71.17 (29.70)
Informal only	N.A.	65.81 (27.33)	34.19 (27.33)	100.00 (0.00)
All borrowers	20.73 (28.360)	55.61 (29.87)	20.99 (25.34)	79.27 (28.36)
Self finance	N.A.	100.00 (0.00)	N.A.	100.00 (0.00)
All firms	14.81 (25.73)	67.86 (32.24)	14.99 (23.42)	85.19 (25.73)

Note: Standard deviation in parentheses.

TABLE 29.11

**Interest Cost of Borrowing and Duration
of Trade Credit Received and Given**

Group	Interest cost (%)	Trade credit received (in days)	Trade credit given (in days)
(1)	(2)	(3)	(3)
A: By Category			
A	11.83 (5.39)	56.06 (49.17)	58.06 (27.95)
B	16.09 (3.71)	32.38 (27.95)	40.28 (25.42)
C	12.66 (8.94)	31.33 (31.16)	39.83 (25.88)
D	N.A.	24.01 (24.28)	33.60 (18.39)
B: By Borrowing Status			
Formal borrowers	15.27 (3.59)	27.7 (18.31)	36.57 (16.68)
Formal & informal borrowers	12.30 (5.42)	47.48 (37.61)	55.21 (33.58)
Informal borrowers	12.77 (8.37)	35.93 (31.09)	40.56 (27.14)
All borrowers	13.38 (6.21)	36.94 (31.16)	43.80 (27.85)
Self financed	N.A.	36.53 (49.95)	43.25 (46.46)
All firms	N.A.	36.48 (36.94)	43.66 (33.65)

Notes: 1. Interest cost is interest paid as a percentage of total borrowed funds.
2. Trade credit days computed as a ratio of value of production (or sales) during the year multiplied by 365 days.

TABLE 29.12

Net Credit Received by Road Construction Firms

Group	Net credit received (Rs.lakh)	No. of days of working capital	Working capital used in days	Shortfall in days (3-4)
(1)	(2)	(3)	(4)	(5)
A: By Category				
A	9.59 (10.99)	218.52 (319.52)	258.00 (458.25)	39.48
B	-0.34 (0.5)	-15.10 (17.56)	75.69 (26.25)	90.79
C	-0.05 (0.57)	-35.10 (84.13)	107.66 (89.88)	142.79
D	-0.26 (0.37)	-47.77 (21.19)	234.20 (197.87)	281.97
B: By Borrowing Status				
Formal borrowers	0.06 (0.86)	-12.53 (27.12)	68.68 (30.68)	56.15
Formal and informal borrower	8.31 (10.31)	230.13 (344.61)	244.31 (454.34)	64.18
Informal borrowers	0.78 (2.89)	-38.08 (97.64)	146.59 (120.28)	184.46
All borrowers	2.69 (6.82)	51.33 (230.30)	167.82 (277.15)	116.49
Self financed	-0.06 (0.52)	-22.03 (35.20)	141.82 (167.36)	163.85
All firms	2.00 (6.03)	32.31 (201.60)	158.97 (256.75)	123.62

TABLE 29.13

Uses of Funds of Road Construction Firms

(Percentage of total assets)

Group	Fixed assets	Inven- tories	Loans and advances		Invest- ments	Inventory holding in days
			Security deposits	Total		
By Category						
A	11.60 (10.36)	36.05 (22.95)	18.60 (20.14)	20.33 (18.42)	32.02 (21.15)	159.88 (255.46)
B	6.23 (5.36)	20.46 (10.24)	26.09 (11.72)	20.46 (10.24)	25.96 (10.94)	30.27 (29.30)
C	10.16 (11.20)	16.96 (8.25)	26.37 (13.90)	16.96 (8.25)	19.13 (16.01)	31.85 (21.34)
D	5.00 (10.00)	28.96 (12.71)	14.94 (8.94)	28.96 (12.71)	13.22 (10.96)	96.19 (86.56)
By Borrowing Status						
Formal borrowers	5.39 (4.23)	15.39 (9.67)	31.65 (7.59)	50.46 (7.15)	28.75 (12.66)	18.97 (13.77)
Formal & informal	10.73 (9.61)	35.77 (22.78)	20.65 (19.14)	22.41 (13.70)	31.10 (17.77)	184.40 (265.80)
informal borrowers	10.49 (11.25)	26.64 (14.69)	21.52 (12.38)	49.12 (23.76)	13.76 (13.99)	55.47 (59.56)
All borrowers	9.01 (9.42)	25.99 (18.28)	24.34 (14.58)	41.40 (21.25)	23.60 (16.87)	83.60 (166.20)
Self financed	7.25 (10.57)	21.51 (8.60)	16.98 (16.08)	48.07 (19.62)	23.17 (17.15)	46.27 (54.63)
All firms	8.56 (9.76)	24.84 (16.46)	22.44 (15.32)	43.12 (21.05)	23.49 (16.94)	74.83 (146.60)

TABLE 29.14

Efficiency Indicators for Road Construction Firms

Borrowing status	Capital Out- put ratio		Labour Out- put ratio		Return on Sales (%)	
	Value	Rank	Value	Rank	Value	Rank
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Formal only	0.079 (0.049)	1	1.037 (0.782)	1	5.53 (1.39)	4
Formal and informal	0.808 (1.352)	4	1.202 (0.923)	2	5.91 (3.12)	3
Informal only	0.233 (0.171)	3	3.809 (3.130)	3	6.98 (2.52)	2
All borrowers	0.349 (0.789)	N.A.	1.197 (2.279)	N.A.	6.21 (2.54)	N.A.
Non-borrowers (trade credit only)	0.209 (0.303)	2	6.808 (8.070)	4	11.82 (14.53)	1
All firms	0.314 (0.710)	N.A.	3.139 (4.893)	N.A.	7.66 (8.08)	N.A.
Coefficient of variation	2.2945		1.5078			
Coefficient of correlation(%)		16.36				

- Notes: 1. Capital : Inventories plus fixed assets in Rs. lakh; ranking from low to high.
2. Labour : Total employment; ranking from low to high.
3. Output : Value of production.
4. Return : Reproduced from Table 29.6: ranking from high to low.
5. All figures are averages over 2 year averages for firms.

CHAPTER 30

INFORMAL FINANCE FOR HOUSE CONSTRUCTION

30.1 Introduction

30.1.1 The house construction sector is an important part of all economies and investment in housing is usually a major item in the total investment portfolio of a country. While this is certainly true of India, housing investment has an added urgency in India in view of the rising population and the rapid urbanisation taking place. While the total housing stock in the country stood at about 114 million dwellings in 1981 an estimated 230 million units are projected to be the requirement by the turn of the century. The investment required for this purpose in the 15 years 1985-2000 is estimated at Rs 1317 billion by the Planning Commission. Furthermore, in the period 1980-1985, the private sector contributed 89.4 per cent of total housing investment. The role played by the informal sector in contributing to this finance is consequently of great interest.

30.1.2 Non government housing in India is constructed in essentially three ways. The largest number of dwelling units are privately constructed. Other than this, houses are constructed by housing cooperatives and private developers. The distinction between the latter two routes is, however, not always clear cut, as private developers sometimes play a leading role in setting up cooperatives in order to gain access to concessional finance from banks and other apex institutions engaged in providing finance to housing cooperatives (Wadhwa, 1987).

30.1.3 In view of this, it is of interest to examine the role of informal credit in housing finance of individuals and also of private developers for schemes which do not involve the setting up

of cooperatives. While excellent information on the magnitude of informal housing finance of individuals is available from Lall (1984), information on the finances of private sector "mortgage financiers" and schemes offered by them was not readily available. Furthermore, quantitative information on developer's finances and the pattern of finance of housing projects by them was also not readily available. Accordingly, a survey of 25 housing developers and "mortgage financiers" was planned in Delhi with the help of the State Bank of India in 1988. Unfortunately no cooperation as to financial information was forthcoming from any of the firms surveyed except for three firms (two developers and one financier) who made their annual reports available. However, some qualitative information as to loan schemes and the finance of housing developments was gleaned from developers, government officials and officials of housing finance institutions.

30.1.4 As is well known in India, the scale of urban construction activity, the rapid appreciation in urban land prices and the vital part played by illegal money in many real estate transactions has attracted a large number of unscrupulous entrepreneurs to housing development and finance.¹ This must certainly underlie the lack of cooperation by some developers and financiers approached, though the limited cooperation extended by even the largest developers was unexpected.

30.1.5 In the next section, a summary of available information on housing finance for individuals, mainly following Lall (1984), is made. In section 3, information obtained on developers' finances is reported. Section 4 offers some tentative conclusions.

1. See, for evidence of the black economy and real estate S. Acharya and Associates (1985). For developers see Wadhwa (1987). as well as articles in newspapers. For example, see the article on the Skipper Group in the Hindustan Times, March 22, 1987.

30.2 Housing finance for individuals

30.2.1 **Lall (1984)** Surveyed a total of 720 home owners drawn on a stratified random basis from 5 urban centres in various parts of India. 83 per cent of these respondents were drawn from owners of authorised, "formal sector", dwellings and 17 per cent from owners of dwellings on unauthorised land and squatter settlements.

30.2.2 **The pattern of finance** for these home owners is given in Tables 30.1 and 30.2. As can be seen, own funds are the dominant source of finance for all categories of home owners. Informal finance, while least important overall, has relatively greater importance for owners of unauthorised and slum housing. Also, informal finance is more important than formal for two of the three lowest income groups (Table 30.2). Within informal finance, friends and relatives are the chief source of funds. About half of the sample reported renting out their house in order to finance loan repayments, while the incidence of houses constructed purely for the purpose of letting increased with income. This would suggest that poorer house owners, being unable to let out their houses after construction, were more credit constrained than richer house owners. This hypothesis is bolstered by the fact that a greater percentage of own funds to finance home acquisition was from the disposal of assets for poorer households than for richer households. A final point is that finance from both formal and informal sectors is available with greater ease for house construction rather than initial acquisition of land.

30.2.3 While about half the sample faced various difficulties in obtaining formal sector loans (Table 30.3), lack of information and lengthy procedures being the most important barriers, Lall reports that the informal sector was approached due to the usual informality, speed and low collateral requirements of informal lenders despite their high interest cost.

30.2.4 **The cost of funds** of house loans is given in Table

30.4. As can be seen, friends and relatives provided the cheapest loans on average followed by formal lenders. Indigenous bankers had effective interest rates of upto 55 per cent per annum and also the highest average interest rate. Regarding collateral, Lall reports that the value of collateral was sometimes twice the value of the loan given even for formal lenders.

30.2.5 **Details on some housing loan schemes from informal mortgage financiers** in Delhi came to light as part of the survey conducted in Delhi. While no formal security was taken, it was reported that several financiers take blank signed sheets of paper from borrowers at the time of disbursing loans while others execute formal mortgage agreements. Typical schemes are as follows:

Financier A: Loans of upto Rs 2.5 lakh are disbursed when receipts of expenditures are produced. Persons with a (confirmed) plot of land and an architectural plan approved by appropriate authorities are eligible. Loans are repayable over upto 15 years at 14 per cent to 15 per cent (flat) per annum (i.e. about 28 per cent to 30 per cent compound).

Financier B: Similar to A except that the firm must be made the beneficiary of an endowment type life insurance policy for the amount of the loan in addition to interest.

Financier C: Finances upto Rs 10 lakh at 24 per cent per annum (flat) against a mortgage.

Developer/financier D: Has several development schemes all over India. Payment for dwelling units constructed by them has to be made in accordance with a pre-specified schedule linked to progress in the construction of the units. Upto 50 per cent of the cost is met by a 5 to 20 year loan at an interest rate of 12 per cent (flat) per annum. Title to the dwelling unit is given to the buyer only when the loan is fully repaid. All taxes at the time of transfer of the title are borne by the buyer. A 2 per cent penalty per month is levied on delayed payments and the agreement

lapses if any payment (whether for the buyer's share of construction costs or for a loan repayment instalment) is not made for 3 months. In the event of the agreement lapsing, money contributed by the buyer is refundable without interest after deduction of the developer's expenses.

Developer E: Payment for a housing plot, inclusive of all development changes, can be made in equal monthly instalments over a period of 3 years. Only a 5 per cent discount is given if the entire money is paid in one initial instalment.

30.2.6 Formalities in all cases are easily completed within 24 hours. Most of the schemes outlined above show that informal finance is available only at a high cost to the borrower with borrowers facing high risk in case of unforeseen problems in keeping up with payment schedules.

30.3 Finances of developers and financing of housing development

30.3.1 Private developers in India provide housing or developed plots mainly for middle and upper income groups (Wadhwa, 1987). Few housing developments, if any, are for low income groups. It is, in fact, doubtful if authorised dwellings which are privately constructed are affordable to the urban poor given current land prices and construction costs. The number of developers is fairly large. For example, Wadhwa (1987) reports between 200 to 300 developers in the city of Ahmedabad in 1987, with the top four developers accounting for about 10 per cent of total housing construction (about 150 to 200 housing units by each of these four developers) in Ahmedabad. The situation in Delhi is broadly similar. Finance for development projects is required for extended periods due first, to the long drawn out procedures involved in getting development plans sanctioned by various government bodies, secondly due to land acquisition costs and thirdly due to the actual cost of construction and site development. The first stage, that of getting government clearances, may take upto 5 years and "entails payment of official and unofficial dues at

every stage" (Wadhwa, 1987, p. 53). Thus the major cost to the developer is that of finance (Wadhwa, 1987).

30.3.2 One way in which some developers ensure the availability of funds is by setting up dummy cooperatives as mentioned earlier. However, this activity has become increasingly difficult and is, consequently, on the decline. An alternative method of financing development projects is to obtain advance payments in instalments from buyers. This practice is widely followed. With either method of finance, it is the initial stages of a development project (upto land acquisition) for which developers require finance from sources other than customers. Increasingly, however, developers are attempting to finance developments almost to completion of construction to take advantage of appreciation in land and property values. The following description of financing of housing projects by developers is based on Lall (1984).

Initial phase (land acquisition, government approvals and provision of basic infrastructure): 25 per cent - 35 per cent of total funds: Own funds and informal finance.

Second phase (Sale of 40 per cent to 60 per cent of plots): Buyers of plots and houses, mortgage finance against remaining plots from the informal sector.

Third phase: (Construction of houses): Buyers and suppliers credit.

30.3.3 The fact that only a portion of plots are sold during the second phase is due to the desire of the builder to take advantage of appreciation in real estate values. As can be seen from this description, informal credit is involved at every stage of the housing project but most importantly in the first stage. Informal finance for the first stage is reportedly provided on a profit sharing basis by most private financiers. Also, owners of land sometimes provide land for a share in the housing project. Thirdly, large developers reportedly plan overlapping projects so

that funds received from buyers in one project can be diverted to other projects (Lall, 1986). Finally, short term bridge finance is obtained by large developers, on occasion, from the intercorporate funds market.

30.3.4 Despite the reported reliance of developers on informal finance, whether from suppliers/buyers credit or from financiers, not all developers take recourse to informal finance. The annual reports of the three large developers who provided these reports to us show the following sources of funds:

Own funds and share capital	:	70.09%, 32.05, and 0.46%	respectively.
Bank borrowings	:	19.47%, 14.90% and 0.45%	respectively.
Advance from buyers	:	Nil, 34.38% and 63.24%	respectively.
Other borrowed funds and liabilities	:	10.44%, 18.67% and 35.85%	respectively.

30.3.5 Of "other borrowed funds and liabilities" some is accounted for by fixed deposits from the public, raised through the formal capital market and some of the balance is trade credit. In the first two cases, there is little evidence of explicit informal loans under this head. However, the relative unimportance of bank finance - the only formal financial institution appearing in the three financial statements - and the importance of capital markets (for share capital and fixed deposits) is revealed as is the importance of advance payments from buyers.

30.4 Conclusions

30.4.1 Informal credit is clearly of some importance in promoting housing investment especially for non-formal housing. It is also of some importance to developers given their need for finance

especially at the initial stage of project finance. However, the limited information in this note suggests that for prospective home owners, available informal credit (aside from friends and relatives) may be expensive and risky even if lenders do not indulge in fraudulent practices. The allocative and equity impact of informal finance is thus difficult to discern without further data.

30.4.2 There has recently been a stepping up of formal involvement in housing finance for home owners due to its high priority in national development programs. Measures include more liberal schemes by specialised housing finance institutions, the formation of a national housing bank and consequent involvement of commercial banks in housing finance and stepped up direct tax concessions for housing investment. However, none of these measures affect the absence of formal support for land acquisition.

30.4.3 Secondly, Lall (1984) and Wadhwa (1987) have recommended additional formal financial support for developers in the private sector. There are some indications of increased commercial bank involvement and the possible involvement of other financial institutions in such activity, in the near future.

30.4.4 As against this, the continued growth in the value of urban real estate and of urban areas themselves continues to attract private capital including, it must be conceded, unaccounted funds. On balance, given the limited information available, it is hard to arrive at a clear prognosis of the future role of informal finance in the housing investment. It is likely, however, that informal finance will continue to play a role at the initial stages up to land acquisition both for individuals - especially those from low income groups - and developers. Similarly, it is difficult to envision advances from buyers being entirely supplanted by formal finance.

TABLE 30.1

Housing Finance of Home Owners (1983)

(Percentages)

Sources of finance	By type of housing			Total
	Formal sectors housing	Unauthorised permanent dwellings	Slum & squatter settlements	
1. Formal Finance	20.29	10.71	2.13	19.98
a. Specialised housing finance institutions	2.47	3.57	Nil	2.50
b. Banks	3.07	0.84	Nil	2.99
2. Own Finance	65.82	62.75	78.72	65.74
3. Informal Finance	13.89	26.54	19.15	14.28
a. Friends and relatives	13.15	17.30	8.51	9.79
b. Indigenous bankers	0.13	4.13	2.13	0.25

Source: Compiled from Lall (1984)

TABLE 30.2

Housing Finance by Home Owners (1983)

(Percentages)

Source of finance	By annual income group			
	0-5000	5,001- 50,000	50,000- 1,00,000	Above 1,00,000
1. Formal Finance	7.93	22.32	8.67	15.12
a. Specialised housing finance institutions	1.15	2.80	1.11	Nil
b. Banks	1.30	2.98	2.60	15.12
2. Own Finance	83.18	62.42	80.93	81.29
3. Informal Finance	8.89	15.27	10.40	3.59
a. Friends & relatives	8.70	14.26	10.14	3.59
b. Indigenous bankers	0.19	0.26	0.26	Nil

Source: Compiled from Lall (1984)

TABLE 30.3**Problems with Formal Finance**

Problem	Percentage of respondents citing this as the major problem in obtaining formal finance
1. Inadequate information	28.84
2. Inadequate security/lack of proper guarantors	13.07
3. Complicated and lengthy procedures	35.26
4. High `margin`	3.04
5. High interest cost	15.81
6. Unsuitable repayment schedules	5.17
7. Other reasons	1.82
8. Percentage of total sample facing problems	45.69

Source: Adapted from Lall (1984).

TABLE 30.4

Distribution of Annual Interest Rates

(Per cent per annum)

Source	Range					Average interest rate (%)
	0-5	5.1-9	9.1-14	14.1-20	Above 20	
<u>1. Formal sector</u>	8.75	53.75	27.08	10.42	0.00	8.87
<u>2. Informal sector</u>	26.67	20.00	21.67	11.67	20.00	11.34
(a) Friends & relatives	60.00	12.00	12.00	8.00	8.00	6.82
(b) Indigenous bankers	6.67	6.67	6.67	20.00	60.00	19.20

- Notes: 1. Figures except for the last column, Source: Compiled from Lall (1984).
are percentages of borrowers from the indicated source.
2. The average is estimated as the weighted average of mid points of intervals assuming a mid point of 24% for the highest interval.
3. Lall points out that the method of computation of interest rates by indigenous bankers may result in a substantially higher effective interest rate.

CHAPTER 31

TEXTILE WHOLESALE TRADE IN INDIA

31.1 Introduction

31.1.1 Apart from certain types of cloth that are distributed through the public distribution system, the bulk of textiles in India are distributed through the private sector distribution system. Furthermore, most agents in the distribution chain between textile production units, whether integrated mills or decentralised powerloom units, and the consumer are in the small, unorganised sector. That is, almost no firms are organised limited companies and most firms are small relative to the total market. Most agents in the distribution trade rely primarily on own funds or informal sector credit. More importantly, many distribution agents are also important sources of credit in their own right. Commercial bank credit is relatively unimportant. Furthermore, these markets reportedly generate and use substantial amounts of unaccounted or improperly accounted funds.

31.1.2 While the study and understanding of distributive mechanisms, especially informal mechanisms like that under discussion here, is important in its own right, the role of informal credit and unaccounted funds in the trading sector is of even greater interest. Since the role played by distribution agents as suppliers of credit is linked to the specific role they play in the distribution system, a description of key features of the distribution system must be provided.

31.1.3 In this chapter our objective is to provide a description of the textile distribution trade in India emphasising the flow of credit and attempt the construction of an analytical model which will facilitate an understanding of its functioning. Understanding the role played by credit is the main task we undertake. The framework will be used to study the efficiency of the distribution system and its impact on income distribution.

31.1.4 For the empirical description we rely on a pioneering India wide study by Abhinandan Jain et.al. (1982) supplemented by our own field work in the Bombay textile wholesale market.

31.1.5 The rest of the chapter is organised as follows. In section 2 we describe the samples used in Jain et.al. (1982) and in our own more modest field study. Sections 3 to 6 are descriptive sections on prevailing distribution systems, distribution agents, the role of credit and own funds and the nature of the distribution market. In section 7 a model of the distributive trade is constructed paying full attention to credit flows. Section 8 uses the model to explore the welfare implications of informal, illegal and bank credit. Section 9 offers some concluding comments and section 10 contains policy recommendations.

31.2 Data base for the study

31.2.1 Jain et.al. (1982) this pioneering study covered a total of 950 distributive units (191 wholesalers, 556 semi-wholesalers and 203 retailers) from 15 major textile trading centres all-over India in 1979. This sample was supplemented by in-depth case studies of a few trading and non-trading units, representative of all types of distribution agents, and also conversations with 'knowledgeable persons' in all the 15 centres. The sample represented an estimated 6.5 per cent of all wholesalers, 3.7 per cent of semi-wholesalers and 0.06 per cent of retailers or 0.31 per

cent of the overall population of these agents. Since the study was sponsored by some associations of textile traders,¹ data reliability may be presumed to be high given the limitations of sample size relative to the total population. The study also threw up a wealth of invaluable qualitative information. By design, the study did not cover any non-trading agents such as aratias (commission agents), angadias and brokers. Furthermore, since the decentralised (mostly small scale) powerloom sector has been growing rapidly in recent years and the integrated mill sector has been declining due to the high costs and obsolescence of the latter, a new breed of production-cum-distribution agents, semi-manufacturers² have recently gained in importance. These agents, not being widely prevalent in 1982, were not covered by the 1982 study.

31.2.2 Our field survey (1988) Accordingly, it was decided to supplement the study by Jain et.al. (1982) with a small survey of a particular textile distribution centre. Bombay was selected because of its importance and because of the prevalence of the full spectrum of distribution agents there. Office bearers of the 4 leading textile distribution agents associations, 6 bank officials, 3 semi-manufacturers, 9 aratias and 20 wholesalers were interviewed. Financial data were obtained on 18 wholesalers, 12 semi-manufacturers and 7 aratias. Of these, data on sales by wholesalers were rejected since their information differed excessively from the qualitative information on finances obtained to cross check the specific interviews. Due to reportedly widespread

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1. The Maskati Cloth Market Association, Ahmedabad, The Bombay Piece Goods Merchants Mahajan and the Panchkuva Cloth Merchants Association, Ahmedabad.
 2. This convenient term, coined by Anil Agarwal, Secretary of the Bharat Merchants Chamber, Bombay is not yet widely used.

tax evasion, sales data was not easily extracted from agents, who harboured the suspicion that we were tax enforcement agents. Capital structure information is, however, very similar to that in Jain et.al. (1982). In the case of semi-manufacturers and aratiyas, most of whom receive bank credit, financial statements were available from banks. These statements may be taken to be fairly reliable. A wealth of useful qualitative information on the role of different agents and interactions between them was also obtained. Thus, while our study does supplement the study of Jain et.al. qualitatively, on the quantitative side we have had less success, at least for sales by wholesalers.³

31.3 Textile distribution systems⁴

31.3.1 The number of distributive agents intermediating between mills/powerlooms and consumers varies between 2 and 6. The shortest chain is mill/powerloom - semi-manufacturers/semi-wholesaler - retailer and the largest chain is of the form mill/powerloom - trading agent/semi-manufacturer - wholesaler - non-trading agent - semi-wholesaler - non-trading agent - retailer. Non-trading agents include brokers, mill's agents and aratiyas. Aratiyas are the predominant non-trading agent though, recently, brokers have been gaining ground. An additional agent, the angadia, plays a role as a courier of cash between geographi-

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3. Since almost all semi-manufacturers and aratiyas receive bank credit, their sample will not display serious bias. The wholesalers samples is clearly biased in favour of those who cooperated with us but the nature of bias is unknown.
 4. To avoid frequent repetition of our source we state at the outset that (i) all quantitative information for 1979 is from Jain et.al., (ii) qualitative description of trading agents also draws heavily on their work and (iii) while we have been selective, many empirical findings are due to them.

cal locations. Table 31.1 provides information on the geographical coverage and cost of distribution of various systems.

31.3.2 Table 31.1 reveals a striking feature of the distribution system: As the distance between consumers and producers increases (whether measured by the index of geographical reach, cost of distribution or total capital employed) the number of links in the chain increases. Return on capital also decreases as the number of links increases, though not uniformly. The return to the typical agent, who participates in more than one system, will be an average of (appropriate proportions of) these figures. This is indirect evidence that the transactions costs and risk of serving customers increases with distance.

31.3.3 An additional feature revealed by our field study is that, when the textile market is depressed, there is a tendency to reduce dependence on long chains even at the cost of greater risk. Specifically, in the currently depressed textile market, the volume of sales intermediated by aratiyas has decreased. The importance of non-trading agents in 1979 is shown in Table 31.2. A final feature of the distribution system is that larger mills tend to bypass wholesalers.

31.4 Types of agents: Their role as suppliers/users of credit and in the distribution of goods

31.4.1 The main trading agents are wholesalers, semi-wholesalers, and semi-manufacturers. They are now briefly described.

31.4.2 **Wholesalers:** Their main function is to provide finance to the distributive trade and insulate mills from price and quantity risks emanating from the demand side. Along with aratiyas, wholesalers are the main financiers of textile distribution. Thus, while the major portion of their purchases are against cash or on

short term credit, sales are made on a relatively long term credit. Jain et.al. (1982) report 51 per cent cash purchases and an average of 31 days credit on credit purchases as compared to 84 per cent credit sales and 55 days credit given. Table 31.3 shows that the same trend has been maintained to the present. Wholesalers now offer 53 days credit on average. However, it was reported to us that the total credit period may exceed 200 days because of the currently depressed condition of the market. Out-right bad debts, reported to be 0.45 per cent of sales in 1979, are now reported to be in the region of 7 per cent to 8 per cent. Most wholesalers specialise in a limited product range. In fact some only deal in 'grey' (unfinished) goods which, in the distribution market, is the most prestigious segment.

31.4.3 Semi-Wholesalers: Their primary function is to stock a large variety of goods to serve retailers in their regional sub-markets. They serve to reduce search costs of retailers. Their role as suppliers of credit is more limited given that, on average, 67 per cent of goods were purchased on credit averaging 48 days and 77 per cent of sales were credit sales with credit given averaging 57 days in 1979. However, inventories were equal to almost twice the number of days of sales as compared to wholesalers in 1979 (43 days as against 22 days).

31.4.4 Retailers: Retailers bought about 55 per cent of goods on credit averaging 51 days in 1979. Most retail sales were on cash or very short term credit (6 days) in 1979. However, inventories averaged 70 days of sales.

31.4.5 Semi-manufacturers: The number of these agents has grown dramatically in recent times. Most semi-manufacturers were formerly wholesalers or aratiyas, though some continue to carry on both their former and new activities simultaneously. These agents purchase grey goods from powerlooms or wholesalers and have them

processed, according to their specifications by the large number of small processing and finishing units in existence, under a putting out system. The latter is used to keep labour costs in check. Processed goods are resold to wholesalers, semi-wholesalers or retailers. For up-country sales, non-trading agents, mainly brokers, are used by them.

31.4.6 The main types of non-trading agents in the wholesale segment are aratiyas, brokers and angadias.⁵

31.4.7 Brokers or indenting agents: These agents, may be located either at the wholesale/semi-wholesale centre or in up-country markets. Brokerage rates are currently 1 per cent to 1.5 per cent of the value of sales. They use their superior knowledge of the wholesale market to lower the transaction cost of purchases by semi-wholesalers and retailers. They also play a role in communicating market intelligence to wholesalers and semi-wholesalers. In recent times there has been an increase in the role played by brokers and a secular decline in that of aratiyas.

31.4.8 Angadias: Though not formally a part of the textile distribution system, this traditional institution plays a significant role in speeding up payments and other financial transfers. Bank cash remittance facilities in India are notorious for their delays, inefficiencies and high prices.⁶ Angadias⁷ who provide a

5. We deliberately neglect agents between mills and wholesalers/semi-wholesalers and between semi-wholesalers and retailers. The former play a relatively passive role as selling agents for mills and the latter are relatively unimportant according to Jain et.al. (1982).

6. The recent, ludicrous, case of computer readable cheques illustrates their gross inefficiency. By a central bank (Reserve Bank of India) directive, only select metropolitan bank branches still have the facility of encashing traditional bank drafts and

cheap , quick and reportedly secure way of transmitting funds have therefore been gaining in importance in recent years. Thus, though they neither supply nor use credit from textile markets, they have an important role to play in providing efficient informal financial services to this sector.

31.4.9 Aratiyas: There are between 750 to 800 aratiyas in the Bombay market intermediating an estimated 65 per cent to 70 per cent of sales. Aratiyas make purchases from manufacturers/wholesalers/semi-wholesalers on behalf of semi-wholesalers/retailers and arrange for their dispatch to these clients. Their rate of commission is normally 2 per cent to 3 per cent over the purchase price. An additional role they play is to extend credit to their clients since the credit they receive (2-3 months) is less than the credit given to clients (upto 6 months). Along with wholesalers they are the main financiers of textile distribution. In order to preserve their credit rating, aratiyas seldom default or delay payments. This has been confirmed by several persons interviewed. Aratiyas specialise in particular up-country sub-markets which they visit during the lean season (peak season is normally the festival months between September and December). They act as pure informal lenders outside the textile business during the lean season. In fact, many aratiyas are former Gujarati Shroffs, who, due to restrictive policies, have found it difficult to survive as pure indigenous bankers. This transition had been well under way even a decade ago (Timberg and Aiyar, 1980). Thus, aratiyas, due to their intimate knowledge of the

cheques though most non-metro branches do not as yet have the new technology. The protests of trading associations have, so far, gone unheeded.

7. Literally "Those who carry on their person". See Timberg and Aiyar (1980) for an earlier reference to them.

wholesale market and particular up-country markets, serve an important transactions cost reducing role. More importantly, due to their superior knowledge of up-country markets and their role as suppliers of informal credit, they serve to reduce the total risk cost of the distribution system. Though Table 31.5 shows that aratiyas are net recipients of credit, it also shows that, of all agents, the loans and advances by aratiyas tie up the greatest share of the funds available to them. This state of affairs, given that aratiyas are the best informed about the creditworthiness of customers of all intermediate agents, suggests that informal credit markets are relatively efficient informationally .

31.4.10 Agents cost structures: The total cost of doing business for all agents except aratiyas is very low, with the exception of bad debts (which are, currently, high) and the processing costs of semi-manufacturers. Table 31.4 provides relevant details.

31.5 Role of bank and informal credit

31.5.1 Commercial bank credit: Although bank credit is a relatively unimportant source of capital for all agents in the market, the experience of different agents varies with their collateral availability. Semi-manufacturers and wholesalers get overdraft or "cash credit" facilities upto specified limits against hypothecation of stock-in-trade, trading premises or guarantees by proprietors/partners in their personal capacity. The limits are normally very conservative relative to the value of collateral. Table 31.5 shows that all wholesalers in the sample use cash credit while two of them also have overdraft facilities. Although Table 31.5 shows only two wholesalers as having bill discounting facilities from commercial banks due to the small sample, it was reported in our field work that most wholesalers, semi-manufacturers and aratiyas have bill discounting facilities. Aratiyas, since they hold little or no stock in trade, are unable

to offer any acceptable collateral to banks and are therefore restricted to bill discounting. If we look at the bank-wise distribution of account holders (Table 31.6), it may be seen that the majority of customers from this sector are dissatisfied with both the finance received and their bankers.

31.5.2 Two types of malpractices have come to light in our discussions. There are reportedly brokers in the market who guarantee the provision of bank loans against bribes (such bribes are picturesquely called 'paperweight') the going rate being 2 per cent of the credit limit sanctioned by banks. Secondly, at the consignee end in up-country sales, consignees pay bribes to bank managers and transport operators to release consigned goods before the bank receives payment on the bill of exchange. Consigners (aratiyas, wholesalers, semi-manufacturers or semi-wholesalers) are then forced to pay back the principal and interest on dishonoured bills and attempt recovery of sales proceeds directly from customers. Several aratiyas and wholesalers reported such corruption (see Table 31.6b). Of other reasons for dissatisfaction, the most serious reasons were delay in the provision of services, high bank charges and poor customer service. Associations of agents in Bombay have been lobbying for credit against hypothecation of book debts, for the facility of giving loans to groups of traders and for raising the credit limit to collateral ratio in order that the usefulness of bank services may be enhanced. They have yet to meet with any success.

31.5.3 The normal bank interest rate is 16.5 per cent per annum (exclusive of bank charges).

31.5.4 Cooperative bank credit: The share of such credit is even lower than that of commercial banks. Cooperatives normally charge a white interest rate of 18 per cent per annum coupled with reported black interest at 6 per cent.

31.5.5 Informal credit: Informal credit is the major source of borrowed funds for all agents. As discussed, distribution agents ensure that credit received by them from primary creditors is passed down the distribution chain. The major suppliers of primary informal credit to the market are 'friends and relatives' at a widely reported, 15 per cent to 18 per cent per annum, 18 per cent being the most prevalent rate. Intra-market loans at the same interest rate are also common. It was found in our survey that out of 28 wholesalers, 18 received loans from friends and relatives at an average rate 14.97 per cent per annum (see Table 31.7). Similarly, of 12 semi-manufacturers and 6 aratiyas, 10 and 5 respectively received loans from friends and relatives at an average rate 16.5 per cent per annum. 'Others' referred to in Table 31.7 are mainly intra-market loans. The upper bound on interest rates at which agents can take loans is fixed periodically by agent's associations. Since loans from 'friends and relatives' are a popular method of laundering own black funds, much of this credit may in fact be unaccounted wealth.⁸ Informal credit for the sample was, without exception, unsecured and without any margin requirement. However, in all cases, borrowers had personal and/or long standing associations with lenders which may be looked upon as implicit security. Most informal loans are repayable on demand but can be substituted by other informal loans unless there is a generally tight credit market.

31.5.6 Trade credit given by agents are subject to delayed payments, and less frequently, outright default. Currently, 75-90 days is reported to be the prevailing recovery period for wholesalers though this is not uniform. Effectively, the price of

8. This has been communicated to one of the authors by an income tax official.

goods sold to borrowers varies with their (subjectively assessed) creditworthiness.

31.5.7 Sources, uses and cost of funds: Quantitative data: Table 31.8 to 31.11 present quantitative information on the sources, uses and cost of funds of different agents covered by the two field studies. The main characteristics revealed by Tables 31.8 to 11 are as follows:

1. Aratiyas receive more bank finance than trading intermediaries. However, they also receive more informal finance except as compared to semi-manufacturers.
2. Except for semi-manufacturers all trading intermediaries rely significantly on own funds, retailers being the most constrained.
3. The proportion of funds outstanding by way of loans and advances is highest for aratiyas. However, they are net receivers of credit.
4. Wholesalers and semi-wholesalers are net suppliers of credit.

31.5.8 Illegal funds and tax evasion: As we have mentioned, data on sales for wholesalers collected by us were not reliable and diverged significantly from other estimates. Since wholesalers harboured suspicions that we were tax enforcement agents, sales figures reported to us were presumably those reported to tax authorities. Using data from Jain et.al. (1982) a guesstimate of income tax evasion and under-reporting could therefore be made.⁹ Our guesstimates, given in table 31.7, are computed as follows:

$$p_i = (x JK_i - S_i)m/xJK_i$$

where

9. We are grateful to Tapas Sen for suggesting this possibility and also helping us with the formulae.

p_i is under-reported profit as a proportion of sales for the i th wholesaler,

x is 0.75, 1.0 or 1.25 for lower, median and upper estimates,

J is the sales to total capital employed ratio as in Jain et.al. (1982), $J= 5.1963$,

K_i is the capital reported by the i th wholesaler in our sample,

S_i is reported sales by the i th wholesaler and

m is the average profit rate before tax of wholesalers in Jain et.al. (1982), $m=0.058$.

Thus xJK_i is our estimate of true sales.

31.5:9 When we assume a conservative 15 per cent effective rate of income taxation we get the guesstimates in Table 31.12. According to these figures, about 0.78 per cent of total sales are evaded taxes. Consequently, since total sales in the textile sector were Rs 6222 crore in 1986-87 (Ministry of Textiles,) the amount of evaded taxes in that year was about Rs 49 crore. This compares to a total estimated informal credit stock of Rs 3311 crore (based on figures from Chapter 16). It should be noted, furthermore that this is only an estimate of income tax evasion and not of sales tax or local tax evasion.

31.5.10 Bank credit versus informal credit: The first feature to note is that the effective bank interest rate we have reported, inclusive of 'paperweight' and bank charges, is higher, on average, than the informal interest rate. That banks require collateral but informal lenders do not is also important. This runs counter to the usual finding for informal and curb markets. The finding is based on oral evidence, we remind the reader, of around 40 interviewers and may be taken as fairly reliable given the lack of contradictory reports. This evidence is indirectly supported

by two considerations.

31.5.11 First, there is the limited informal credit in the market as a whole at, furthermore, a rate of interest fixed by the associations in the short run. Secondly, the fact that agents reported that they need bank credit facilities most in the peak season, corresponds with a priori expectations of the use of a high interest source of loans. Furthermore, Table 31.13 reveals that banks finance relatively inefficient agents, judging by profitability, to the extent that higher bank charges are not the cause of lower profitability. However, since there is a gap between the demand for credit and supply of informal credit during the peak season, by providing funds to agents formal credit does play a useful role, though this can clearly be enhanced.

31.5.12 The distinguishing features of informal credit - speed, informality and absence of collateral requirements - are normally cited as reasons for their being preferred to bank funds. In this sector the lower cost of informal finance is also important. On the whole, given the peak season role of bank credit under current conditions, bank and informal finance can be seen to be complementary.

31.5.13 A final feature of informal credit may be mentioned. Though there were no cases of this in sampled firms, higher cost informal credit, from indigenous bankers, was reported to be a source of funds if credit from friends, the market and the banks was inadequate. However, recourse to such credit would be a signal of extreme distress and would not be publicised by firms using it.

31.6 The structure of markets in the distribution system

31.6.1 The first point to note in this context is the prevalence of tied credit and goods transactions in the textile

market. This can be attributed to the lower informational costs of market agents in supplying credit as well as due to the high transactions costs of obtaining formal credit.¹⁰

31.6.2 Secondly, though there is specialisation in particular goods within the market, the degree of price competition in all segments may be taken to be high since most goods have either close substitutes or many sellers. Furthermore, entry and exit barriers do not appear to be a major factor. In the currently depressed market, it is reported that agents, mainly wholesalers, are downing shutters every week. Finally, since, in Bombay, all agents have their establishments close to each other - many under the same roof¹¹ - widely dispersed prices are difficult to sustain. It is therefore reasonable to suppose that the Bombay markets, for each type of agent, are competitive or nearly so. Up-country markets, being localised, are less competitive.

31.6.3 Agents are organised, along community lines or according to specialisation, into four Associations. Associations have their own dispute arbitration mechanisms (parallel courts) whose rulings are generally followed. Their main function, however, is to serve as lobbying organisations with banks and government. A third, interesting, role jointly played by associations is to serve as the 'auctioneer' for the fixation of informal interest rates, since both borrowers and lenders belong to these associations. This makes the interest rate unresponsive to short term fluctuations in loan market conditions but not long term trends.

10. Such costs are standard explanations in the theoretical literature on interlinked transactions. See, for example, Bardhan (1980).

11. Visits to Surat and Calcutta, two other leading textile distribution centres reveal much the same locational pattern as in Bombay.

31.7 A model of trade and distribution

31.7.1 Basic features: In order to examine the role of credit, we now construct a stripped down analytic model. The framework contains three active agents, an intermediate trading agent, 'wholesalers', a purchasing agent 'retailers' (or semi-wholesalers) and a non-trading agent, aratiyas. The wholesale sub-markets is assumed to be competitive and have many agents of each type while retailers are assumed to face downward sloping demand curves. Aratiyas are assumed to have scale economies due to costs incurred during their off season search activities. Nevertheless, given the absence of entry barriers and also the difficulty faced by aratiyas in responding quickly by lowering prices once a rival effects entry, they are assumed to set entry deterring limit prices. The difficulty in speedy responses to entry occurs since aratiyas are not likely to realise that a rival has entered the market till after some customers are lost, given that they would have returned to the wholesale centre from the up-country trip. Other stylised assumptions gleaned from the description given above are: the gross information structure which wholesalers have on the credit worthiness of retailers and the better information structure of aratiyas for retailers from the regions they serve; the fact that transactions costs increase with the distance of the retail from the wholesale market; and the option that retailers have of making credit purchases direct from wholesalers or aratiyas. The fact that wholesalers insulate producers from demand shocks is taken into account by assuming that purchases from producers are made at a predetermined price. Quantity insulation through inventory adjustment by wholesalers is omitted for simplicity.

31.7.2 Besides the assumption of only 3 types of agents, the main simplifying assumptions are:

1. All agents are risk neutral profit maximisers and each type of agent is identical with every other agent of the same type except as specified for retailers.
2. In the 'medium' run (when informal interest rates can vary) the opportunity cost of own capital of wholesalers and aratiyas is the informal interest rate. The 'medium' run is distinguished from the 'long' run here in an attempt to capture the fragmentation of markets. Though the supply of credit in the market serving aratiyas and wholesalers is small relative to the entire credit market, the supply of funds is not perfectly elastic in the medium run and the interest rate is not a datum to the system.

31.7.3 The main purpose of the analytical exercises undertaken is to explore the efficiency and regional income distribution impact of informal credit supply by wholesalers and aratiyas. We find that both efficiency and income distribution are improved. However, interesting differences exist between the effects of credit through wholesalers and aratiyas.

31.7.4 Agents

Retailers: Define the following notation:

p = Wholesale price of textiles.

C_R = Retailer specific per rupee transactions, search or brokerage cost applicable on direct purchases from wholesalers. We have $0 \leq C_R \leq C^*$.

H = Wholesaler's premium over the cash sale price applied on credit sales.

I = Aratiyas' premium over the market price.

s = Retailers' discount factor, $s = 1/(1+r_R)$, common to all retailers.

Retailers are assumed to incur transactions costs if they buy directly from wholesalers. They stock their shops on date 1. Retail sales and payments to wholesalers/aratiyas are made on date

2. Transactions costs will, in general be a function of the retailers distance from the market, the quantity of goods purchased and the price of goods purchased. Quantity affects costs since retailers buy many varieties so that each unit or lot has individual search requirements. Shipping costs also rise with quantity. Price enters due to brokerage or freight insurance costs and because expensive textiles will necessitate a more careful search in order to satisfy discriminating customers in local markets. The simplest function that captures all three elements is the function $C_{Rp}q$. This is, accordingly, assumed.

31.7.5 Retailers face identical state-dependant downward sloping demand curves. The inverse demand curve is assumed to be

$$R = N_1 - 0.5q \quad \text{with probability } x \text{ in state 1 and} \quad (1)$$

$$R = N_2 - 0.5q \quad \text{with probability } (1-x) \text{ in state 2} \quad (2)$$

where $N_1 > N_2$.

31.7.6 Retailers may either buy goods from the wholesale market for cash or make credit purchases through wholesalers or aratiyas. In the event of purchases through aratiyas, no transactions costs need be incurred. In the event that state 1 (the good state) occurs, retailers are assumed to honour their debts to wholesalers or aratiyas. If state 2 occurs, retailers are assumed to honour only a fraction J of their debts. Expected retail profits are therefore given by

$$E_c = s(N-0.5q)q - p(1+C_R)q \quad (3)$$

$$E_w = s(N-0.5q)q - p(sVH+C_R)q \quad (4)$$

$$E_a = s(N-0.5q)q - pVIq \quad (5)$$

where $N = xN_1 + (1-x)N_2$; $V = x + (1-x)J$ and E_c , E_w and E_a are respectively profits given cash purchases, credit purchases through wholesalers and credit purchases through aratiyas. In what follows we will treat N as constant so that each retailer has the same market size in this sense. Implicitly therefore, N_1 and N_2 are assumed to vary as x varies so as to leave N constant. From here, retailers demand curves on the wholesale market can be found to be

$$q_c = N - p(1 + C_R/s) \quad (6)$$

$$q_w = N - p(VH + C_R/s) \quad (7)$$

$$q_a = N - pVI \quad (8)$$

Clearly, retailers will choose the option with the lowest unit costs.

31.7.7 Wholesalers: Define the additional notation

m = Per-unit ex-mill price of textiles.

k_w = Own capital of wholesalers assumed to be given.

b_w = Borrowed capital of wholesalers.

f_w = $k_w + b_w$.

r = Market interest rate.

g = Wholesaler's subjective probability of receiving payment from a buyer of type g , common to all wholesalers. $g=1$ for aratiyas. g is assumed to be a constant for all direct sales to retailers.

31.7.8 Wholesalers are assumed to borrow (or lend) own funds and purchase textiles from producers on date 1. The market meets on date 1 and goods are delivered on that date. Payments are received on date 2 and loans plus interest are paid out on the

same date. The per period opportunity cost of wholesalers own funds is the market interest rate r in the medium run. Additional transactions costs are incurred on date 1 and payments made on date 2 along with additional interest. These costs are $y+Q_W^2$, so that, adding interest cost, a normal quadratic cost function is assumed. Competition between wholesalers ensures that the expected present value of payment per unit of sales received on date 2 equals the market price p prevailing on date 1. That is $p = gpH/(1+r)$, so that

$$H = (1+r)/g \quad (9)$$

31.7.9 No idle balances are kept by firms, so that goods purchased are $Q_W=f_W/m$. In the aggregate, this gives

$$Q = F_W/m = (B_W+K_W)/m. \quad (10)$$

Thus, a wholesaler's profits are given by

$$pq - mq - q^2 - y$$

31.7.10 In medium run zero profit equilibrium, the price is given by the minimum of the average cost curve and is, with our assumptions, constant:

$$p = 2y^{0.5} + m \quad (11)$$

and

$$Q_W = y^{0.5} \quad (12)$$

31.7.11 Aratiyas: Aratiyas borrow (or lend) on date zero and incur fixed costs of information collection from both the wholesale market and the up-country market they serve. The up-country market is assumed to consist of retailers, all of whom have the

same cost parameter C_R . These costs are denoted by Z . The remaining funds, if any, are lent out on the market till date 2. On date 1 aratiyas order goods from wholesalers and despatch it to customers. On date 2, wholesalers are paid, payment is received from clients and loans plus accrued interest paid off. An aratiya's subjective probability that a retailer defaults is V , which is taken to be equal to the true probability, based on a knowledge of retail demand conditions in the up-country market. Given that the fixed costs incurred by aratiyas are their major cost item apart from interest costs and the opportunity cost of their own funds, we assume away the existence of other, nonlinear cost terms. For reasons discussed earlier, each aratiya is assumed to operate in a contestable market and to limit price. Limit pricing is justified given that aratiyas would find it difficult to adjust their premium after entry occurs since they would have returned from their trip to their up-country market. Since there are no other entry barriers, the limit price is assumed to give aratiyas zero profits. Thus, I is set so that

$$Vplq_a - p(1+r)q_a - Z(1+r) = 0 \quad (13)$$

Using 8 in 13, I may be determined. From 13, using 8, it is easy to show that

$$I = f(r, N, Z, p) / pV; f_r > 0; f_N < 0; f_Z > 0 \quad (14)$$

Finally, demand for borrowed funds is given by $(Z + pq_a - K_a)$ where K_a is the aratiya's own funds.

31.7.12 The role of credit: A full specification of market equilibrium will require the specification of demand/supply equilibrium in the wholesale market the sub-market served by aratiyas and the credit market to which aratiyas and wholesalers but not retailers have access. In addition, expectational equilibrium

requires that the ex post unit price received by wholesalers equals the (ex ante) expected value (gpH). Otherwise, wholesalers will revise their beliefs. While such an exercise and the identification of conditions under which an equilibrium exists is easily undertaken, it will entail a lengthy digression from the main objective of this section. Instead, we simply assume that the existence and stability of equilibrium for the system just described and proceed directly to an analysis of the role of credit.

31.7.13 To analyse the impact of informal credit we first partition the set of pairs (V, C_R) , which identify retailer types, according to their preferred route of purchase. Note that C_R indicates the distance of a retailer from the wholesale market and V measures the variability in demand, with low V indicating a higher probability of the bad state occurring.

31.7.14 Equating (6), (7) and (8) after substituting (14), we get three loci: The locus of indifference between credit purchases through wholesalers and cash purchases (wc), the indifference locus between credit from aratiyas and wholesalers (aw) and the locus of indifference for aratiyas purchases and cash purchases (ac). These are given by

$$sV = 1/sH \quad (wc) \quad (15)$$

$$sV(1-H) = c_R \quad (aw) \quad (16)$$

$$sVI = (1+c_R) \quad (ac) \quad (17)$$

31.7.15 The three loci are plotted in Figure 31.1. The arrow in the north-east of the figure indicates the direction in which retailers facing greater disadvantages in terms of distance from wholesale markets and variability in demand are to be found. The figure at once provides a first insight into the role played by informal credit whether through wholesalers or aratiyas.

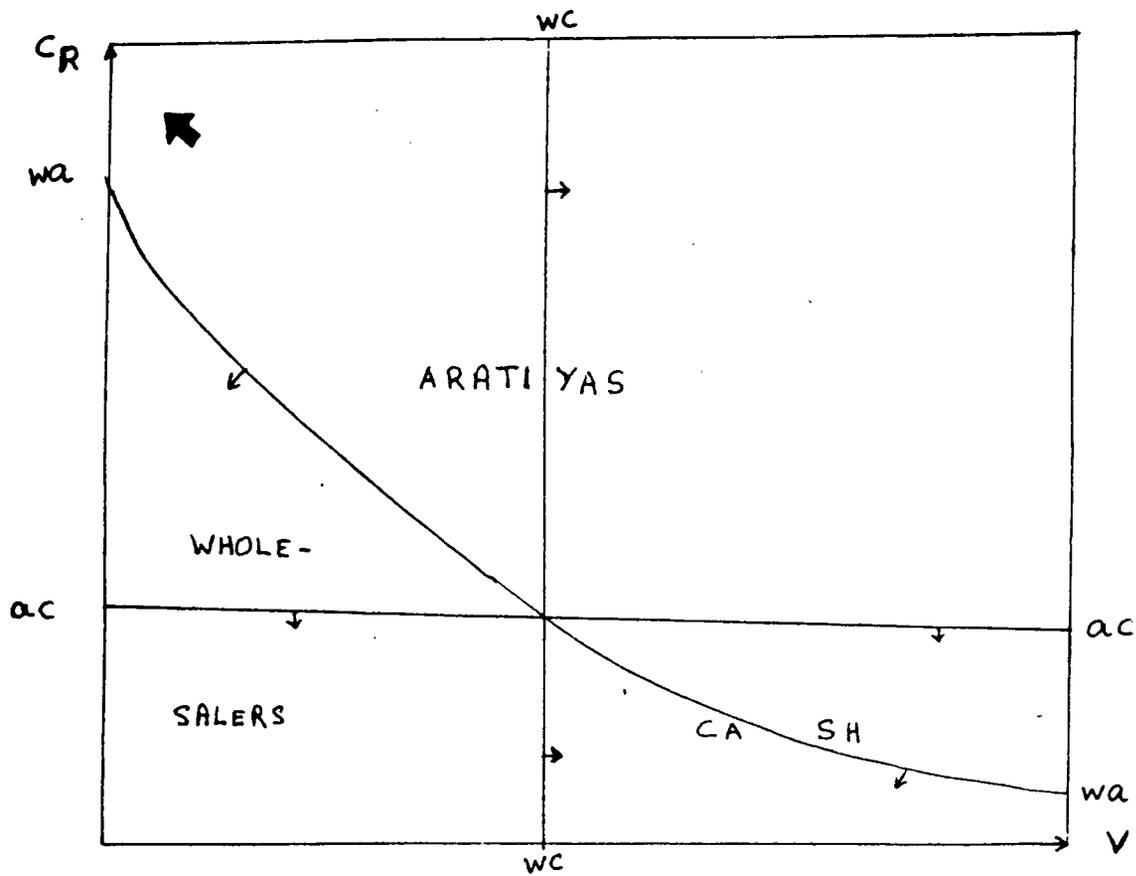


FIGURE 31.1 Mode of Purchase on Wholesale Markets by Retailers of Different Types.

Property 1: Existing informal credit channels in the wholesale market selectively lower costs of disadvantaged retailers. Only retailers in markets near at hand with relatively constant demand do not avail of informal credit provided by wholesalers or aratiyas.

31.7.16 A second property which is also evident is the following.

Property 2: If retailers with a given c_R are served by credit from both aratiyas and wholesalers, then, of these retailers, wholesalers serve retailers with greater demand uncertainty (lower V).

31.7.17 Property 2 can be used to derive an additional insight into the role of informal credit. From the structure of the model it is evident that some retailers would continue to make purchases through aratiyas even if they did not offer any credit. Their main role is to reduce transactions costs, though aratiya credit does ensure that aratiya services are used by more retailers than would otherwise be the case. However the credit aspect of wholesaler credit sales is crucial for it to have an advantage over cash sales. Thus we have

Property 3: Informal credit serves primarily to distribute the costs of demand uncertainty through the distribution chain though it does aid in reducing transactions costs as well.

31.7.18 Additional insight into the effects of informal credit may be gained by measuring its impact on the efficiency of goods distribution. An appropriate yard stick for this is the expected difference between retail prices for cash and credit sales. Noting that the expected retail price is $N-0.5q$ we can get in the

case of credit from wholesalers

$$\text{Efficiency gain} = p (1 - V_s H) / 2s$$

and in the case of credit from aratiyas

$$\text{Efficiency gain} = p (1 + c_R - sVI) / 2s$$

Since VI does not change with respect to V in view of (14) we may state

Property 4: The efficiency gain due to informal credit from wholesalers increases as demand variability increases but is independent of the distance between the retail market from the wholesale market. Conversely, the efficiency gain due to sales through aratiyas is independent of demand variability but increases with distance between the retail and wholesale markets.

31.7.19 It is clear that the efficiency gain for retailers already using informal credit will increase if there is a greater external supply of informal credit (lower r) to wholesalers and aratiyas. Also, in this event, the cash sales region in figure 1 will shrink. Finally it is easily shown that aratiyas will gain market share relatively to wholesalers, due to scale economies, if external informal credit supply increases.¹² Thus, increased supply of informal credit expands the market share of aratiyas and also credit transactions as a whole.

12. From (16) this requires $d(I-H)/dr > 0$. Note from (13) that $I = (Z + pq)(1+r)/pqV$ and $H = (1+r)/g$, and also from (16) that $I > H$ for C_R to have an interior solution. Now $I > H$ is equivalent to $I/(1+r) > 1/g$. Thus it suffices show that $dI/dr > I/(1+r)$. Simple differentiation and comparison of the resulting expressions establishes this.

31.7.20 These findings, besides having efficiency implications also have implications for income distribution. That the benefits from informal credit through aratiyas increase (or does not decrease) with the distance separating retailers from wholesale markets means that informal credit promotes inter-regional equalisation of real income. Secondly, it may also be argued that since credit through wholesalers leads to a greater absolute cost reduction in regions with greater demand variability, it too leads to regional income equalisation. The argument is as follows. Demand variability, in the sense taken in this study, will depend both on the variability of consumer income and their income elasticity of demand for textiles. The demand for textiles is likely to have a greater income elasticity in very poor regions of India rather than in the better off regions. Consequently, given equally variable consumer income in the sense of equal coefficients of variation, poorer regions will have a more variable demand for textiles.¹³ Thus we may state

Property 5: Informal credit through aratiyas and, under some conditions, wholesalers promotes regional income equalisation.

31.7.21 The implications for policy are clear. More funds should be made available to wholesalers if demand variability is perceived to be a major contributing factor to inter-regional inequality. Likewise if promotion of more equal textile prices across regions is desirable, more funds should be made available to aratiyas. In both cases, average efficiency of textile dis-

13. Note that retailers may still have the same expected market size if they serve more customers in poorer areas.

tribution increases. Furthermore, given the informational disadvantage of banks, formal credit should not attempt to supplant the credit supplying role of wholesalers and aratiyas in the distribution chain.

31.7.22 We now turn to a brief examination of black funds.

31.7.23 Black money: While a full analysis of black money and evasion would first call for the introduction of taxes, a task beyond the scope of this paper, some general remarks can be made. A nondistortionary tax can be introduced by subtracting a fixed amount, t , from wholesalers' and aratiyas' profits if a similar amount is also deducted from the opportunity cost $K_A(1+r)$ or $K_W(1+r)$. In the absence of evasion, profit equations are unaffected. Tax evasion is then seen as a declaration of bankruptcy when, in fact, excess funds are available. This lowers the expected tax burden on the textile business, and is therefore equal to a decrease in the fixed cost.¹⁴ This will, clearly, lead to an increase in investment in the distribution industry in zero profit equilibrium which lowers prices and raises welfare in this sector. Thus the general welfare decreasing effects of black money (due to reduced tax revenues, funds not flowing to their most productive use and distorted opportunity costs) may be mitigated by welfare increases in the sector of origin, textile distribution. This suggests that in designing optimal enforcement policy for a sector, the government needs to weigh both direct and indirect costs of stepped up enforcement, the indirect cost arising from reduced welfare in the sector. A full analysis of this phenomenon would of course require a careful incorporation of prevailing distortionary taxes.

14. Additionally, if black wealth has limited alternative uses, this lowers the opportunity cost of the stocks of capital K_W and K_A .

31.8 Concluding comments

31.8.1 The role of agents left out of the model developed in the previous two sections can be briefly commented on.

31.8.2 Semi-wholesalers can be seen to be clubbed with retailers in the wholesale market when they purchase from wholesalers. Semi-wholesalers who buy direct from producers can be clubbed with wholesalers. The former role of semi-wholesalers implies that they participate in a second distribution market, with retailers as the buyers, where they have some monopoly power. Clearly, for this to be possible, retailers transactions costs of going directly to the wholesale market must be sufficiently high.

31.8.3 Semi-manufacturers combine production and wholesale operations, thus being exposed to supply risk. The extra profits they can make by the flexibility they have in producing in small lots, geared explicitly to current fashions in the retail market, compensate them for additional losses arising from supply risk. Goods produced by them, in this case, will have to be seen as imperfectly substitutable for wholesalers' stocks.

31.8.4 Finally, the role played by brokers is implicitly reflected in the transactions costs of retailers.

31.8.5 This chapter has attempted an examination of the textile distribution trade in India. The textile distribution sector is distinguished by the fact that it handles many closely substitutable durable products with uncertainty in product demand for specific varieties. Furthermore, as has happened recently, droughts which lead to an increase in the relative prices of food products affect demand for the product adversely. That is, the market is vulnerable to aggregate supply shocks. Consequently,

availability of credit plays a key role with intermediaries also acting as creditors. Furthermore, the industry is distinguished by large numbers of producing firms.

31.8.6 The distribution systems for foodgrains, oilseeds and molasses share many of these features. However, none of these markets have much product diversity though some quality gradation exists. The main features focused on here, demand variability and distance, are likely to be equally important in all these distribution systems. Thus, the framework of this paper is likely to be of use in the study of the distribution systems for these goods. On the other hand, this paper is only a modest first attempt and leaves many issues unexplored.

31.9 Recommendations and suggestions

31.9.1 While the main thrust of this section is on ways in which banks can better serve the sector, at the outset it must be pointed out that a coordinated approach by commercial banks and agents' associations is needed if the credit restrictions faced by this sector are to be eased. In line with the suggestions of respondents - which we find worthy of consideration - the following activities may be considered by banks for better service and credit availability to agents in the distribution system.

- a. Although advances against cotton textiles have been excluded from the purview of all selective credit controls with effect from January 8, 1985, traders are still not getting the full benefit of bill discounting and cash credit. Better credit facilities with long term renewals of credit limits, which should not be overly conservative, should be considered.
- b. If possible, recently enhanced bank charges for collection and remittance of drafts, mail transfers or telegraphic transfers should be reduced.
- c. Since these trades need more funds during the peak season, banks should adopt a more liberal approach

during the peak season.

- d. Banks may also examine ways to improve the quality of their services. Collection of up-country cheques and bills, despatch of account statements, sanctioning of loans and processing of loans are areas needing improvement.
- e. Local branches of different commercial banks should accept non-MICR (magnetic ink character recognition) drafts issued by outstation branches till such time as conversion to MICR instruments is completed.
- f. Banks should consider provision of book-debt loan facilities to traders and, if possible, consider reintroduction of joint loan facilities.
- g. Since aratiyas do not maintain sufficient stock to use as collateral, banks should formulate an alternative mode of providing cash credit to commission agents or aratiyas.

31.9.2 Finally, formal financial institutions should, on the whole, continue to channel funds to the distribution trade through agents based at wholesale centres and permit trade credit to enable percolation through the distribution chain. This has the virtue of decentralising credit supply decisions to better informed agents and curbing bank portfolio risk.

TABLE 31.1

Features of Textile Distribution Systems in India (1979)

No. of links between produ- cers & consumers	Cost of distri- bution (% of consum- er price)	Index of geograp- hical reach	Return on capi- tal em- ployed (%)	Total capital employed (days of sales)	Share of total sales (%)
Two	19.1	0.73	21.6	163	13.5
Three	19.8	0.89	18.2	213	38.0
Four	22.8	1.14	19.0	255	13.6
Five	24.0	1.51	18.9	265	24.8
Six	25.0	2.34	16.6	312	9.9

Note: The index of geographical reach is a value weighted average of distance between mills and retailers.

Source: Compiled from Jain et.al. (1982)

TABLE 31.2**Percentage of Sales Intermediated by Non-Trading Agents
in 1979**

Between	Intermediated transactions (%)
Mills and wholesalers	33
Mills and semi-wholesalers	53
Wholesalers and semi-wholesalers	75
Semi-wholesalers and retailers	33

Source: Jain et.al. (1982)

TABLE 31.3**Pattern of Credit Sales**

1.	Average credit in days offered by wholesalers to their customers	53 (17.09)
2.	Average percentage of customers from distant locations	67 (23.98)
3.	Average percentage of customers in Bombay	33 (23.98)
4.	Average percentage of customers introduced by brokers	67 (25.74)
5.	Total respondents	18

Note: Figures in bracket are standard deviations.

Source: Field survey in Bombay.

TABLE 31.4

Expenditure Sales Ratios of Agents

(Figures are percentages of sales)

	Whole- salers (1978)	Semi- whole- salers (1979)	Retail- ers (1979)	Semi- manufac- turers (1988)	Aratiyas (1988)
Total expenditure	3.04	3.36	4.64	16.68	35.40
Expenditure other than interest cost	2.31	2.78	3.28	16.10	31.64

Note: Purchase expenditure omitted.

Source: Jain et.al. (1982) and
field survey in
Bombay.

TABLE 31.5

Types of Credit Facilities

	No. of borrowers
1. Cash credit	10
2. Overdraft	2
3. Demand loans	1
4. Term loans	1
5. Bill discounting facilities	2
Total no. of respondents	10

Source: Field survey in Bombay

TABLE 31.6

Wholesalers' Opinion of Bank credit

(a) Bank-Wise details

	Total no. of account holders	Percentage getting need base finance	Percentage satisfied with banker
Central Bank of India	4	14	21
Bank of India	4	29	29
Dena Bank	4	14	7
Bank of Baroda	3	0	7
Others	5	43	36
Total	20	7	14
Total respondents	20	9	20

(b) Issue-wise details

	Yes (%)	No (%)	Total respondents
1. Reason for dissatisfaction:			
a) Delay in services	100	0	6
b) Inadequacy of credit	-	-	-
c) Others	-	-	-
2. Better services can be obtained from other agencies	40	60	15
3. Banks exercise undue supervision	50	50	8
4. High bank charges (including interest)	35	65	20
5. Corruption by bank officials	25	75	20
6. Overly short duration between renewals of loan limits	25	70	20

Source: Field survey in Bombay

TABLE 31.7

Salient features of Informal Credit

	Friends & relatives	Others	All informal sources
Wholesalers			
No. of firms	18	9	18
% of firms in sample	90	45	90
Average rate of interest	14.97	16	15.31
Minimum rate of interest	10	15	10
Maximum rate of interest	18	18	18
Average loan amount (Rs lakh)	7.70	5.71	7.03
Collateral and security	Nil	Nil	Nil
Semi Manufacturers			
No. of firms	10	5	11
% of firms in sample	83.33	41.66	92
Average rate of interest	16.5	16.5	16.5
Minimum rate of interest	15	15	15
Maximum rate of interest	18	18	18
Average loan amount (Rs lakh)	4.61	9.84	6.35
Collateral and security	Nil	Nil	Nil
Aratiyas			
No. of firms	5	3	5
% of firms in sample	71	43	71.42
Average rate of interest	16.5	16.5	16.5
Minimum rate of interest	15	15	15
Maximum rate of interest	18	18	18
Average loan amount (Rs lakh)	4.34	3.15	3.89
Collateral and security	Nil	Nil	Nil

Source: Field Survey in Bombay

TABLE 31.8¹

Sources and Uses of Funds of Sampled Agents (1979)

(All figures in percentage)

Item	Wholesalers	Semi-whole- salers	Retailers
Sources of funds			
Own capital	63.3	68.6	77.1
Informal credit	27.9	23.6	16.1
Bank (formal) credit	8.9	7.8	6.8
Uses of funds			
Inventories	31.8	54.1	64.6
Loans and advances	57.2	25.5	5.6
Other assets	11.0	20.8	29.8
Sample size	191	556	203

Note: Figures may not add to 100%
due to rounding.

Source: Jain, et.al. (1982)

1. The large 'other assets' of most firms are primarily income tax deductible government bonds which offer a very high rate of return while tax benefits last and, correspondingly, reduce the effective tax rate.

TABLE 31.9¹

Sources and Uses of Funds of Sampled Agents (1988)

(All figures in percentage)

Item	Wholesalers	Semi-manuf- acturers	Aratiyas
Sources of funds			
Own capital	63.37 (34.65)	22.59 (9.59)	18.02 (13.31)
Informal credit	31.16 (34.16)	65.51 (19.10)	61.71 (24.40)
Bank (formal) credit	5.46 (8.54)	11.89 (18.03)	20.25 (19.63)
Uses of funds			
Inventories	26.11 (20.63)	25.94 (19.42)	9.00 (13.70)
Loans and advances	63.27 (24.97)	68.19 (18.02)	72.45 (14.08)
Other assets	10.62 (10.52)	5.87 (5.44)	18.55 (14.68)
Sample size	18	12	7

Note: Figures in parentheses are standard deviations.

Source: Field survey in Bombay

1. See note 1 in Table 31.8.

TABLE 31.10

Percentages of Agents Receiving Credit From Different Sources (1988)

Item	Wholesalers	Semi-Manufacturers	Aratiyas
Percentage receiving:			
Formal credit only	22.22	0.00	0.00
Informal credit only	0.00	50.00	28.57
Formal and informal credit	55.55	50.00	71.42
No credit	22.23	0.00	0.00

Source: Field survey in Bombay

TABLE 31.11

Net Credit Received

	Net credit received (Rs lakh)	Days of working capital	Working capital used (days)	Shortfall in days
Semi-Manufacturers				
All	3.44 (6.70)	7.44 (45.59)	194.17 (268.23)	186.72 (302.51)
Informal borrowers only	1.89 (3.99)	19.74 (39.4)	115.14 (46.57)	95.39 (47.56)
Both	4.98 (8.32)	-4.84 (.48)	273.21 (33.948)	278.06 (405.07)
Aratiyas				
All	1.53 (2.51)	6.28 (202.30)	133.94 (1408.65)	1328.65 (1454.33)
Informal borrowers only	1.43 (1.48)	146.57 (124.82)	2978.28 (195.9)	2831.70 (70.48)
Both	2.53 (2.29)	97.23 (148.69)	634.04 (1021.41)	536.80 (874.80)

Note: Figures in parentheses
are standard deviations.

Source: Field Survey in Bombay

TABLE 31.12

Guesstimates of Unreported Income and Tax Evasion
for Wholesalers

	Average	Standard deviation
Unreported profit:		
Upper estimate	5.39	0.67
median estimate	5.18	1.00
Lower estimate	4.61	1.89
Evaded tax (median estimate only)	0.78	0.15
Number of observations: 12		
All India estimated unreported profit (median estimate only) in Rs crore		322.03
All India estimated tax evaded (median estimate only) in Rs crore		48.53

Notes: 1. Standard deviations must decrease as x increases by construction. Source: Computed.
2. Figures are percentages of estimated sales except for the last row.

TABLE 31.13

Profitability of Firms (%)

(Figures in percentage)

		Pat/total assets	Pat/income
Semi manufacturers		21.37 (18.51)	1.81 (2.29)
Aratiyas		27.24 (13.28)	16.10 (15.70)
By Borrowing Status:			
Semi manufacturers	Formal only	-	-
	Informal only	23.47 (20.32)	1.08 (.61)
	Both	19.80 (16.86)	2.54 (3.00)
Aratiyas	Formal only	-	-
	Informal only	37.89 (13.69)	16.53 (10.17)
	Both	20.86 (7.81)	15.84 (18.22)

Note: Pat: Profit After Tax.

Source: Field survey in Bombay

PART H

Case Studies in Regulation

SHROFFS OF WESTERN INDIA

32.1 Introduction

32.1.1 Over the past two decades, there have been a number of regulatory steps taken which have had the effect of curbing the operations of indigenous bankers in India, in particular Shikarpuri and other Shroffs of Western India. Such measures include reduction in the extent of commercial bank refinance of their operations through bill discounting, requirements (under the Income Tax Act) that payments and receipts of cash should be through cheques or drafts and restrictions on acceptance of deposits from the public (through the Banking Laws (Amendment) Act, 1983). At the same time, commercial banks have not been able to step in to fill the gap in the credit needs of small scale industry and private trade thus created, despite official recognition of this short fall.¹ Furthermore, the most recent measures run counter to the views held by expert groups in the past on the need to foster, or at least not get in the way of, activities of certain segments of the informal credit market, including indigenous bankers.²

32.1.2 In this chapter it is argued that the social consequences of curbing some informal credit channels may be negative. For those trade and manufacturing sectors served by Shroffs of Western India it is argued that they have an absolute - not just a comparative - advantage in relation to banks. Curbing of their activities therefore results in higher costs of production and distribution of goods. Furthermore, besides such direct losses, the resultant misallocation of bank funds that takes place³ contributes to the widely publicised inefficiency in the

1. See for example Chapter 11 of the Report of the Committee to Review the Working of the Monetary System (Chakravarty Committee), 1985.

2. See, for example, Banking Commission, 1972.

financial operation of banks.

32.1.3 A plea is made for the removal of the worst impediments faced by the Shroffs of Western India to permit them to compete on an equal footing with banks. The argument has often been advanced that informal credit is available at a higher cost than formal credit. It is pointed out here that higher interest charged by informal credit agencies (if indeed higher interest is charged) arises, firstly, as an efficiency rent: the actual cost of bank credit (despite lower interest costs) to the borrower exceeds the cost of informal credit. Secondly, restrictions on the availability of both bank credit and non-bank credit, the latter through the regulations alluded to above, also contribute to the high cost of consequently scarce informal funds. Permitting greater competition - instead of creating artificial cost disadvantages which go in favour of the banking sector - can only reduce the cost of finance to affected groups. Furthermore, it is argued below that high interest rates are not true of all segments of informal credit. In the case of the main credit instrument used by the Shroffs of Western India (the darshani hundi), the profit maximising interest rate is low in relation to bank finance.

32.1.4 In view of the centuries of experience of indigenous bankers in serving the needs of trade and the comparatively recent origin of commercial banking, the cost disadvantage of commercial banks is unlikely to disappear in the near future. If it does, then, in a competitive market, indigenous banking will gradually wither away. If this is to happen, the market place - and not official regulation should lead to this outcome.

32.1.5 In section 2, the opinions of various expert groups on the role of indigenous bankers, and in particular Shroffs of Western India, is reviewed. Section 3 reviews the current regulatory framework. Section 4 briefly reviews the role of banks in financ-

3. Which could increase in the light of the Chakravarty Committee's recommendation (No. 166).

ing trade and small scale industry. Section 5 examines the consequences of recent regulation for the operations of Shroffs of Western India. Section 6 examines the consequences of this for the cost of credit to segments formerly served by Shroffs of Western India. Section 7 proposes an approach to the regulation of the sarafi system and specific policy recommendations. A description of different types of hundis and certain other indigenous credit instruments is in the Appendix to this chapter.

32.2 Review of views held by the Banking Commission (1972) and the World Bank (1980)

32.2.1 Various official commissions and bodies, going back at least to the various Provincial Banking Enquiry Committees (ca. 1929), have studied the operations of indigenous bankers and have recognised the useful role played by these intermediaries. They have, consequently recommended that their operations be aided, or at least not hampered, by appropriate measures.⁴ Here the views of the most recent bodies, the Banking Commission (1972) and the study for the World Bank by Timberg and Aiyar (1980) are summarised.

32.2.2 Functions and role of indigenous bankers

- a. "The broad conclusion of the Study Group's enquiry is that the system of indigenous banking is an institution worthy of notice, its roots firmly established in the soil, its evolution and growth a striking measure of its popularity and superiority over other financial institutions, at least in regard to some specific needs. Oral evidence given by a cross section of the borrowers supports their belief that indigenous bankers have fulfilled their limited role rather well." (Banking Commission, Study Group on Indigenous Bankers, Para VII.4).
- b. "Activities like trade in cloth, grain and 'beedis' are essential and related in a relatively automatic way to the overall growth of the economy. The "organised" banking sector's rejection of them has preserved a growing role for indigenous informal agents in serving them. the "organised" banking sector will not for the foreseeable

4. For a useful summary see Banking Commission, Study Group on Indigenous Bankers (1971).

future be able to fill all the pressing if not "priority" needs of the Indian economy - and an informal market will necessarily exist to do so". (Timberg and Aiyar, 1980, p.119).

- c. "Indian ICMs certainly do serve traditional and other sectors that would otherwise be unserved. The volume of intermediation is certainly higher than it would be without the ICM and the allocation of credit different". (Timberg and Aiyar 1980, p.123).
- d. "The Gujarati shroffs perform functions in many ways analogous to a modern bank. For instance, (a) they receive deposit on current and fixed accounts from the public, (b) they advance money on call and for fixed periods on security or on personal credit, (c) they arrange for remittance of funds by issuing hundis for private and trade purposes and also undertake the collection of hundis, (d) they act as commission agents in respect of commodities such as grains, cotton, seeds, piece-goods, gold and silver, iron and steel and in some cases do the financing as well." (Banking Commission, Study Group on Indigenous Bankers, Para II.44).

32.2.3 The Main credit instrument of Shroffs of Western India (Darshani Hundi)

- a. "The hundi is the oldest surviving credit instrument, the merits of which cannot be denied. For instance, the ease with which darshani hundi can be endorsed and the wide spread use of this instrument for transfer of funds suggests that this indigenous instrument has a close kinship with the more sophisticated demand-draft." (Banking Commission, Study Group on Indigenous Bankers, Para VII.5).
- b. "In view of the delays in remittances through banks, the 'darshani' hundi has proved to be a convenient instrument for remittance of funds by certain sections of the community." (Banking Commission, 1972, Para 18.34).
- c. ".....the Group is convinced that in the case of the darshani hundi there is no scope for the concealment of any transactions or of any funds." (Banking Commission, Study Group on Indigenous Bankers, Para III.17).
- d. ".....we recommend that payments by darshani hundi may be recognised as an eligible mode of payment under this section."⁵ (Banking Commission, 1972, Para 18.97).⁶

5. Section 40A(3) of the Income Tax Act.

6. It may also be noted that, in view of another recommendation by the banking commission, a committee headed by Justice Rajamannar was set up to draft a Hundi Code Bill. The Committee submitted its Report, including a

32.2.4 Impact on economic activity: Besides the opinions of this matter already contained in para 32.2.2 above, it may be mentioned that the Study Group on Indigenous Bankers of the Banking Commission (1972), is of the opinion that "but for the services of indigenous bankers, several segments of the neglected sector would be even more neglected" (Study Group, Para VII.1) and that they contribute to economic development and are an important component of the financial system.⁷

32.2.5 Cost of funds: While it is often alleged that indigenous bankers (who are sometimes erroneously clubbed with moneylenders) charge usurious interest rates, both authorities quoted here feel that the higher cost of funds from Shroffs of Western India as compared to banks is due to greater risks and their higher opportunity cost of funds.⁸ Monopoly power is not important and, indeed, Timberg and Aiyar (1980) are of the opinion that rates are competitively determined. In some cases rates lower than the nearest comparable bank rates were found.

32.2.6 Future role of indigenous bankers

a. "The foregoing chapters lead to the conclusion that while indigenous banking has been rendering a valuable service to certain segments of the economy, may be, its continued utility and growth would depend upon the readiness with which it transforms itself into an instrument of productive credit to the neglected sectors of the economy at a reasonable price." (the Banking Commission, Study Group on Indigenous Bankers, Para VI.I).

b. "The future of indigenous bankers would thus be in their evolving as discount and acceptance houses or as mini mer-

draft bill, in 1978 though no action has since been taken.

7. See Banking Commission, Study Group on Indigenous Bankers, para VI.a.

8. References are scattered throughout the studies. For example see para VII.25 of the Banking Commission, Study Group on Indigenous Bankers (1972) or page 84 of Timberg and Aiyar (1980).

chant banks oriented towards financing small scale industry. (the Banking Commission, Study Group on Indigenous Bankers, Para VII.48).

- c. In effect, it is the conclusion of the Study Group that the indigenous banking business, of the multanis in particular, needs to be resuscitated. This can be achieved by the Reserve Bank of India extending credit facilities for rediscounting the hundis at the Bank Rate under the Bill Market Scheme in order that the commercial banks may finance the hundi business in larger amounts at reasonable rates of interest and in a regular manner and uninterruptedly throughout the year." (the Banking Commission, Study Group on Indigenous Bankers, Para VII.49).

32.2.7 Regulation of indigenous bankers

- a. "The best approach to the problem (of regulation) would be for the regulatory authority to stimulate the financial institutions to create their own internal regulations. The authorities should rely on such self regulation and on an external audit, once satisfactory standards have been developed." (the Banking Commission, Study Group on Indigenous Bankers, Para VII.21).
- b. "A system of licensing needs to be introduced which may provide for recognition by the Reserve Bank of the various associations of indigenous bankers with details of each individual member's qualifications." (the Banking Commission, Study Group on Indigenous Bankers, Para VII.22).
- c. "Indigenous bankers should evolve for themselves a self imposed convention in regard to the relationship between their own funds and outside commitments. No licensed indigenous banker should hold at any one time risk assets in excess of seven times the amount of his own capital invested in the business." (the Banking Commission, Study Group on Indigenous Bankers, Para VII.23(c)).
- d. "A summary statement of the volume and nature of business should be furnished annually by each indigenous banker to the Reserve Bank. The commercial banks and the Reserve Bank after due consultation with the Associations will review annually the activity of indigenous bankers to assess if advances granted by them are for socially desirable purposes and not detrimental to the interests of deposits." (the Banking Commission, Study Group on Indigenous Bankers, Para VII.23(e)).
- e. "After the Study Group's report was largely endorsed by the whole Banking Commission - some efforts were made to carry out these recommendations efforts to effect the recommendation floundered on the issue of the precise controls to be implemented and have largely been dropped." (p.117, Timberg and Aiyar (1980)).

32.2.8 Conclusions: While the comments made by the Banking Commission on indigenous bankers were not uniformly laudatory - especially with regard to their secrecy and unwillingness to be externally regulated - the paragraphs quoted above do give a fair representation of their views. Furthermore, what is important is that it has been ascertained in conversation with members of various Associations of Shroffs that they are willing to accept the bulk of these recommendations (including the Hundi Code Bill if it is made into law). Instead, as we now indicate, the current regulatory framework appears designed to choke the activities of indigenous bankers.

32.3 Recent regulations and policy measures adversely affecting Shroffs of Western India

32.3.1 The view of the Banking Commission on the debilitating effects of Section 40A(3) of the Income Tax Act, which requires payments of Rs 2500 or more to be made by crossed cheque or draft, on the darshani hundi have already been hinted at (Para 2.3(d) above). In view of the fact that this instrument is nearly impossible to use in facilitating "Black" transactions (see para 2.3(c) above) they had recommended that the darshani hundi be included in the list of eligible instruments in Section 40A(3) after extensive analysis of the logic of restricting the concerned section to cheques and drafts.⁹ However, the unamended section still remains on the statute books and its adverse effect on the darshani hundi as a payments instrument therefore continues.

32.3.2 The chief advantage of the darshani hundi was that it could be used as a virtually riskless means of remitting or carrying funds between business centres in view of the close contacts between shroffs in different places or in view of the network of branches maintained by a shroff. Furthermore, since a shroffs

9. See the Banking Commission, Study Group on Indigenous Bankers, paras III.15 to III.21.

pedhi does not keep "banking hours", speedy payments and drawals are facilitated. The resultant efficiency with which cash balances were used has been hamstrung by Section 269SS (inserted in 1984) of the Income Tax Act which specifies that loan repayment in sums exceeding Rs 10,000 must be by account payee cheque. This disadvantage is especially felt in smaller towns.¹⁰

32.3.3 The ability of Shroffs of Western India to attract deposits has also been hurt by the Banking Laws (Amendment) Act, 1983, which limits the total number of depositors with a partnership or an association of individuals to 250 (or 25 per partner). Even among types of deposits, Section 269T (inserted in 1981) of the Income Tax Act, which specifies that deposits in excess of Rs 10,000 are to be made by account payee cheque or draft, has virtually dried up the flow of very short term deposits to them. Since much of the business of Shroffs is in very short term loans - financed by putting word out in the "market" for short term funds requirements - this has seriously damaged their business. The reason for this insistence on transactions by cheque is to put obstacles in the way of markets which facilitate the laundering of illegal funds. Secondly, the objective of the Banking Laws (Amendment) Act is to check the fraudulent practices of "Bangalore type" finance corporations and protect the small depositor. The useful call money market in various financial centres (served by Shroffs of Western India) and their general business have been the casualties of these regulatory measures.¹¹

10. See Section 32.6 for an example.

11. While this does not imply that no black money finds its way into the call money market nor that no Shroff of Western India has ever defaulted on obligations to depositors, a proper assessment of the social loss from curtailing their activities - instead of introducing appropriate scrutiny measures and safeguards - must surely be made and weighed against the limited gains in curbing "black" money. Depositor safety, which is consistently high for Shroffs of Western India, except in one or two recent cases in Anand (Gujarat), can be ensured by appropriate deposit insurance. It should be

32.3.4 Other policy measures hurting Shroffs of Western India have been the withdrawal of hundi discounting facilities by commercial banks (especially the State Bank of India) and the withdrawal of bank remittance facilities to them. Memoranda by Shroffs Associations asking for amending legislation have, thus far, gone unheeded.

32.3.5 The contrast between the recommendations contained in section 32.2 and the reality outlined in this section are stark enough not to warrant further elaboration.

32.4 Commercial bank finance to trade and small scale industry: A brief review

32.4.1 That bank finance to small scale industry and trade has not been satisfactory can be clearly seen from the following excerpt from the Reserve Bank of India (1985):

"Like the small scale industries sector, another sector which finds itself at a considerable disadvantage in the present system of credit allocation, is the trade and distribution sector. As regards its role as a supplier of raw materials to the industrial sector it shares to some extent the problem faced by small scale industries in regard to working capital finance, though not all units in the trade sector are small or financially vulnerable, or weak in terms of bargaining power." (Para 11.26)

32.4.2 Table 32.1 gives selected statistics on bank support to industry and trade. In Table 32.1, Rows 5 and 6 show how scheduled commercial bank advances to small scale industry and trade have moved with respect to indicators of total turnover in that sector.¹² It may be seen that bank credit to both sectors has

emphasised that most shroffs are not fly-by-night concerns. Furthermore, the Banking Laws Committee has spoken with approval of the comprehensive self-regulation and policing by the various associations of shroffs in different cities.

been falling or stagnant as a proportion of turnover. Thus stagnancy or decline is revealed even if attention is restricted to total scheduled bank advances to these sectors (rows 1a and 1b) as a percentage of total advances. In contrast, the growing importance of both these sectors in national income is revealed, by an examination of rows 7 and 8.¹³

32.4.3 Thus, it is clear that bank support to small scale industry and trade has not improved since the 1970's. Specifically, though bank advances have been growing faster than NDP (row 9) as have both small scale industry and trade (rows (7) and (8)), the lending pattern of banks has resulted in both trade and industry losing ground in bank loan portfolios. It is, therefore, clear that units in these sectors must increasingly rely on non-bank finance.

32.4.4 The picture become even more bleak when account is taken of the fact that banks have a bias towards lending to older, established and large units as compared to newer or smaller units especially those with limited access to collateral¹⁴.

32.5 Consequences of recent regulation for the operation of Shroffs of Western India

32.5.1 The most visible impact of the recent regulations is that several shroffs have withdrawn from their traditional business. For instance, as compared to the 6 pure Gujarati shroffs observed by Timberg and Aiyar (1980) to operate in Bombay in 1978-79, there are only 2 pure shroffs currently. Prominent among the firms

12. The indicator for trade, while not ideal, gives a reasonably goods idea as to trends.

13. While the levels of ratios given may not be very meaningful in view of data limitations, their movement is certainly indicative of broad trends.

14. See chapter 16

forced to close down in other parts of the country is the first firm to be granted recognition by the Reserve Bank of India as an indigenous banker in the last century (Harjiwandas Kushaldas Parekh, established 1862).

32.5.2 The comparison of basic statistics in Table 32.2 also provides evidence of the decline in the business of Shroffs of Western India.

32.5.3 This decline is evident whether one goes by the number of shroffs (row 1), annual turnover (Row 2), or own capital and capital:deposit ratio (Rows 6 and 7). While comparative statistics as to the consequences of decline in darshani hundi business are not available, the decline in the share of finance made available to trade (Row 12) provides indirect evidence of this.

32.5.4 Restriction of the number of depositors allowable under law has, as is evident from Row 6, resulted in a substantial decrease in the own capital to deposit ratio. Furthermore, as Table 32.3(a) reveals, even among deposits, deposits from the general public have decreased substantially, thus vitiating the role of shroffs as financial intermediaries. Table 32.3(b) shows that the maturity structure of deposits has tilted towards long term deposits as would be expected in a situation of tight finance where there would naturally be a preference for long term availability of borrowed funds.

32.5.5 Summary of impact of recent changes on activity of Shroffs of Western India: It is of interest to decompose the interest on advances made by Shroffs in Western India in 1979 and 1988. Data from Table 32.2 used for this purpose is reproduced in Table 32.4(a). Concentrating on middle values, the spread between, advance and deposit rates can be seen to have fallen from 9 per cent per annum (17.5-8.5) to 8.5 per cent between 1979 and 1988. Likewise there is a marginal increase in the earnings: expense

ratio reflecting the reduced volume of business while bad debts are unchanged. Thus, the major factor contributing to the decline in the earnings of shroffs is the fall in the capital: deposit ratio due to the recent prohibitory legislation discussed above. The consequence of this has been to squeeze the profitability of sarafi operations so that the return on own funds now contributes 6.53 per cent to the spread as opposed to 6.74 per cent in 1979. Economic rent, which represents the return to shroffs both for their superior efficiency and due to monopolistic elements, if any, and which contributed 5.82 per cent to the spread in 1979 now contributes 3.03 per cent to the spread even at the conservative opportunity cost of 14 per cent assumed in Table 32.4. The fall in the "monopoly rent" element in the wake of the reduced capital base of Shroffs casts doubt on the extent of monopoly enjoyed by them unless such monopoly power was due to the unlikely prevalence of scale economies. A more likely explanation for this fall is the curtailment of efficiency rents due to the decline in the use of the darshani hundi. Since a part of such efficiency benefits would have been shifted forward to buyers of sarafi services, an overall decrease in the efficiency of financial intermediation can be apprehended.

32.6 Consequences of decline in activity of Shroffs of Western India for trade

32.6.1 The extent of finance extended to the trading sector by Shroffs of Western India will clearly have fallen relative to the size of total trading activity. Unfortunately, no information is available on this aspect. However, a list of activities financed by shroffs in Western India is given in Table 32.5. The worst affected sectors are those who formerly relied extensively on the services of these financiers such as the traders in cotton, groundnut, and 'beedi' mentioned by Timberg and Aiyar (1980).

32.6.2 From the national perspective, this would not be of much importance if it was not for the fact that Shroffs of Western India were much more efficient suppliers of the type of financial services demanded by these sectors than commercial banks. A cost

comparison would make this apparent.

Example: An established up country trader needs to purchase trade goods worth Rs 1 lakh at Bombay from one of several possible suppliers. The trader must pay cash on purchase of the goods but wishes to avoid carrying a large sum of cash on his person. His options are, therefore, to carry a crossed bank draft drawn on his Bombay account (in case he does not know his supplier in advance), remit funds through a bank to his Bombay account or to carry a darshani hundi. For the bank draft, he must visit the branch where he has his account during banking hours (before 2 or 3 p.m.) and obtain the draft. On reaching Bombay, the draft must be presented during banking hours. If the trader's Bombay account is with the same bank the matter ends. If not, the trader must either remit funds by bank transfer before going to Bombay or wait for the draft to clear in Bombay. In either case, his funds are tied up for the duration (normally 3 days) taken to effect the transfer of funds between one account and another. In the case of a darshani hundi, the shroff's 'pedhi' may be visited after the trader's shop is closed prior to boarding the Bombay train and a hundi obtained without need for security. The trader may then visit a correspondent shroff in Bombay in the morning, obtain funds, return the same evening and pay the first shroff the following day even if his own funds are not on deposit with this shroff. Two days interest must then be paid. If the trader has funds on deposit with the shroff, the debt can be retired the same evening saving one day's interest. The comparative costs are as in Table 32.6.

32.6.3 In the example given above, the inconvenience cost to the trader caused by banking hours and, perhaps, the indifferent attitude of lower level bank officials has not been considered. It can be verified by the reader, furthermore, that no other method of funds transfer through commercial banks leads to lower costs to the trader. However the example may be thought to be biased due to the short period chosen. It is easy to see that, if the interest on the loan from the shroff exceeds the trader's opportunity

cost of funds, then bank transfers cost less if the period for which the loan is taken (or draft is held) is sufficiently long. The formula for the break even period is $C+KR/R-r=n$, where C is the cost of the draft, K is the number of days for a bank transfer less the number of days required with a darshani hundi, R is the shroff's per day interest charge and r is the opportunity cost of the trader's funds. For example, if the shroff charges 20 per cent per annum, the trader's opportunity cost is 15 per cent and K is, 2 days, then for Rs 1 lakh, we have $200+3 \times 50/50-38.30=25.6$ days.

As has been mentioned, since such extended trips are likely to occur only in exceptional cases, shroffs do not normally deal in such long period advances.

32.6.4 A brief interpretation of the cost differential between banking and sarafi systems may be called for at this stage. The interest cost of the hundi is mainly a reflection of the shroffs cost of funds as seen in Table 32.4. The cost of bank funds, given that a bank draft is fully secured, so that no own funds are deployed, is entirely transactions or establishment costs plus profits. This includes both the direct charges for the draft as well as the value to the bank from the extra cash it receives in exchange for its debt instrument. If it is assumed that the trader's opportunity cost and the value received by banks balance, then the net social cost of the draft is simply the draft charge. Even so, this exceeds the net social cost of the hundi which may simply be taken as the interest cost.

32.7 An approach to regulation

32.7.1 If the efficient provision of financial services is considered to be worthwhile in the national interest, then till such time as its use withers away naturally, the darshani hundi should be allowed to function unimpeded. As a corollary, regulatory obstacles which impinge on the ability of Shroffs of Western India to provide this service should be removed. To ex-

amine possible regulation we look first at regulations impinging on the use of the darshani hundi directly and then at measures affecting the sources and uses of funds with shroffs.

32.7.2 It is apparent that section 40A(3) of the Income Tax Act should be amended as recommended by the Banking Laws Committee. Regarding sections 269SS and 269T, modifications may be considered after calling for submissions from various associations of Shroffs on the following points:

- i. In what way do these regulations impinge on the flexibility of hundis.
- ii. What assurances/suggestions can be given to reduce the possibility that these sections, if suitably amended to aid hundi usage, are used for transactions in 'black' money. For example, record keeping and scrutiny aspects may be explained.

Furthermore, the Hundi Code Bill (1979) formulated by the Banking Laws (Rajamannar) Committee may be expeditiously passed to codify hundi usage.

32.7.3 Steps should be taken to remove impediments faced by shroffs in raising funds. One way is to allow shroffs access to concessional bank refinance through bill discounting or otherwise. However, this results in shroffs competing for scarce bank loanable funds and in the neglect of the advantage shroffs have in raising deposits from certain segments. Thus, it is not recommended. The second way is to exempt shroffs from the provisions of the Banking Laws (Amendment) Act to enable them to raise deposits from the public as before. This has the virtue of aiding net saving mobilisation efforts over and above any movement to shroffs of funds currently with banks. Also, if hundis cease to be efficient payment instruments over time, shroffs will be unable to compete deposits away from banks as their deposit rates will suffer. Thus, allocation of savings to hundis only if they are efficient will be achieved. Furthermore, some system of scrutiny by the RBI, in consultation with shroff's associations, may be devised. Finally, the memoranda by shroffs' associations on sec-

tions 269SS and 269T of the Income Tax Act, should include their suggestions as to how scrutiny can be exercised on deposit and loan repayment activities to ensure that no facilitation of the black economy ensues.

32.7.4 With regard to uses of funds and interest charged or paid by shroffs, no RBI scrutiny or regulation is recommended. In the normal course of affairs, scrutiny by Income Tax authorities of their books (which are, according to the Banking Committee, more than adequate) and regular auditing of the books should reveal misuse of funds if any. The social desirability of their loan portfolios should be influenced if at all, by interest subsidies/taxes for loans given to particular high or low priority segments. A second channel of influence may be moral suasion directed through the shroffs' associations. The recommendations in this paragraph stem from the view that, firstly, additional effective regulation is - to be realistic - not really feasible and that, secondly, given that funds from shroffs flow largely to neglected sectors (to use the words of the Banking Committee), unnecessary.

TABLE 32.1

Commercial Bank Lending to Small Scale Industry and Trade

(Amounts in Rs Crore at current prices)

Item	1970	1975	1980	1982	1985
1. Scheduled Commercial Bank Lending					
a. Small Scale Industry	N.A. (12.4)	1118 (11.9)	2534 (11.9)	3537 (13.3)	6629
b. Internal Trade (excluding food procurement)	496 (12.1)	705 (7.9)	2331 (10.9)	2663 (8.9)	4922 (9.9)
c. Total	4108 (100.0)	9011 (100.0)	21312 (100.0)	29644 (100.0)	49995 (100.0)
2. Production of Small Scale Industries (At 78-79 prices)	N.A.	N.A.	28098	34927	61299 (P)
3. NDP at factor cost from transport, communication & trade	5457	11907	21507	29144	42842
4. NDP at factor cost	34519	62324	120973	134488	197178
5. Ratio of (1a) to (2) (%)	N.A.	N.A.	9.0	10.1	6.8
6. Ratio of (1b) to (3) (%)	9.1	11.3	10.8	9.1	11.4
7. Ratio of (2) to (4) (%)	N.A.	N.A.	23.2	26.0	31.1
8. Ratio of (3) to (4) (%)	15.8	19.1	17.8	21.7	21.7
9. Ratio of (1c) to (4) (%)	11.9	14.5	17.6	22.0	25.4

Notes: P: Provisional

1. Items 2,3,4 are for fiscal years (e.g. 1970-71 instead of 1970).
2. Small Scale Industry production is deflated with the wholesale price index for manufacturing.
3. Actual figures were at 78-79 prices.
4. Figures in brackets are percentages of the total.

Source: RBI, Report on Currency and Finance, Various Issues.

TABLE 32.2

**Business of Shroffs of Western India
1970-1988**

	1970	1980	1988
1. Number of Shroffs - Bombay	200	250	50
Ahmedabad	150	250	125
2. Total annual turnover in Bombay (Rs crore)	3000	1600	500
3. Average interest	12% to 15%	15% to 18%	18% to 21%
4. Rate on loans - general			
- powerloom cloth -		21.5%	-
5. Rates of interest on deposits: (Bombay)			
on demand:	6% to 7%	5% to 9%	8% to 10%
on year :	9% to 10%	10% to 12%	12% to 14%
6. Capital: Deposit ratio	1:15	1:12	1:3
7. Average own capital (Rs crore)	50 lakh	40 lakh	20 lakh
8. Ave. bad dbts to income (Bombay)	3% to 5%	3% to 5%	3% to 5%
9. Earnings/expenses ratio (Gross) Bombay	N.A.	20:11.5	20:12.5
10. Credit: Deposit ratio	75:100	81:100	82:100
11. Funds kept as reserve with commercial banks	40%	30%	20%
12. Finance to trade/export/SSI/others (%)	75/10/ 5/10	60/10/ 5/25	50/15/ 10/25
13. Percentage of total business in hundis	-	60	-
14. Average commission on cash-paid hundis	-	Rs 11 per Rs 1 lakh	-
15. Average size of advance per borrower	-	Rs 75000	-

Source: Items 1-3 and 5-12: Bombay Shroffs Association
Items 4 and 13-16 Timberg and Aiyar (1980).

TABLE 32.3

**Sources, Maturity Pattern and Size of Deposits
(Bombay and Ahmedabad)**

	1980-81	1987-88
(a) Sources of Deposits (%)		
Relative and friends	50	65
Business associates	25	25
General public	25	8
(b) Type of deposits (%)		
Call	20	15
Saving	30	25
Fixed (1 to 5 year)	50	60
(c) Size of deposits (%)		
Rs 1 to Rs 2500	40	N.A.
Rs 2501 to Rs 5000	30	N.A.
Rs 5001 to 10000	20	N.A.
Rs 10001 and above	10	N.A.

Source: Bombay Shroffs Association

TABLE 32.4

Estimated Decomposition of Interest Rate on Advances

(Figures in percentage per annum except ratios)

Item	1979			1988		
	Upper	Middle	Lower	Upper	Middle	Lower
(a) Data from Table 32.2						
Interest on advances	20.0	17.5	15.0	21.0	19.5	18.0
Deposit rate	5.0	8.5	12.0	8.0	11.0	14.0
Bad debts	3.0	4.0	5.0	3.0	4.0	5.0
Capital deposit ratio	1:12	1:12	1:12	1:3	1:3	1:3
Earnings expense ratio	20:11.5	20:11.5	20:11.5	20:12.5	20:12.5	20:12.5
(b) Decomposition						
Default cost	0.6	0.7 (4.0)	0.75	0.63	0.78 (4.0)	0.9
Establishment cost	6.88	2.21 (12.67)	Neg	7.13	3.94 (20.21)	0.75
Opportunity cost of own funds	0.92	0.92	0.92	3.5	3.5	3.5
Borrowing cost	4.62	7.85 (50.11)	11.08	6.0	8.25 (60.26)	10.5
Economic rent	6.98	5.82 (33.26)	2.25	3.74	3.03 (15.54)	2.35
Total	20.0	17.5	15.0	21.0	19.5	18.0
(c) Return on own funds						
	90.74	75.66	29.25	14.96	12.12	9.4

- Notes: 1. Figures in parentheses are percentage of spread between borrowing and lending rates. Source: Table 32.2 and computation.
2. Opportunity cost of own funds taken at 12% in 1979 and 14% in 1988.
3. Upper bound on the interest rate in 1979 assumed to be 20% in view of the small size of powerloom advances reported at 21.5% by Timberg and Aiyar (1980) and maximum of 18% reported by Bombay Shroffs Association.

TABLE 32.5**Activities Financed by Shroffs****(a) Export finance**

- | | |
|---------------------------|----------------|
| 1. Cotton | 8. Tobacco |
| 2. Oil and oil cakes | 9. Yarn |
| 3. Onions | 10. Gunny bags |
| 4. Potatoes | 11. Pulses |
| 5. Textile | 12. Turmeric |
| 6. Coir and coir products | 13. Chillies |
| 7. Spices | 14. Garments |

(b) Domestic trade

- | | |
|------------------------------------|--|
| 1. Oilseeds | 20. Onions |
| 2. Ground nut | 21. Potatoes |
| 3. Jute/wool | 22. Spices |
| 4. Tobacco | 23. Polymers |
| 5. Cotton staple and art-silk yarn | 24. Wool |
| 6. Chemicals | 25. Coconuts |
| 7. Metals | 26. Tamarind |
| 8. Pipes | 27. Iron rods |
| 9. Rice | 28. Corrugated sheets |
| 10. Grains | 29. Hardware |
| 11. Jaggery, sugar | 30. Chemicals |
| 12. Groundnut | 31. Gold/silver jewellery |
| 13. Oil seeds | 32. Plastic and rubber |
| 14. Paper | 33. Tyre and cords |
| 15. Textiles | 34. Footwear |
| 16. Tea | 35. Metal-Ware, utensils
and auto parts |
| 17. Jute | 36. Engineering items and
machinery |
| 18. Hessian and gunny bags | 37. Rural handicrafts |
| 19. Coal | |

(c) Transport, shipping and clearing

1. Bus and truck operators
2. Auto part manufacturers
3. Country-craft owners
4. Clearing agencies and shipping agents

(d) Building construction and housing schemes

1. Industrial sheds
2. Roads and public utilities.

Source: Extracted from information supplied
by Bombay Shroffs Association.

TABLE 32.6

Example of Comparative Costs of Bank Draft and
Darshani Hundi (Based on Para 6.2)

Item	Bank draft (Rs.)	Darshani Hundi (Rs.)	
1. Cost of instrument (For Rs 1 lakh)	200		Nil
2. Interest cost (2 days)	Nil	At 20% p.a.	50.00
3. Opportunity cost of	114.94		Nil
	314.94		50.00
4. Additional inconvenience cost	50.00		15.00

Note: Inconvenience cost of darshani hundi is due to
Section 40A(3) of Income Tax Act.

CHAPTER 33

THE SANCHAITA AND PEERLESS CASES

33.1 Introduction

33.1.1 While, in principle, free functioning of financial markets, limited, if at all, solely by financial controls in the larger social interest, would appear to be desirable, the possibility of fraudulent practices by financial intermediaries as also inherent limitations in the informational environment of financial markets must be taken note of as they crucially affect the role which the ICM can usefully play in financial intermediation in a country like India. Quite apart from any moral issues, the efficient functioning of financial markets, as intermediaries between savers and investors, requires that savers be protected from excess risk arising from imperfect information regarding the terms and conditions of the contract entered into by them with a financial intermediary or from the possibility of fraud on the part of the intermediary. Likewise, intermediaries should not be in a position to channel funds to socially undesirable activities, thereby depriving legitimate economic activity of finance and negating the social objective of financial intermediation.

33.1.2 The task of financial regulation is made extremely difficult by the need to curb undesirable activity while not, at the same time, stifling legitimate financial intermediation. In chapter 32 we commented on how Reserve Bank of India regulations inhibit the activities of certain legitimate groups of financial intermediaries. In this chapter we provide two case studies of questionable dealing by financial intermediaries to understand the reasons for the harsh regulatory stance taken by the Reserve Bank towards non-bank financial intermediaries in general and also to bring out some gaps in the existing regulatory framework.

33.1.3 The two cases, that of Sanchaita Investments and of the Peerless General Finance and Investment Company Limited are notable not only because of the very large deposits mobilised by each of these concerns but also for the inability of the Reserve Bank and the Government to make much headway against them despite initial evidence to suggest gross irregularities and, in the ultimate analysis, protect the interest of a large number of small savers.

33.1.4 The plan of this chapter is as follows. Sections 33.2 and 33.3 present the factual position with respect to the nature of business of 'Sanchaita' and 'Peerless' respectively, as also a description of their skirmishes with regulatory authorities and the judiciary. Section 33.4 discusses the main issues raised by these cases, issues which have already been raised in the previous paragraphs, in greater depth.

33.2 Sanchaita investments

33.2.1 Background: Sanchaita was floated as a partnership firm by Behari Prasad, Murarka, Sambhu Mukherjee and Swapan Kumar Guha in 1975 with a paid up capital of seven thousand rupees. Its head office was in Calcutta (in the State of West Bengal).

33.2.2 Deposit mobilisation: Its main line of business was the acceptance of deposits from the public for fixed periods with the provision that deposits were repayable on demand with a 1 per cent interest penalty. While, on paper, the rate of interest on deposits was 12 per cent per annum, it was established that interest was paid at 48 per cent up to September 1979 and at 36 per cent thereafter till 1981 after which no interest was paid on any deposit.¹ Interest was reputedly paid on the 7th of every month

1. The material for these case studies is taken from newspaper reports and from the judgments relating to Calcutta High Court and Supreme Court cases filed by the State of West Bengal. Full citations are in the Ap-

and delivered to the doorsteps of depositors by agents of the company. The total deposits mobilised by the concern at the time of its winding up in 1981 was around Rs. 110 crore from 1.67 lakh small depositors. Approximately 55,000 depositors had deposits of Rs. 4000 or less (Rs. 22 crore) a further 33 per cent of depositors had deposits of Rs. 5,000 each (Rs. 28 crore) and the rest had deposits ranging from Rs. 6,000 to Rs. 25,000. About 15 per cent to 20 per cent of the depositors were reputed to be widows who had invested their life savings in safe but high yielding assets. The interest in excess of 12 per cent was not accounted for either by the firm or by several depositors and thus constituted a clear case of black money generation.

33.2.3 Uses of funds: Since it emerged during subsequent court proceedings that the firm did not have any significant source of income by which such high interest payments could be sustained, the obvious conclusion is that new deposits were used to pay interest on old deposits. However, the firm was in the business of making short term or demand loans to shopkeepers, wholesalers and importers (i.e., for dockyard finance). Interest rates charged on secured loans were as high as 72 per cent on an annualised basis. The company also invested in retail trading establishments, stocks and shares, film production, processing and exhibition (there were at least 2 unreleased films made with Sanchaita money with all-star casts), real estate and housing and had a large number of motor vehicles and even a motor launch.² In addition, money was given to political parties to help them fight election campaigns - the main reason for the drop in the deposit interest rate in 1979. Large commission were apparently paid to their agents (in one case an agent was found to have seven houses in Calcutta) and crores of rupees were deposited under fake names in Swiss bank accounts

pendix to this chapter.

2. This information is gleaned from the attachment orders of the Commissioner, Sanchaita Investments, for the most part. It is difficult to determine at this stage what portion of these assets was in the name of the firm and what in the name of partners or

(Amrita Bazar Patrika, 18 March, 1986).

33.2.4 Regulatory history: If Sanchaita had been a company within the meaning of section 45I(a) of the Reserve Bank of India Act, 1934, the provisions of the Non-Banking Financial Companies (Reserve Bank) Directions, 1977 would have been applicable to it. Under these Directions deposits accepted by such companies could not exceed 25 per cent of net owned funds (i.e. paid up capital plus free reserves). However, since Sanchaita was a partnership firm, with a paid up capital of less than Rs. 1 lakh, no financial regulations of any kind, except the insufficiently enforced West Bengal Moneylenders Act, applied to it. It did of course fall within the purview of normal tax and criminal law.

33.2.5 In 1978, the Prize Chit and Money Circulation Scheme (Banning) Act was passed by the Indian Parliament. The implementation of the Act was left to the individual State Governments. Accordingly, the West Bengal government issued a set of Rules in 1979 for the implementation of the Act and, after an extensive review of various non-banking financial firms in the State, sent notices to firms falling within the purview of the Act ordering them to submit winding up plans by December, 1980. The notice and the list of firms was published in a leading Calcutta paper (The Statesman) on September 25, 1980. Significantly, Sanchaita was not on the list.

33.2.6 However, in an apparently contradictory move, a First Information Report (FIR) was filed by the West Bengal Government with the Calcutta Police in which it was alleged that Sanchaita was promoting a money circulation scheme in contravention of the 1978 Act. The events leading up to the FIR were, briefly, as follows:

- i. In July, 1979, a member of the Lok Sabha (Lower House of Parliament), Rudolph Rodriguez, wrote to the Deputy Prime Minister alleging that Sanchaita was a 'cover-up for a parallel banking system for black money'.
- ii. The letter was sent to the Chief Officer of the Department

of Non-banking Companies of the Reserve Bank of India at Calcutta. After enquiring into the matter, the officer replied to the letter stating that Sanchaita fell outside the scope of section 54(c) of the RBI Act, 1934 and hence was outside its control.

- iii. In September 1980, the Deputy Secretary of the Finance Department, Government of West Bengal wrote to the Chief Officer, RBI, asking for legal advice on Sanchaita. A similar letter was sent by the State Finance Minister, Dr. Ashok Mitra to the Union Finance Minister. The letter was forwarded by the Union Minister to the Deputy Governor of the Reserve Bank, who sent a legal report to Dr. Mitra stating that Sanchaita would not ordinarily fall within the purview of the Prize Chit Act. The report is still confidential.

33.2.7 The FIR was accompanied by raids on the houses of two partners, Murarka and Mukherjee, and on the offices of the firm. A number of incriminating documents, a large sum of money and books of accounts were impounded. Subsequently, eighty other premises were searched and further documents seized. Following these events, the partners were arrested and released on bail. They then filed a petition on behalf of the firm and themselves with the Calcutta High Court. The Calcutta High Court rejected the FIR's contention that Sanchaita's was a money circulation scheme and ordered the return of seized items to the firm. On appeal to the Supreme Court, the position of the Calcutta High Court was upheld (February, 1982). The Supreme Court however gave the State government two months grace before it was required to return items seized from Sanchaita in order to let it make a detailed enquiry into the affairs of the firm.

33.2.8 A case was then filed against Sanchaita under the Indian Penal Code and the Income Tax Act and subsequently, a special Commissioner was appointed by the Civil Court, Calcutta to oversee the disposal of Sanchaita's assets and refund depositor's money. On March 20th, 1985 one of the partners, Mukherjee, committed suicide while in police custody.

33.2.9 Aftermath: Despite the efforts of the Commissioner appointed for the liquidation of the assets of Sanchaita, not all

its assets could be traced or, in some cases, lack of evidence prevented attachment of assets. It is also worth mentioning that the Commissioner had to work under constant threat of violence. As of July, 1986 only Rs. 1.67 crore had been distributed among depositors who could establish the genuineness of their position out of total recoveries of Rs. 2.5 crore. The break-up was as follows: About 1250 people who had proved deposits of Rs. 1,000 each were given Rs. 200 each; 19,100 persons with deposits of Rs. 2,000 each had been given Rs.340 each; 14,000 persons with deposits of Rs. 3,000 each had been paid Rs. 450 each; and the commission had started payment of Rs. 750 each to depositors with Rs. 5,000. 107 physically handicapped persons had been given 5 per cent more than their deposits. Large depositors had not received and were unlikely to receive any refunds.

33.2.10 Some observations: The manner in which the West Bengal Government proceeded against Sanchaita and the expressed inability of the RBI to proceed against Sanchaita are manifestations of the weakness of the Indian legal structure in enforcing financial probity of informal sector intermediaries. That the West Bengal Government was able to proceed against this firm only under the Prize Chit Act of 1978, against the advice of the RBI, is a sad commentary on the state of the law in this respect. The impotence of the law was further underlined by the pronouncement of the Supreme Court in this case. While the Supreme Court judgement opined that "The FIR bears on its face the stamp of hurry and want of care" the judgement quashing the appeal of the Government hinged on a fine distinction between the following two situations: "A scheme for the making of quick and easy money" and "A scheme for the making of quick and easy money, dependent on any event or contingency relative or applicable on the enrollment of members into the scheme". Only the latter, in its judgement, was a money circulation scheme. Since the FIR did not contain the latter phrase or a phrase with similar meaning, the court held that the FIR could not "form the foundation or constitute the starting point of a lawful investigation". Thus, the case was quashed even though the court accepted the possibility that "interest was being

paid out of capital itself" and stated that "the fact that the accused are indulging in an economic activity which is highly detrimental to the national interest is a matter which must engage the prompt and serious attention of the State and Central governments". From this, the difficulties faced by even well intentioned governments in complying with the strict requirements of Indian Courts should be clear. Besides the courts and the West Bengal Government, it is also the case that "neither the Reserve Bank nor the Central government put its best foot forward when it was alerted about the Sanchaita affair" in the words of an editorial in a leading financial daily (Economic Times, February 10, 1982). The editorial further speculated that "perhaps it was considered prudent to let sleeping dogs lie since politicians and their patrons were involved in the small firms" (like Sanchaita). A recommendation by this editor and other sections of the press for the setting up of a high powered commission of enquiry into the alleged nexus between informal intermediaries, black money and politics has not, as yet, been acted on. Thus, despite the new regulations (chapter 9) and the strengthening of the regulatory machinery, the ability of the authorities to curb fraudulent intermediaries in the future is still open to doubt.

33.3 Peerless general finance and investments limited

33.3.1 While the Sanchaita case related to a (perhaps pardonably) mistaken notion on the part of the regulatory authorities as to the nature of a "money circulation scheme" the Peerless case relates to an inexplicable and even more mistaken notion on the part of authorities as to the nature of a prize chit. Furthermore while Sanchaita was a young firm which undoubtedly engaged in crooked practices, Peerless is a firm of more than 50 years standing. As described below, while Peerless is by no means lily white, in the words of a Supreme Court Justice who heard the case of Reserve Bank of India versus Peerless (Justice V. Khalid) "when the activities of the Peerless and the Life Insurance Corporation are considered juxtaposed, one is tempted to observe that Peerless is less harsh than the Life Insurance

Corporation."³ Furthermore, to set the tone for the case study, the following quotation from the same Supreme Court bench (in this case Justice O. Chinnappa Reddy) is of relevance "we must add here that both sides⁴ talked of the public interest and shed copious tears for the "unfortunate depositors"; but neither side appeared to have any ready plan or even a contingent plan to protect or benefit the depositors. On the one hand, there is a demand for the retributive pound of flesh, unmindful of the future of thousands of employees and the fate of small savings of millions of depositors, all in the name of the interest of the depositors. On the other, having bled the depositors white, there is now a glib and make-believe offer of submission to strict regulation or even nationalisation for the protection, it seems, of employees and depositors".

33.3.2 Background: Peerless was founded in 1932 by one Radhashyam Roy, a school teacher, with a capital of Rs. 300. The company was incorporated in Dhaka (now in Bangladesh) as the Peerless Insurance Company Limited. Its initial business was life insurance. After the nationalisation of life insurance in 1956, the company introduced a number of saving schemes, the most publicised being patterned on a standard endowment life insurance policy but without the benefit of life cover. The company also flirted briefly during the late 60's with general insurance, but this came to an end at the time of nationalisation of general insurance in 1971.

33.3.3 Deposit mobilisation practices: At the time of the Supreme Court case referred to above (in 1987) the endowment certificate scheme was as follows. A fixed annual subscription for a period of 10 to 30 years on the part of subscribers would result

agents.

3. The Life Insurance Corporation of India is the monopoly, public sector life insurance firm in India. This comment was made after a detailed comparison between the two firms and their business.

in a contractual amount being handed over at the end of the contractual period. The annual compound rate of return on the 10 year scheme worked out to be 6.4 per cent. Certificate holders received free accident insurance under a group insurance scheme with the General Insurance Corporation of India. The surrender value of the scheme in case of premature termination of the contract was zero for the first year; 90 per cent of the difference between the total subscription paid and the first year subscription thereafter; and an amount equal to the subscription paid after the seventh year. Policies were to be treated as lapsed if subscription was not paid when due apart from a grace period. Lapsed first year policies had subscriptions forfeited by the company. For the second and third years, policies could either be surrendered or paid back at par at the end of the contract period. For periods above 3 years, policies could either be surrendered or a prorated portion of the endowment sum (less 10 per cent bonus) could be recovered at the end of the contract period.⁵

33.3.4 In the light of the Supreme Court's harsh comments about the nature of this scheme and also the Residuary Non-Banking Companies (Reserve Bank) Directions promulgated in 1987, Peerless has since modified the scheme by increasing the rate of return to 10 per cent per annum (inclusive of bonus); allowing premature withdrawal after 7 years with a 2 per cent interest penalty; abolishing forfeiture; and allowing discontinued certificates to continue to earn interest till the date of maturity (but at lower rates) even if the subscription is discontinued after the first year.

-
4. That is the Reserve Bank and Peerless.
 5. Justice O. Chinnappa Reddy in his Supreme Court judgement compared the stringent terms of the Peerless scheme with the Life Insurance Corporation's Pure Endowment Policy. He concluded: "we do not have the slightest doubt that the terms of the "Table No. 21 Policy" of the Life Insurance Corporation are very stringent and much more to the disadvantage of the subscriber than the terms of the

33.3.5 Subscribers to the Peerless schemes were sought out by its agents from all over India including, allegedly, the remotest rural areas where public sector organisations and banks had not yet reached. Small savers were led to purchase Peerless certificates by dazzling and often misleading advertising, smooth sales talk and - it has been alleged - by sharp practices. Sharp practices are alleged to have included:⁶

- i. Recruitment of agents with political or government connections who could use their influence and contacts to extract subscriptions.
- ii. Recruiting agents closely related to persons in power so that bribes could be paid through the prevailing generous agents commissions by persons in need of favours by the simple expedient of purchasing a Peerless certificate.
- iii. Part time agents such as loan officers of cooperative banks or medical officers making loans/medical services contingent on subscription to a Peerless scheme.
- iv. Using agents of public sector savings organisations to sell Peerless policies while their salaries were paid by the government.

33.3.6 Field agents received 30 per cent of the first year subscription but only 5 per cent of subsequent year subscriptions as commission. This led to a bias among agents to seek out new business and neglect existing depositors. **The total commissions paid to agents at the field level and in the higher tiers of their pyramidal structure averaged about 70 per cent of first year subscriptions in 1979 and had risen to about 82 per cent in 1984 (See Table 33.1 and 33.3) but declined to 80 per cent in 1986.** Total sales of policies had also shown phenomenal growth from Rs. 3.94 crore in 1969 (at face value) to Rs. 460 crore in 1979 to an estimated Rs. 3,200 crore in 1985. Likewise, the total number of new certificates sold rose from 16,000 in 1969 to 14 lakh in 1979 to over 30 lakh policies in 1985. The total field staff also increased by leaps and bounds to nearly four lakh agents in 1985 ac-

endowment scheme of the Peerless Company".

6. Points (i) and (iv) taken from the RBI Inspection Report (1979) and points (ii) and

ording to claims made by the company.⁷

33.3.7 While the achievements of Peerless in the mobilisation of small savings and in employment generation are remarkable and may contain some lessons for the banking sector and other formal sector savings institutions, the malpractices by this company are equally remarkable. The result of the lopsided structure of commission for field agents and also - one suspects - the result of deliberate company policy was a high lapse rate of certificates after the payment of first year subscription. This resulted in a substantial inflow of unencumbered funds into company coffers through forfeiture of subscriptions. Table 33.2 provides details of the percentage and value of lapsed certificates as compiled by the Reserve Bank of India. As can be seen, 48 per cent of certificates lapsed on average.⁸

33.3.8 For policies which did not lapse, the situation was not without risk. While it is true that Peerless had an investment portfolio largely consisting of gilt-edged securities, the normal precaution against moral hazard through a substantial ratio of own to borrowed funds was lacking. As shown in Table 33.3 own funds formed about 1 per cent of total capital implying an abnormally high debt-equity ratio even for a deposit accepting non-bank company.

33.3.9 Uses of funds: As shown in Table 33.3, nearly 90 per cent of the funds available with Peerless were invested in securities,

(iii) from The Telegraph, March 21, 1986.

7. 1986 is the most recent year for which the company supplied its annual report to us. Figures reported here are not available in the two most recent reports.

8. The figures in column 6 are computed by us from company financial statements as per note 2 of the table. These figures, though crude estimates with substantial margin of error are even more astonishing. As per figures given by Justice Reddy, The Life Insurance Corporation had 33 per cent and 31 per cent of their new policies lapsing and/or for-

the bulk being government securities and fixed deposits with nationalised banks. The amount invested is in excess of their secured loans and deposits outstanding.⁹ Peerless is in the habit of giving wide publicity to the fact that contractual liabilities to depositors were more than fully covered by, not just its total investment portfolio, but even by its portfolio of government securities and nationalised bank fixed deposits. However, due to the accounting practices followed by Peerless - a practice also followed by the Life Insurance Corporation, and reportedly, common to insurance companies - first year subscriptions were shown as income of the company and not as liabilities. Instead, just prior to the time of maturity of policies which had not lapsed, a provision was made in the liabilities account for matured certificates. This had the effect of enlarging the profit figures of Peerless and also concealing the "true" extent of their liabilities. Table 33.4 presents the ratio of investments to deposits including first year deposits. As can be seen, this ratio was less than 100 per cent till 1985. Thus, even ignoring the low current ratio (Table 33.3), upto 1985 the company was not in a position to honour all its obligations to depositors solely from disposal of investments in case of its winding up.

33.3.10 While it is true that savings with Peerless fetched only 6.4 per cent per annum till recently, even so, the spread between its borrowing rate and rate of return on investments was small given its high rates of commission to agents. Table 33.5 gives the estimated yield on the Peerless investment portfolio.¹⁰ It is instructive to estimate the required break even rate of return on all Peerless investments, given its outstanding deposits, under the assumption that no policies lapse. This is done in Table 33.6. The table shows that, since, on average, 54

fetched in 1982-83 and 1984-85 respectively.

9. Which included accrued interest and provisions for paying matured certificates.
10. The inclusion of fixed assets and rental or other income on fixed assets does not change the picture in view of the small size of

per cent of total subscriptions received in a year were spent, the required annual rate of return on the total asset portfolio of Peerless was 21.6 per cent as compared to an actual yield of 10.4 per cent in 1986. However, if the fact that on average 48 per cent of first year subscriptions lapsed is taken note of, the required rate of return works out to be 15 per cent. These figures are biased downwards due to 2 reasons. First, current liabilities include a small amount of subscriptions received but not included in secured loans and deposits, due primarily to incomplete application forms.¹¹ It also includes an item relating to outstanding commissions (See table 33.3 at 3.1 and 3.2). Thus both deposits and expenditure figures used by us are biased downwards, the bias in expenditures being much greater than that in deposits. Secondly, secured loans and deposits include accrued interest and provision for matured deposits. Since the business of Peerless has been growing, this imparts a proportionate upward bias to the deposit figures. However, even without making these corrections, - information is not available for all years - that the hypothesis that Peerless would be in financial difficulties in the absence of lapsed policies finds support is clear. The situation must be even worse after the recent abolition of lapsing. That the rate of return required for break-even, even after considering only 52 per cent of first year subscriptions as liabilities (and subtracting 48 per cent of this item from expenses to arrive at net expenditure), exceeds its actual return reveals another important feature. It is likely that despite the many policies lapsing, Peerless must still use additional funds, such as from its subscriptions, to meet interest payments.¹²

fixed assets.

11. RBI Inspection Report, 1979.

12. A more sophisticated approach to calculating the required rate of return on Peerless investments taking into account deposit growth and the maturity structure of investments was also tried. Analytically, the approach used here is valid only when the deposit growth rate and the rate of return on its investments are equal. If the latter is less than the former, then it would be optimal for the

33.3.11 Regulation and control: The chronology of regulatory actions in the two cases for which studies are presented here underlines the seriousness of the gaps in the regulatory framework covering non-bank financial intermediaries. While part of the failure could be due to defects in the legal structure, the failure must be partly attributed to administrative lapses and ineptitude as brought out in the court's judgement in the Sanchaita case. The current chapter begins in 1973 when the Miscellaneous and Non-Banking Companies (Reserve Bank) Directions under the RBI Act of 1934 came into force. Under clause (4) of these Directions, Miscellaneous Non-Banking Companies were restricted to accepting deposits equal to no more than 25 per cent of net owned funds. Miscellaneous non-banking companies included conventional and prize chits. The RBI sent a notice to Peerless to comply with these directions. Peerless, while reserving their right to dispute this classification, requested the RBI for exemption from this Provision in view of its 'sound' business practices and excellent small savings mobilisation and employment generation record. This was granted by the RBI subject to 4 conditions:

- i. 50 per cent of after tax profits should be transferred to reserves every year. (A provision that had clearly turned out to be ineffectual).
- ii. Its dividends should be at most 6 per cent on ordinary shares and 7 per cent on preference shares.
- iii. At least 75 per cent of its assets should be in fixed deposits with nationalised banks or government securities.
- iv. Peerless should submit a certificate from its auditors certifying compliance with (i) to (iii).

The exemption was to be reviewed every two years.

33.3.12 In 1977, the RBI revised its 1973 Directions and imposed a ceiling of 36 months on the contractual period for deposits.¹³

firm not to invest but simply to pay interest out of deposit growth. Any investment reduces its financial viability.

13. This followed in the wake of severe criticism of prize chits by the Reserve Bank's Study

Peerless once again applied for exemption stating that a three year endowment scheme was not financially viable. This was, refused. However, Peerless continued to sell its endowment scheme taking advantage of the slow speed at which letters between itself and the RBI were being exchanged. In the meanwhile, in January, 1978, the Reserve Bank, in an affidavit-in-opposition to a writ petition by Favourite Small Investment Private Limited at Calcutta High Court alleging discrimination between itself and Peerless, certified that Peerless was a sound firm with a scheme based on scientific actuarial principles.

33.3.13 In 1978, when the Prize Chit (Banning) Act was passed, the RBI decided to undertake a detailed inspection of the company before taking any decision on its future. The inspection report which was submitted in May 1979 was highly critical of Peerless and condemned inter alia

- i. its accounting practices
- ii. its policy lapse rate
- iii. its commission structure
- iv. and its appointment of agents with high social and political connections.

33.3.14 Stories allegedly 'leaked' to newspapers by certain RBI officials also pointed out that several of its dealings were illegal (as discussed by us earlier) but cleverly concealed.

33.3.15 Accordingly, in July, 1979 the RBI withdrew the exemption granted to Peerless in 1973 and the West Bengal Government ordered Peerless to wind up its operations. A similar notice was sent to Peerless by the Madhya Pradesh Government in 1980.

33.3.16 Thereupon, Peerless moved the Calcutta High Court (under article 226 of the constitution) challenging the validity of the order and obtained an interim stay order. The case was finally disposed of by the Calcutta High Court in 1986 wherein the order of the West Bengal Government was upheld. On appeal, a three member division bench of the same Court overruled the earlier judge-

ment. An incredible situation arose during the appeal whereby there were contradictory claims by the State governments and the Reserve Bank. The former alleged that Peerless was a money circulation scheme, while the latter called it a prize chit company! In his summation, Justice A.K. Sen of the Calcutta High Court observed that the Reserve Bank could exercise control over Peerless under residuary clause 19 of the Non-Banking Financial Companies (Reserve Bank) Directions, 1977, as amended in 1978, even though it was not a prize chit company. Both stipulations - as to quantum of deposits in relation to net owned funds and as to duration - were present in these directions for residuary companies.

33.3.17 In 1987, the Supreme Court quashed an RBI appeal against the Calcutta High Court judgement while, at the same time, urging the RBI to take steps to curb the activities of unscrupulous firms such as South Indian 'blade' companies and, indirectly, Peerless. The opinion of the Supreme Court on Peerless's practices has already been covered earlier.

33.3.18 The RBI's next move was to attempt to regulate Peerless under the residuary clause 19, against which Peerless once again moved the courts. Meanwhile, the RBI issued a new set of Directions called the Residuary Non-Banking Companies (Reserve Bank) Directions, 1987. In these directions, the maximum period of deposits was increased to 120 months and an interest floor of 10 per cent per annum was laid down. The RBI also dropped the net owned funds to deposit ratio stipulation but laid down that 10 per cent of deposits were to be in fixed deposits with public sector banks and 70 per cent in approved securities. At most 20 per cent or 10 times the net owned funds (whichever was less) could be in other investments. The method of calculating total deposits was also laid down and forfeiture was abolished.

33.3.19 Aftermath: The stringent financial controls imposed by the RBI - after its earlier errors - appear to have had an impact on the management of Peerless. Among the several facts and rumours appearing in the press are the following.

- i. In 1987, the family who held the major block of Peerless Stock sold a large block to the Nicco Groups of Companies. This resulted in a major reconstitution of the board of directors and the introduction of several managerial innovations. However Nicco pulled out of the company after only 7 months due to "differences in the style of management"! The shares were sold by it to a well known real estate developer.
- ii. Both the company and its workers unions, had separately in 1986-87 asked the government to nationalise Peerless. In 1988 however Peerless and the various unions concluded a collective agreement which could end their labour troubles.
- iii. The son-in-law of the late B.K. Roy, who headed Peerless for a quarter of a century, resigned his post as the managing director of a large professionally managed firm to take over the helm of Peerless.
- iv. Peerless is reported to be going into housing finance and the purchase of real estate in a big way. It is also reported to be lending large sums on the intercorporate funds market. In 1987 and 1988, Peerless set up three subsidiaries, Peerless Drive (P) Ltd., Peerless Developers Ltd. and Peerless Financial Services Ltd. The former is engaged in oil drilling or its financing and the second in the housing industry.
- v. In 1987, the income tax department raided the houses of the directors of Peerless and various company offices. The results of these raids are not known.
- vi. On 31 March, 1988, the results declared by Peerless showed a rebound in funds outstanding in their Social Welfare Fund Scheme from Rs 593 crore to Rs 883 crore. However their liability as to formerly lapsed certificates was still under ascertainment.
- vii. A new 10 year saving schemes the 'Pragati Patra' apparently patterned on the Government's Kisan Vikas Patra was introduced with an annualised rate of return of 11.6 per cent. The scheme allows for loans against the amount invested and medical insurance benefits.

It is clear that Peerless is still thriving after a small set back in its performance.

33.4 The main issues

33.4.1 The Sanchaita case was one of a company which engaged

in outright fraudulent dealings. In the process of bringing it to book the various regulatory authorities proceeded in a manner which showed a degree of discomfort with of the law and lack of coordination between different agencies. The case study, therefore, throws up the following issues.

- i. How can the regulatory authorities ensure that such fraudulent companies are not able to obtain deposits from the public?
- ii. How can the authorities ensure that savers are better informed as to the quality of different channels of saving and the probity of financial intermediaries?
- iii. How can authorities ensure that funds available to informal intermediaries do not finance the underground economy?
- iv. At the same time how can the regulatory authorities ensure that the healthy growth of financial markets is not stifled?
- v. Can anything be done to ensure that if, despite all precautions, a questionable organisation comes into existence, corrective action will not be marred by the kind of problems which arose in bringing Sanchaita to book?

33.4.2 The Peerless case leads to certain additional issues. While items (ii) to (v) above are questions which can also be raised equally validly in the case of Peerless, whether or not Peerless finances the underground economy, additional issues relating to proper financial reporting and monitoring by the Reserve Bank and the proper classification of informal intermediaries for the purpose of monitoring and control arise as well. That our analysis, performed solely on the basis of company financial statements, points to the possibility that Peerless was paying old depositors from new subscriptions - a hypothesis not mentioned in the RBI inspection report - also throws up the need for properly designed inspection and audit procedures. This point is underscored dramatically by the fact that Peerless was given a clean chit by the RBI during the Favourite Small Investments case. These questions have been dealt with in an earlier chapter (Chapter 15) and is not repeated here.

TABLE 33.1

**Ratio of Agent's Commissions and Bonus
to First Year Subscriptions**

1978	1979	1980	1981	1982	1983	1984	1985	1986
77.17	77.55	81.42	81.58	81.57	82.40	82.02	79.91	79.90

Source: Computed from Annual Reports of the company.

TABLE 33.2

Details of Certificates Lapsed

Year	Number of cer- tifi- cates	Amount of certifi- cates (Rs.lakh)	Percentage of lapsed certi- ficates (%)		Percentage amount lapsed to first year subscription
			Number	Amount	
(1)	(2)	(3)	(4)	(5)	(6)
1971	12503	360.38	48.27	48.96	-
1972	24545	802.16	46.66	47.18	-
1973	66606	2102.96	53.49	50.88	-
1974	NA	NA	45.20	45.80	-
1975	NA	NA	48.50	48.20	-
1976	NA	NA	50.20	47.60	-
1977	NA	NA	NA	NA	-
1978	NA	NA	NA	NA	-
1979	NA	NA	NA	NA	-
1980	NA	2121.86	NA	NA	76.91
1981	NA	3704.25	NA	NA	92.40
1982	NA	6124.71	NA	NA	71.50
1983	NA	NA	NA	NA	NA
1984	NA	NA	NA	NA	NA
AVE. % FOR AVAILABLE YEARS			48.72	48.10	80.26

- Notes: 1. Figures in columns (4) & (5) for 1974-76 are RBI estimates.
 2. Col.(6): First year subscription (FYS) less increase in renewal subscription in the next year as a % of FYS.
 3. 1983 Annual Report unavailable to us so that Col. (6) for 1983 and 1984 could not be computed. Between 1985 and 1986 renewal subscriptions decreased.

Sources: 1. RBI Inspection Report, 1979.
 2. Annual Reports of the Comany.

TABLE 33.3

**Financial Structure of Peerless: Financial Years
1983 to 1986**

	(Percentage)			
	1983	1984	1985	1986
Sources of Funds				
1. Share capital, resources and surplus	1.11	1.11	1.07	1.06
2. Secured loans and deposits	75.85	76.76	76.27	72.36
2.1 Of which renewals	N.A.		17.10	7.11
3. Current liabilities and provisions	22.92	22.13	22.66	26.58
3.1 Of which subscription deposit	1.46	1.38	1.41	2.14
3.2 Outstanding commission	17.71	17.02	11.96	9.43
Uses of Funds				
4. Fixed assets	2.58	1.97	1.64	1.51
5. Investments	87.88	89.19	89.91	87.64
5.1 Of which investments in government securities or fixed deposits with nationalised banks	86.51	87.68	89.70	86.41
6. Current assets, loans and advances	9.94	8.84	8.45	10.85
Income				
7. First year subscription (less refunds and provisions)	80.76	75.41	61.47	30.66
8. Other income	19.24	24.59	38.53	69.34
Expenditure				
9. Commissions, etc. to field force	66.55	61.85	49.12	24.49
10. Management expenses	10.82	10.35	11.86	18.86
11. Interest paid and accrued	19.00	23.11	34.47	50.34
12. Other expenses and depreciation	0.29	1.85	1.96	2.56
13. Profit before tax	3.34	2.84	2.59	3.75
14. Current ratio(%)	44.34	39.95	37.31	40.84
15. Ratio of first year subscription to secured loans and deposits(%)	38.73	27.47	16.66	5.41
16. Ratio of 9 to 7 (%)	84.20	82.02	79.91	79.90

Source: Annual Report of the Company.

TABLE 33.4

**Investments and Total Non-current Assets as a
percentage of Total Deposits (1978 to 1986)**

Year	Investment as a percentage of deposits	Fixed assets +investment as a percentage of deposits
1978	77.5	79.28
1979	78.9	80.15
1980	78.0	79.09
1981	80.5	81.50
1982	78.1	80.42
1983	83.5	85.98
1984	91.2	93.17
1985	101.04	102.89
1986	114.89	116.87

Note: Deposits include first year
subscriptions and secured
loans and deposits.

Source: Annual Reports
of the Company.

TABLE 33.5

Average Yield on Investments

Year	Interest and dividends earned (Rs.lakh)	Investments (stock) (Rs.crore)	Average yield (2/3 in per cent) ¹
(1)	(2)	(3)	(4)
1977	184.04	35.13	8.4 ²
1978	301.45	45.90	8.6
1979	475.53	72.25	10.4
1980	773.79	111.77	10.7
1981	1135.65	185.22	10.2
1982	1954.47	279.87	10.6
1983	3048.48	387.42	10.9
1984	4085.68	534.90	10.5
1985	5965.16	676.66	11.0
1986	7033.89	717.91	10.40

Notes: 1. This has been calculated by dividing the interest and dividend earned during the year by the investment outstanding at the end of the previous year.

2. As quoted in the RBI inspection report.

Source: RBI Inspection report and annual report and accounts of the company.

TABLE 33.6

**Computation of Break Even Rate of Return
on Peerless Investments**

(Rs. crore)

Part I						
Year	Total expen- diture	Secured loans and deposits	First year subscr- ptions	Increase in (3)	(4)+(5)	(2)/(6)
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1978	16.17	42.08	17.16	-	-	-
1979	26.16	64.03	27.59	21.95	49.54	0.5281
1980	45.59	95.18	48.07	31.15	79.22	0.5755
1981	78.33	144.33	85.70	49.15	134.85	0.5809
1982	118.04	229.04	129.23	84.71	213.94	0.5517
1983	124.54	334.33	129.50	105.30	234.80	0.5304
1984	124.19	460.35	126.47	126.01	252.48	0.4919
1985	97.90	574.06	95.62	113.71	209.33	0.4677
1986	47.99	592.81	32.05	18.75	50.80	0.9446
				Average:	0.5838	
				Average considering only 52% of (4) and adjusting expenditures accordingly:	0.3881	

Part II

- Total amount due to a policy holder for an endowment plan with subscription of Re.1 annually at the end of ten years (at 6.4% per annum) = $(1.064) (1.064)^{10} - 1 / 0.064 = \text{Rs } 14.29$
- Total earnings on investments required for break even (S):
 $S = \text{Rs } 14.29 / (1 - 0.5424) = \text{Rs } 34.33$
- Required annual rate of return (r):
 $S = (1+r)((1+r)^{10} - 1) / r$; Therefore, required annual rate of return: $r = 21.6\%$.
- If 48% of first year subscriptions lapse: $S = \text{Rs } 23.35$ and $r = 15.0\%$

Notes: (1) The increase in secured loans and deposits is used as a proxy for the net inflow of subscriptions excluding first year subscription. Source: Annual Reports of the Company.

APPENDICES AND BIBLIOGRAPHY

**INDIGENOUS FINANCIAL INSTITUTIONS IN URBAN INDIA:
A REVIEW OF THE LITERATURE**

A2.1 Introduction

A2.1.1 The Indian financial market may be divided into two segments. The formal credit market consists of the commercial banks, co-operatives banks, development banks and other financial institutions like investment companies, insurance companies. The informal credit market (ICM) includes indigenous bankers, moneylenders, finance companies, chit funds, nidhis and so on. The dividing line used in this note takes into account whether the Reserve Bank of India imposes interest rate controls or reserve requirements on the institutions. If so, the sectors are treated as within the formal market. Whereas the operations of the formal sector are well documented, the same is not the case with the informal sector. The exact size of or volume of credit extended by the informal sector or their structure of interest rates is not well documented. A few estimates have been made by various studies, the estimates being localised or dealing with a particular indigenous financial institution. Timberg and Aiyar (1980), one of the few all-India studies of the ICM, estimates that about 30 per cent of working capital in India is financed by the 'legal' informal sector. Goldsmith (1983) attributes a much smaller share to the informal market.

A2.1.2 Here we shall be dealing with various aspects of the ICM - their operations, sources and uses of funds, the structure of interest rates prevalent at various centres and establishment costs - as evidenced by the literature available on the subject.

A2.1.3 Section A2.2 describes the various indigenous financial institutions. Sections A2.3 and A2.4 deal with their functions and sources of funds. Sections A2.5, A2.6 and A2.7 describe respectively the types of credit extended and its uses, the structure of interest rates and establishment costs and default losses of these agencies per se and in comparison with the commercial banks. Section A2.8 contains conclusions.

A2.2 The main intermediary groups and their lines of business

A2.2.1 The ICM in India is composed of different types of agencies catering to specified clientele. Each group of agencies has its own method of operation though their functions overlap. Six groups are most prominent in the literature:

- i. Indigenous bankers,
- ii. Chit funds,
- iii. Nidhis,

- iv. Hire purchase companies,
- v. Finance corporations, and
- vi. Moneylenders.

A2.2.2 Most of these agencies have long histories except for hire purchase companies, which developed after World War I, and finance corporations which developed during the sixties.

A2.2.3 Details of the number of indigenous financial institutions between 1955 and 1980 are in Table A2.1. Moneylenders, followed by pawnbrokers, can be seen to predominate.

A2.2.4 Indigenous bankers Indigenous bankers came from the trading castes or groups of trading castes from different regions - 'Gujaratis' from south Gujarat, 'Shikarpuris' (Multanis) from Sindh, 'Marwaris' from north and west Rajasthan, 'Rastogis' from the Oudh regions of Uttar Pradesh and 'Chettiars' from the Chettinad region of south India. They all accepted deposits, issued and discounted bills of exchange and other commercial paper, provided credit and gave letters of credit to merchants requiring finance at various trade centres. Marwaris and Chettiars spread all over India, and also overseas, initially catering only to their compatriots, but later to a more cosmopolitan clientele.

A2.2.5 **Shikarpuris** originate from Sindh, where they were local bankers. They came a century ago to Bombay which is still their main centre, though they have spread to Madras, Salem, Calicut, Vijaywada, Bangalore and Coimbatore. They are the most widely known among indigenous bankers (Timberg and Aiyar, 1980). There were a total of 600 firms in 1979 who were members of the Shikarpuri Bankers' Association and an equal number of non-members (Timberg and Aiyar, 1980) as opposed to an estimated 800 at the end of 1969 (Government of India, Banking Commission, 1971). The average firm had a capital of Rs. 10 lakh and relied mainly on own capital. With refinance facilities from banks being reduced, the Shikarpuris had diversified into instalment financing, especially in South India.

A2.2.6 **Gujarati Shroffs:** They are among the most ancient of Indian bankers and are well organised, traditional family firms. Some of their 'pedhis' (offices) are 150 to 200 years old (Banking Commission, 1971). They operate in Bombay and Ahmedabad and have an extensive network covering all districts of Gujarat and Bombay city. They are of two types: pure bankers, who are mainly found in Ahmedabad, and those who combine banking with trade as commission agents. There were a total of more than 4000 Gujarati Shroffs with 1500 pure shroffs in Gujarat and 6 of them in Bombay city, the latter each having several branches in Gujarat, in 1979 (Timberg and Aiyar, 1980). They were mainly organised as partnership firms. The Banking Commission (1971a) estimated a total of 350 Gujarati firms: 150 pure bankers in Ahmedabad and 200 shroffs, mainly of the second type, in Bombay. The 1000 or so shroffs who also do commission agency business are either purchasing commission agents, who provide consumer goods to urban and rural merchants on credit (charging interest, commission and other incidental charges) or selling commission agents, who give advances to

up-country clients of about 80 per cent of the value of goods ordered against railway receipts (Timberg and Aiyar, 1980). Most Gujarati shroffs specialise in a single commodity.

A2.2.7 Marwaris: They operate mainly in Bombay and Calcutta and combine banking with trade, credit transactions being ancillary to trade. There is also a group called Marwari 'Kayas' of whom little is written though they have been operating for over a century in tea estates, mostly in upper Assam. There were about 400 in 1969 (Banking Commission, 1971a). They are mostly traders having shops on estates and they render banking facilities to the estate manager and workers and also, in some cases, to neighbouring tea estates.

A2.2.8 Chettiars: The name is derived from 'chetti' a trading and business community among the Hindus. They migrated from Veddranyam and Kaveri-pun-pattinam (capital of the 3rd century B.C. Chola Kings), where they largely engaged in trade in salt with the Fiji Islands, into Chettinad where they spread over 78 villages of two districts, Ramnad and Padukottai. Over the last 150 years they emigrated to Burma, Malaysia, Singapore and Sri Lanka and established themselves as prosperous businessmen. Besides Chettinad, they scattered in small towns throughout Tamilnadu (Timberg and Aiyar, 1980). Important banking centres of the Chettiars were Pudukottai, Tanjore, Coimbatore, Trichy, Madurai, Karaikudy, Virudhnagar and Salem. They numbered about a lakh in India in 1979 (Timberg and Aiyar, 1979). Chettiars are principally moneylenders - giving loans against security - but a large number accept deposits and finance trade transactions.

A2.2.9 Rastogis: Rastogis, from the Oudh region of Uttar Pradesh, are the most prominent among various castes such as Agarwals, Khattris and Kayasthas engaged in moneylending in this State. Important centres of operation of Rastogis are Lucknow, Varanasi, Farukhabad and Moradabad (Timberg and Aiyar, 1980). Rastogis accept deposits and give loans. In Lucknow alone there were 500 of them engaged in banking in 1979. They have now mainly diversified into hire purchase financing of transport vehicles.

2.2.10 Chit funds, nidhis, hire purchase finance companies and finance corporations: These informal intermediaries have been described in detail in the opening sections of the relevant case studies in Part F of the report. The number of reporting chit fund companies had increased from 97 in 1967 to 541 in 1982 while the chit subscription has increased from Rs 0.34 crores in 1967 to Rs 208.06 crores in 1982 (Nayar, 1986). According to Nayar (1986) 75 per cent of the chit funds are in South India. There were an estimated 150 Nidhis operating at the end of 1966 with total assets of about Rs 25 crores (Banking Commission, 1971). Finance corporations are recent financial intermediaries which originated in Madanapalle in Andhra Pradesh in 1960 and have spread to Tamilnadu, Kerala, Karnataka, Punjab, Gujarat and Madhya Pradesh. According to Nayar (1982), 90 per cent of these companies are in South India while their population was estimated at 2200 firms by Timberg and Aiyar (1980).

2.2.11 Moneylenders: Indigenous moneylenders can be classified as urban and rural each of which can be further grouped into professional and non-professional (Karkal, 1967). Professional moneylenders are those whose sole occupation is moneylending. Non-professionals include pawnbrokers, merchants, traders and 'others' in urban areas and landlords, merchants, and other agriculturists in rural areas. 'Others' include widows, retired Government personnel and, in some cases, church and temple authorities who lend on promissory notes (Karkal, 1967). Rural loans may be in cash or in kind.

A2.3. Functions

A2.3.1 Indigenous bankers: Indigenous bankers perform various functions like receiving call money and short term deposits, remitting money, buying and selling hundies, discounting commercial paper and cheques, giving commercial guidance and offering transient accommodation to out of town clients and associates. Some even provide long term capital to industrialists. Gujarati shroffs also act as commission agents for up-country clients. Bankers lend money with or without security except for Chettiars, who always require a security. Shikarpuris, Chettiars and Rastogis provide hire purchase credit for old and new vehicles and consumer durables. About 25 per cent of Rastogis are pawnbrokers. (Timberg and Aiyar, 1980).

A2.3.2 Moneylenders: Village moneylenders usually advance loans in both cash and kind, whereas urban moneylenders only advance cash. The village moneylender also acts as an agent for the town moneylender - supplying the latter with agricultural produce and raw materials. The village trader, when lending in cash or kind, typically stipulates that borrowers should sell their produce to him or through him at an agreed price. Pure moneylenders and merchant moneylenders finance trade and commerce. Their loans facilitate the transfer goods from one centre to another. (Karkal, 1967 and Banking Commission, 1971).

A.2.4 Sources of funds

A2.4.1 Indigenous bankers have large working capital bases consisting of both of owned and borrowed funds - though the ratio of owned to borrowed funds varies from group to group. The Shikarpuris mainly use their own funds and accept limited deposits from friends and relatives. They also borrow from commercial banks. The ratio of their own funds to borrowed funds varies from 1:1 to 1:5 (Timberg and Aiyar, 1980). Advances to Multani shroffs by scheduled and non-scheduled banks for the period 1964 to 1970 showed an upward trend from 1967 to 1970 (Table A2.2) but has since, it is reported, declined. Advances were made basically by discounting hundies. Pure Gujarati shroffs accept deposits from the public both on current account and for fixed periods. Demand liabilities constitute over 70 per cent of their total deposits (Timberg and Aiyar, 1980). They also borrowed from commercial banks in the past, though this source is limited. They have an indigenous call market for short term funds, which is a very impor-

tant source of funds for these shroffs. Chettiars operated mainly on their own funds though they did accept deposits, usually term deposits, of three months or more. Their borrowed funds were 15 per cent of their owned funds in 1970 (Banking Commission, 1971). Their capital deposit ratio, as estimated in the Timberg and Aiyar (1980) study, was 2:3. They accept deposits, mainly time liabilities, for fixed periods of upto 5 years. Demand deposits are not significant. The capital-deposit ratio of Rastogis varied from 1:4 for large firms to 1:1 for smaller firms in 1979 (Timberg and Aiyar, 1980).

A2.4.1 Deposits accounted for 82 per cent of total liabilities of nidhis in 1965-66 and about 84 per cent in 1977-78 (Radhakrishnan, 1979). Of deposits, the share of recurring deposits has fallen over the years, whereas that of fixed deposits has increased from 46 per cent in 1965-66 to 66.3 per cent in 1977-78 (Radhakrishnan, 1979). The major source of funds for finance corporations were fixed deposits from the public. Savings deposits, cumulative, seasonal, call, lucky, trust and life deposits were some of the other types of deposits accepted. Their capital-deposit ratio was, on average, 1:6 in 1979 (Timberg and Aiyar, 1980). Term deposit made up 97 per cent of the deposits of finance corporations in South India (Nayar, 1982).

A2.4.2 Moneylenders operate mainly with their own funds. A very small number of moneylenders may accept deposits, but this forms, at most, 20 per cent of their own capital (Banking Commission, 1971).

A2.4.3 No comprehensive time series data is available on the composition of funds from various sources for the different indigenous financial institutions. Historical details of deposits with some indigenous financial agencies are in Table A2.3.

A2.5 Type of credit and end-use of funds

A2.5.1 Indigenous bankers usually gave short term loans so as not to keep their capital tied up for too long. They mainly financed internal trade and provided working capital to commercial and business concerns including small industries. Table A2.4 gives the purpose-wise distribution of credit of some indigenous financial institutions.

A2.5.2 **Shikarpuris** lend almost solely for working capital. Funds were loaned to meet trade and production requirements, for bridge finance or to meet margin requirements for bank finance. The most commonly used instrument was the usance hundi or promissory note, which is a 90 days credit bill. In Bombay, Shikarpuris lent only on 90 day term notes whereas, in the South, funds were provided on an instalment payment basis. These instalments, against promissory notes, constituted about 45 per cent of total advances in 1979. Interest was deducted in advance. Shroffs that were not members of shikarpuri associations lent mainly through promissory notes or demand notes supported by post-dated cheques. Shikarpuris generally did not lend more than 25 per cent of the net worth of the borrower. For large loans, a number of Shikarpuris pooled

their resources. (Timberg and Aiyar, 1980).

A2.5.3 Gujarati shroffs lent with or without security for working capital and mainly to traders. According to Aiyar's estimate, 60 per cent of their credit went to trade (See Table A2.4). They operated through brokers in the larger centres while in the smaller centres, direct advances were made. The average size of advances ranged from Rs 50,000 to Rs 1 lakh per borrower and 60 per cent to 70 per cent of their business was through hundies (Timberg and Aiyar, 1980). They remitted funds by using 'darshani' (sight) hundies and cheques on outstation banks. They financed retail trade, commerce and small-scale industries, lending mainly to Gujarati traders and covering nearly all commodity markets.

A2.5.4 Short term trade credit through hundis by indigenous bankers for the period 1949 to 1961 increased from Rs 22.32 crore to Rs 288.68 crore (Table A2.5). The volume of transactions is reportedly lower now due to Reserve Bank regulation.

A2.5.5 Chettiars engaged in moneylending, pawn-broking and banking (Timberg and Aiyar, 1980). They financed businessmen on the basis of hundies, promissory notes and hire purchase agreements. They gave short term loans, which were repayable in instalments, and also financed high risk ventures like film production.

A2.5.6 Rastogis directed advances and loans to traders and artisans and gave hire purchase credit. A few were pawnbrokers. Advances were usually given directly to traders and to artisans mainly through traders. Most of these loans were made without tangible security. Their main area of activity was hire purchase financing of transport vehicles, though the survey estimates of Aiyar shows that 55 per cent of the Rastogi's credit goes to trade (Table A2.4).

A2.5.7 Chit funds were usually used for consumption, social events, jewellery, housing, medical care and other personal expenditure and rarely for investment in industry, though some loans were used for commerce.

A2.5.8 Nidhis usually give long term loans on security to their members. The loans are mainly for house construction, domestic or social functions, repayment of prior debts, extension and repair of house properties and medical expenses. A negligible amount is also lent to agriculture, industry and commerce. Radhakrishnan (1979) estimated that only 7.7 per cent of advances of 15 nidhis went for investment in business, 23.5 per cent for construction, purchase and repair of houses while the rest was used for consumption.

A2.5.9 Hire purchase companies mainly lent for purchase of new and old vehicles, consumer durables and equipment for professionals like doctors, engineers and scientists, much as at present.

A2.5.10 Finance companies gave loans to wholesale and retail traders, small scale industry and self-employed persons. A negli-

gible amount went to agriculture. The credit mainly went to cloth merchants (silk) and traders dealing in food grains and oil (Banking Commission, 1971). They often gave loans to borrowers whom banks had refused and to traders dealing in commodities covered under selective credit controls (Bhole 1982 and Timberg and Aiyar, 1980). Loans were usually short term and unsecured (not exceeding 90 days) but were renewable. They also gave hire purchase credit for old and new vehicles and other consumer durables. Loans were usually given on the basis of the partners' personal knowledge of the creditworthiness of the borrower. Shares, jewellery, property or any other tangible assets were taken as security from unknown borrowers in a few cases (Nayar, 1982).

A2.5.11 **Moneylenders** usually gave short term loans, (4 to 6 months). Urban moneylenders operate in taluka headquarters or at certain commercial or industrial centres. Pure moneylenders and merchant-moneylenders mostly financed trade and commerce through unsecured loans. Consumption loans were rarely given on a large scale. The 'Other' class of moneylenders essentially gave petty unsecured consumption loans to workers and labourers.

A2.5.12 Table 32.1, in chapter 32 above, and the discussion regarding deployment of bank credit there, documented the limited role played by banks in certain sectors especially trade. The break up of total bank credit, given in Table A2.6, provides additional information on the deployment of bank credit up to 1985.

A2.5.13 Trade is the sector which draws the most on the informal credit market. Cloth wholesalers and large dealers in Kanpur and Amritsar borrow large amounts from informal sources - as much as 50 per cent of working capital during the peak seasons - since cloth trade did not get much bank credit due to selective credit controls prior to 1985. Traders dealing in oil and foodgrains also borrowed from informal sources. Other major segments financed by the informal credit markets are leather tanneries, handloom/powerloom owners, beedi merchants, small pharmaceutical manufacturers, self-employed persons, hoteliers, small restaurant owners, contractors and also some exporters. (Timberg and Aiyar, 1980)

A2.6 Structure of interest rates

A2.6.1 Interest rates charged varied between different financial institutions and also between different regions. In general, **brokers** lent at the rate of 18 to 24 per cent per annum to larger established traders, with 18 per cent as the norm, and to smaller traders and artisans in the range 24 per cent to 35 per cent per annum (Timberg and Aiyar, 1980). Higher rates were generally prevalent in South India which also has a larger number of informal institutions.

A2.6.2 Interest rates differed substantially from city to city and show the localised and segmented nature of the informal credit market. Table A2.7 gives the effective rates charged by the indigenous financial institutions at various centres. Nominal interest rates are given in Table A2.8.

A2.6.3 **Shikarpuris** in Bombay charged Rs 1.70 per month (Timberg and Aiyar, 1980). Taking into account that interest was paid in advance, the effective rate becomes 23.3 per cent per annum (Table A2.7). In Madras the rate was 2.3 per cent per month (33.1 per cent per annum). In the smaller towns of South India, the effective rate varied from 24 per cent per annum to 32.3 per cent per annum in 1971, while the effective rates in Bombay, Madras and Bangalore were 17.6 per cent, 25.3 per cent per annum and 19.4 per cent respectively (Banking Commission, 1971). Interest rates in metro areas appear, from this, to have been lower than in non-metro areas.

A2.6.4 **Gujarati shroffs** charged a modal interest rate of 18 per cent per annum in the seventies though there was some variation across centres and types of loans. The interest rate charged by **Chettiars** on hundis or promissory notes was normally about 24 per cent per annum and not less than 18 per cent per annum (Timberg and Aiyar, 1980). Loans repayable in instalments earned them 47 per cent while the annual rate for short term advances of 200 days or less and repayable in daily instalments was 38 per cent per annum. The rate on hundis in 1971 was 21 per cent per annum plus brokerage and stamp duty (Banking Commission, 1971). Rastogis lent at a rate not less than 24 per cent. The effective rate calculated was 37 per cent per annum on hire purchase financing in Uttar Pradesh. **Marwaris** doing multani type business in the South charged 28.4 per cent per annum (Timberg and Aiyar, 1980).

A2.6.5 **Nidhis** charged 7 per cent to 10.5 per cent per annum for loans made against house property and 12 per cent per annum on special loans (Banking Commission, 1971). Loans against deposits were charged 1 to 1.5 per cent higher than the rate paid (Banking Commission, 1971 and Radhakrishnan, 1979). Interest rates varied according to the type and period of the loan and the amount lent. Rates for different types of loans varied from 10 to 13.5 per cent per annum in 1971 and from 15 to 18 per cent in 1977-78 (See Table A2.7). **Hire purchase companies** usually charged a flat rate calculated on the total amount lent and not on the diminishing balance. Rate charged for new vehicles were:

Southern Region	9 to 12% per annum flat
Western Region	10 to 12% per annum flat
Northern Region	10 to 15% per annum flat
Eastern Region	10 to 15% per annum flat.

For used vehicle the charge is 12 to 24 per cent flat (Banking Commission, 1971a). **Finance companies** reported 21 per cent per annum though borrowers reported a rate of 24 per cent in 1979 (Timberg and Aiyar, 1980). At certain times in the year the rate could go up to 36 per cent per annum.

A2.6.6 Interest rates of **moneylenders** ranged from 33.3 per cent to 50 per cent on kind loans for 6 months. For loans against tangible assets, the rate varied from 19 per cent to 37.5 per cent per annum (Karkal, 1967). The average rate of interest was higher in commercial and industrial centres as compared to rural areas.

Rates of interest on petty loans could be as high as 75 per cent per annum (Karkal, 1967). According to a study by Bhende (1983), the interest rates varied from 18 to 24 per cent per annum in Mahabunagar, Andhra Pradesh and from 25 to 120 per cent per annum in Shirapur and Kanzara villages of Maharashtra. The rates in the Sambalpur district of Western Orissa varied from zero to 120 per cent per annum. The corresponding rates of formal credit institutions varied from 12.6 per cent to 21.8 per cent per annum with 13.5 per cent being the average effective rate (Sarap, 1986).

A2.6.7 Table A2.9 gives lending rates of commercial banks for relevant years. A comparison of rates of interest of indigenous financial institutions and those of banks shows that the rates of the latter were much lower. Despite the lower rates, the long process of getting a loan, lack of a proper collateral and non-flexibility in bank dealings were some of the reasons cited for using informal sources of finance.

A2.7 Bad debts and establishment expenses

2.7.1 On average, bad debts for Shikarpuris and Gujaratis formed 5 per cent of the gross profits in Bombay. In smaller towns it is usually larger ranging from 7 to 10 per cent of gross profits (Timberg and Aiyar, 1980). For Chettiars, bad debts averaged 10 per cent of profits whereas for Rastogis they were 10 to 15 per cent of gross profits (Timberg and Aiyar, 1980). Default loss for finance corporations was about 1 per cent of their total working funds in 1979. For chit funds, 15 per cent to 18 per cent of subscribers failed to pay their periodical instalments after getting the prize (Banking Commission, 1971a). Bad debts were usually absent in the case of moneylenders though in a few cases bad debts were reported at upto 10 per cent of their working capital (Banking Commission, 1971).

2.7.2 Establishment expenses were generally low. The average Shikarpuri and Gujarati firm's expenses were Rs 30,000 to Rs 35,000 per year (Timberg and Aiyar, 1980). Transaction costs of Shikarpuris were 5.5 per cent of their working funds, whereas that of the Gujarati shroff was 3 to 3.5 per cent of working funds (Timberg and Aiyar, 1980). The establishment expenses for the Chettiars and Rastogis were, on an average, Rs 15,000 per year. As a percentage of working funds this was 4.6 for Chettiars and 5 for Rastogis. Transaction costs as a percentage of working funds for finance corporations and hire purchase companies were 5 per cent each while for pawnbrokers and nidhis these were 3.5 and 3.6 respectively (See Table A2.10). Transaction costs for moneylenders were nearly absent since their establishment costs were negligible. Administration costs for commercial banks were 3.4 per cent of working funds in 1976. No data was found on default losses of banks.

2.7.3 Details of establishment of transaction cost of informal credit market agencies are given in Tables A2.10 and A2.11. The percentage of total expenditure to total income is highest in the case of Shikarpuri shroffs and lowest in case of finance corporations. Major expenditures can be seen to have been wages,

salaries and rents.

2.7.4 Though establishment costs of indigenous financial agencies were comparable with those of the commercial banks, their figures for bad debts cannot be considered reliable since they may be overstated to avoid taxes. However, this is not a limitation as commercial bank bad debt figures are unavailable.

2.8 Conclusions: The importance of urban informal credit in the recent past

2.8.1 The formal credit market has grown rapidly since 1950 and now comprises a large number of financial institutions, covering most of India. Total assets of formal financial institutions as a percentage of GDP have grown from 38.1 per cent in 1950 to 102.7 per cent in 1980 (Morris, 1985). Gross bank credit to various sectors has also grown from Rs 11,620 crore in 1976 to Rs 74,953 crore in 1985. On the other hand, data on the informal credit markets is scanty and its total size has not yet been reliably estimated. But comparing the Banking Commission's reports and the Timberg and Aiyar study on various segments of the urban informal credit markets, it is seen that in absolute terms the volume of credit in sectors studied seems to have grown. The latter study's estimate of the informal sector in 1979 suggests that the total credit extended by the urban informal financial market, excluding intra-market loans, was about 30 per cent of gross bank credit outstanding as on June 1979. The study also estimates that the informal sector finances about 30 per cent of the urban market in India, about 50 per cent of wholesale trade in some commodities and about 10 to 30 per cent of the capital requirements of small-scale units like powerlooms, pharmaceutical manufacturers and leather tanneries.

2.8.2 Despite the growth in bank credit, informal markets continue to cater to certain segments of society. Some reasons suggested for borrowing from the informal sources are (1) the actual cost to the borrower is comparable with the bank rate, (2) lack of proper collateral required by formal institutions, (3) bank policy, which controls the credit extended to certain sectors, and (4) flexibility in the operations of indigenous financial institutions.

2.8.3 The long drawn out procedures for getting bank credit entail a number of visits to the bank before credit is sanctioned. In certain cases, where credit is required quickly (for instance by exporters and traders), it becomes imperative to borrow from informal sources. Lack of security attracts other groups such as restaurant owners, contractors and self-employed persons. Lack of knowledge of bank procedures and loan schemes is also a reason for borrowing from moneylenders.

2.8.4 Wholesale trade is given little bank credit and credit is controlled in the case of certain sensitive commodities like foodgrains, oil and oilseeds, sugar, gur and khandsari. Cotton, kapas and cotton textiles, were, till recently, covered by selective credit controls. In fact, in 1979, a large portion of the

credit needs of the cloth trade was financed by the informal credit markets in Kanpur, Amritsar and Gujarat (Timberg and Aiyar, 1980). About Rs 900 crores of informal credit went to the foodgrain market in Bombay and in Anand about 80 to 90 per cent of the working capital requirements of the beedi merchants, (about Rs 25 crore) was financed by shroffs (Timberg and Aiyar, 1980). Finance companies were the main source of credit for traders dealing in sensitive commodities and for those who are unable to get bank credit in some areas.

2.8.5 Small-scale industry also finds it necessary to borrow from informal sources, especially during tight credit periods when they have to supply trade credit to the large and medium industries. Finally, the flexibility and informality in the operations of the indigenous financial institutions make it easier to borrow from them. Substantial credit is made available at short notice and use of funds is not monitored. Loans are renewable and defaults negligible, since borrowers are usually known to creditors.

2.8.6 Thus, we see that informal credit markets exist partly because the credit requirements are not satisfied by formal institutions and partly due to bank policy.

TABLE A2.1

Number of Indigenous Financial Institutions

(Number of units)

Institution	Year(s) of estimate			Remarks
1. Chit funds	1955-60	1960-65	1965-70	
Kerala	3469	5113	3909 ¹	
Tamil Nadu (1970-75)		15109		
2. Shikarpuri or Miltani Bankers (1979)				
Members, Non-members & brokers		1750		
Shikarpuri submarkets		238		
Bombay (Members & Non-members)		588		
Madras (Members & Non-members)		326		
Other South Indian Cities (Members & Non-members)		191		
Marwaris in Madras doing same business		100		
3. Gujarati Bankers (1979)				
Pure bankers		2000		
Bankers & commission agents		2500		
4. Chettiars (1979)				
Bankers		25000		
Pawnbrokers		40000		
5. Rastogi Bankers (1979)		500		
6. Moneylenders	1964-65	1965-70		
Northern India	36	199	(Includes Delhi only)	
Southern India	2059	25822	(Includes Tamil Nadu, Karnataka Bombay)	
Eastern India	2053	8451	(Includes West Bengal)	
Western India	7612	43036	(Includes Rajasthan & Gujarat)	
7. Finance corporations (1980)			Estimated by Nayar	
Karnataka		200		
Andhra Pradesh		107		
Tamil Nadu		1233		
Kerala		1224		
India		3071		

1 Upto 1967-68. Sources: Timberg & Aiyar (1980), Banking Commission (1971), Nayar (1982), Radhakrishnan (1979), Karkal (1967).

TABLE A2.2**Advances to Multani Shroffs by Scheduled
and Non-Scheduled Banks (1970)**

(Rs Crore)

1964	1965	1966	1967	1968	1969	1970
20.43	10.40	21.14	11.49	17.72	22.40	24.33

Source: Banking Commission (1971)

TABLE A2.3**Deposits with Indigenous Financial Institutions**

(In Rs Lakh)

Name of the institution	Number of firms	Deposits	Year	Remarks
1. Multani shroffs	319	372.66	1969	For South India
2. Gujarati shroffs (at Bombay & Ahmedabad)	350	26.00	1969	For South India
3. Finance Corporations	86	1832.15	1976-77 ¹	
	86	2290.85	1977-78 ¹	
	86	2697.08	1978-79 ¹	
	86	3016.09	1979-80 ¹	
4. Nidhis	59	909.85	1965-66	For South India

¹ From April-March.

Sources: Banking Commission (1971), Nayar (1982), Timberg & Aiyar (1980).

TABLE A2.4

Sector-wise Distribution of Credit from
Indigenous Financial Agencies

(Percentage shares)

Institution/ Year (Source)	Sector													Remarks
	WT	RT	SSI	SB	T	E	H	F	C	OI	A	O		
Shikarpuri Shroffs and Brokers														Mostly working capital loans by hundli/prom. note. T through HPW; post-dated cheque discount for tan-neries/hand-/ powerloom in Bangalore & Madras.
1970 (SBE)	7	21	27	5	5	7	4	-	9	-	-	15		
1971 (BC)														
i. Bombay	36	35	-	-	11	5	-	-	-	-	7	6		
ii. Madras	28	27	-	-	8	7	-	-	-	-	5	25		
1978 (SBE)	7	25	25	5	5	21	1	1	4	-	-	6		
1978 (Ai)	6	22	16	3	7	20	1	3	4	7	-	6		
Gujarati Shroffs														1971: Finance for T, SSI & SB in 1978: Finance mainly for Gujarati traders: all commodities.
1978 (Ai)	60	5			10					10		15		
Chettians														Secured loans; SSI only in Coimbatore; HP for old and new vehicles and durables.
1978 (Ai)														
Bankers	45	5	-	-	10	-	-	-	-	20	-	20		
Pawnbrokers	22	5	-	-	-	-	-	-	-	-	-	73		
Rastogis														O includes artisans; T through HPW; limited pawn-broking.
1978 (Ai)	55	-	-	-	12	-	-	-	-	-	-	33		
Finance Corporations														
1979 (T&A) ²	10	30	8	5	2	-	2	1	2	-	12	28 ³		
1980 (N)		35	-	2	4	-	-	5	11	6	10	28 ⁴		
Nidhis														
1979 (T&A)	WT&RT(20) SSI(5) Housing/Consumption(75)													
Hire Purchase Companies Finance mainly for new and old vehicles and durables.														
Chit Funds According to a memorandum by Brahmaanda to BC: 95% of prizes over Rs 5000 go to WT/RT/T/SSI. 10% to 60% of other prizes are used unproductively.														
Moneylenders Loans for consumption, farm investment and to traders.														

Notes: 1. Key to abbreviations:
WT : Wholesale trade.
RT : Retail trade.

Sources: Karkal (1967),
Banking Commission (1971a, 1971b),
Gyatak (1976),

TABLE A2.5

Volume of Hundi Transactions: 1949-50 to 1960-61

(Rs Crore)

	1949-50	1950-51	1951-52	1952-53	1953-54	1954-55	1955-56	1956-57	1957-58	1958-59	1959-60	1960-61
Annual sale of hundis												
Bombay State	20.5	19.48	16.08	15.64	18.68	18.8	20.02	34.68	180.32	255.89	296.4	221.05
Madhya Pradesh	-	-	-	-	-	-	-	-	40.19	39.08	27.92	29.41
Uttar Pradesh	2.58	6.28	8.58	2.68	2.82	2.74	3.4	4.18	9.52	12.47	25.85	27.76
Kerala	0.94	0.38	0.24	0.54	1.02	0.78	0.92	0.32	1.44	1.94	4.39	10.46
TOTAL	24.02	26.14	24.90	18.86	22.52	22.32	24.34	39.18	231.47	309.38	354.6	288.68

Source: Karkal (1967)

TABLE A2.6

Sectoral Deployment of Gross Bank Credit

(Rs Crore)

Item	1976 June	1981 March	1986 March
Gross Bank Credit	11620	24804	47953
a. Public Food Procurement Credit	2185	1759	5827
b. Priority Sectors	2815	8504	18407
i. Agriculture	1092	3584	7657
ii. Small-scale Industry	1222	3229	6608
iii. Other Priority Sectors	501	1691	4142
c. Medium and Large Industry	5039	9960	15948
d. Wholesale Trade	809	1994	2651
i. Public Sector	NA	582	385
ii. Others	NA	1412	2266
e. Other Sectors	772	2587	5120
Export Credit	977	1640	2342
Net Bank Credit	NA	24317	46153

Notes 1. Other than for food procurement.

Source: RBI, Report on Trends and Progress of Banking in India

TABLE A2.7

**Information on Effective Annual Interest Rates
of Indigenous Financial Agencies**

Location	Year	Rate (%)	Purpose	Source	Remarks
Shikarpuris					
Bombay	1971	17.6	General	BC	
	1979	23.3	Do	T&A	
Madras	1971	25.3	Do	BC	
	1979	33.11	Do	T&A	
Bangalore	1971	19.4	Do	BC	
Small towns in south India	1979	24.1-33.3	Do	T&A	
Gujarati Shroffs					
West India	1971	12	On goods sent on	BC	
	1979	18	Hundi rate	T&A	
Chettlars					
South India	1971	21	General	BC	plus brokerage, and stamp fee on hundis.
	1979	23.9	Usance hundis	T&A	
	1979	47	Instalment Finance	T&A	
	1979	38.15	Daily payment loans	T&A	
	1979	19.46	Hire Purchase	T&A	
Marwari Bankers					
Upper Assam Tea Estates	1971	24-30	Loans to labour	BC	Usually in Kind.
Madras	1979	28.44	General	T&A	
Rastogis					
Uttar Pradesh	1979	37	General	T&A	
	1979	27.4	Hire Purchase	T&A	
Nidhis					
South India	1971	7.5-13.5	Secured against	BA	Loans against deposits deposit rate plus 1% to 1.5%.
	1979	15-18	mortgage, gold, etc.	T&A	
Hire Purchase Firms					
West India	1971	15-18	For New Vehicles.	BA	Used Vehicle charges: 18%-37%.
South India	1971	13.4-18	Do	BA	
East India	1971	15-22.7	Do	BA	
North India	1971	15-22.7	Do	BA	

TABLE A2.7 Contd.

Information on Effective Annual Interest Rates
of Indigenous Financial Agencies

Location	Year	Rate (%)	Purpose	Source	Remarks
Finance Corporations					
South India	1971	26.8-42.6		BC	
	1979	23		T&A	
	1982	22.8-42.6	Various (unsecured)	N	
	1982	24	Gold loans	N	Simple Interest.
Bombay	1979	23		T&A	

Note: Annual effective rates have Sources: Banking Commission (1971 and been computed by us using 1971a): **BC**. appropriate compound interest/ Tinberg and Aiyar (1980): **T&A**. amortisation formulae. Nayar (1982): **N**.

TABLE A2.8

Nominal Interest Rates of Indigenous Financial Institutions

(In per cent)

Indigenous financial institutions	Interest rate		Remarks
	Rate	Year	
(1)	(2)	(3)	(4)
1. Shikarpuris			
Bombay	15	1979	For 1980 effective interest rate is 23.3% For 1980 effective interest rate is 33.11%
Madras	21.6	1979	
Bangalore	18	1979	
2. Gujarati Shroffs			
Bombay Gujarat	18	1980	In Bombay
3. Chettiars			
Chettiar Bankers	18-30	1979	
Chettiar Pawanbrokers	18-30	1979	
4. Marwaris			
	28.44	1979	
5. Rastogis			
	18-24	1979	
7. Nidhis			
Ordinary mortgage loan	10-12	1971	Rates in Madras
Special mortgage loan (4 to 5 years)	10-12	1971	
Special loans	11-12	1971	
Gold & jewellery loan	10-13.5	1971	
Against LIC policy	12-13.5	1971	
Against deposits	7-10	1971	
Produce loans	12.5	1970	
8. Hire purchase companies (flat rates)			
Western India	10-12	1971	For used vehicles interest rate was 12-24% per annum in 1971.

TABLE A2.8 (Contd.)

(1)	(2)	(3)	(4)
Southern India	9-12	1971	
Eastern India	10-15	1971	For used vehicles the effective interest rate was 18-37% in 1971
Northern India	10-15	1971	
9. Finance corporations			In South India
Simple interest	24.47	1980	
	p.a.		
Export credit	24-36	p.a. 1980	
Bill discounting	19-24	p.a. 1980	
Gold loan	24	p.a. 1980	
10. Moneylenders			For South India
Below Rs 5000	6.3-6.9	1967	
Above Rs 5000	6.5-7.1	1967	

Sources: Timberg & Aiyar (1980), Banking Commission (1971a, 1971b), Nayar (1982), Karkal (1967)

TABLE A2.9

Lending Rates of Commercial Banks

(Per cent per annum)

Effective date	Prescribed minimum lending rate		Ceiling rate for banks with			Ceiling rate		Ceiling rate on food procurement	State Bank of India advance rate	Remarks
	General credit control	Selective credit	DTL above Rs 50 crores	DTL of Rs 25 to 50 crores	DTL less than Rs 25 crores	Export credit (other than deferred payments)	Rate on deferred payments			
April, 1974						9.0	7.0	9.0	9.0-12.5	
July, 1974	12.5	14.0-15.0				10.5		11.0	13.5	
August, 1974								12.0		
September 1974						11.5	8.0			
April 1, 1975									13.5-14.0	
March 15, 1976			16.5	17.5	No ceiling					
March 1, 1978			18.0	15.0	16.0	11.0		11.0	13.0	
September 13, 1979		15.5-18.0	18.0	18.0	19.0				16.5	
July 1, 1980	13.5	16.7-19.4	19.4	19.4	20.5	11.85	8.65	11.85		Lending rates made uniform
March 2, 1981	No general minimum rate	17.5-19.5	19.5	19.5	19.5	12.5-17.5		12.5		
April 1, 1983		16.5-18.0	18.0	18.0	18.00					
October 1, 1984								14.0		For 1986: Export credit rates vary with item and period.
April 1, 1985		16.5-17.5	17.5	17.5	17.5					
April 1 1986	-	16.5-17.5	17.5	17.5	17.5	12.0-16.5	8.65	14.0	16.5	

Source: Reserve Bank of India, Report on Currency and Finance, Various Issues.

TABLE A2-10

Establishment and Transaction Costs of Informal Credit Market Agencies

Name of agency	% of total expenditure to total income	% of wages & salaries to total expenditure	% rental to total expenditure	Remarks
1. Shikarpuri shroffs	30	25	20	For 1979
2. Gujarati shroffs (Bombay)	15.0	45	20	do
3. Chettiars	25.0	55	15	do
4. Rastogi bankers	25.0	35	25	do
5. Finance corporations	19.88	47	13	For 1979-80

Sources: Timberg & Aiyar (1988), Banking Commission (1971a), Nayar (1982)

TABLE A2.11

Transaction Costs as a Percentage of Working Funds

Type of Intermediary	Adminis- tration	Default loss	Total
Shikarpuris	4.5	1.0	5.5
Gujarati shroffs	2.5	0.5	3.0
Chettiars	3.1	1.5	4.6
Rastogis	3.5	1.5	5.0
Pawnbrokers	2.5	1.0	3.5
Finance corporations	4.0	1.0	5.0
Nidhis	3.1	0.5	3.6
Hire purchase companies	4.0	1.0	5.0
Commercial banks	3.4 (1976) ¹		

1 Mampilly 1980), pp. 36, 41-42, 148, 185, 195-6. This is an average figure. For smaller loans the cost works out to several times this figure. Mampilly estimates that the Commercial Banks lose 34.9 per cent on full cost basis on cash credit loans under Rs 10,000. They break even at Rs 45,506. The modal loan at least for Gujaratis, Chettiars and Rastogi bankers is well under this figure.

Source: Timberg and Aiyar (1980)

The Basis of Aggregate Estimates.

1. **Housing (private residential construction):** Ratio of total cost of new housing stock of homeowners to housing finance from external (informal) sources in V.D.Lall (1984), 'Housing Finance in India' NIPFP, New Delhi, and gross fixed capital formation in housing, National Accounts Statistics, 1987.
2. **Private Construction:** Proportionate increase by relevant aggregate statistic using (1).
3. **Small Scale Industry:** Low estimate: Proportion of non-institutional credit to formal credit in RBI, Survey of Small Scale Industrial Units, 1977, and Scheduled Commercial Banks advances to small scale industry from RBI, Report on Currency and Finance, 1986-87.
High estimate: Ratio of non-institutional credit to value of production and value of production of small scale industry in the same sources respectively as for low estimate.
4. **Road Construction:** Informal credit is estimated using Gross Capital Formation in Roads and Bridges in the Public Sector from National Accounts Statistics and sample ratio of informal credit to value of production.
5. **Road Transport:** Low estimate: As for high estimate for small scale industry, using RBI Survey of Traders and Transport Operators, 1978-79 and number of vehicles (of different types) in 1984-85 from Basic statistics relating to the Indian Economy, 1986.
High estimate: As for low estimate of small scale industry using the same source of aggregate data and using the RBI Survey of Traders and Transport Operators for the informal to formal credit ratio.
6. **Road transport, related services and storage:** As for (2), using the middle estimate of (5) and value added proportions.
7. **Trade:** Both low and high estimates as in (3), but using RBI survey of Traders and Transport Operators, 1978-79 for survey data and gross value added for the high estimate. Aggregate gross value added was taken from National Accounts Statistics, 1987.
8. **Trade, Hotels and Restaurants:** As in (2), using (6) and value added on the middle estimate.
9. **Recreation, Entertainment and Personal Services:** Residual Estimate using value added with and without this sector from the National Accounts Statistics, 1987.
10. **Public and Private Limited companies:** Sample figures from 'Finances of Public Limited Companies 1982-93 to 1984-85', RBI Bulletin, May, 1987 and 'Finances of Private Limited Companies',

RBI Bulletin, September, 1986, using residual category of borrowed funds (Item 14(iii)) and Trade Dues and Other Liabilities (Item E).

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

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

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

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

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

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

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

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

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

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

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

**EARLIER LEGISLATION AFFECTING INFORMAL
FINANCIAL INSTITUTIONS**

A8.1 Introduction

A8.1.1 Laws enacted earlier to regulate informal financial institutions were aimed at registration or licensing of moneylenders, controlling loan interest rates or ensuring the maintenance of proper records for deposits and advances. Such regulations were not always effectively enforced. The main pieces of legislation are now described.

A8.2 Major legislation

A8.2.1 One of the first major legislative attempts to protect indebted farmers from usury was the Deccan Agriculturalists' Relief Act, 1879. While this Act imposed no controls on activities of moneylenders, it authorised courts of law to invalidate a loan agreements if the interest rate specified in it was excessive. In such cases courts could prescribe fair rates of interest, authorise repayment of the outstanding debt in instalments or provide the debtor the opportunity to take advantage of insolvency proceedings. Implementation of this Act was hindered because, first, loan agreements were often unwritten and, secondly, because debtors were tempted to evade repayment of debts by taking advantage of insolvency proceedings (Karkal, 1967 and Banking Commission, 1971).

A8.2.2 The Land Improvement Loans Act, 1883 and the agricultural Loans Act, 1884 did not aim to control credit agencies either but provided for government intervention in loan markets to break the 'monopolistic situation' of indigenous agencies. Funds could be supplied by the government both for general development as well as during periods of economic distress (Karkal, 1967). Government loanable funds were, however, limited and, as often as not, moneylenders ended up being the beneficiaries of government loan programs in times of poor harvests. Thus these Acts also had a limited impact.

A8.2.3 A number of States passed **Land Alienation Acts** to prevent the transfer of land from indebted farmers to moneylenders and thus prevent the growth of landless labourers (Karkal, 1967). Either the sale of land or its mortgage were covered by these acts. Certain castes were declared to be castes engaged in agriculture and land transfers could take place among members of these castes only. Thus, while these acts provided some protection against non-agriculturalist moneylenders, they led to the formation of a class of landowner-moneylenders among the specified caste groups (Narang and Wadhwa, 1984).

A8.2.4 The Usurious Loans Act, 1919 gave courts the power to open up old cases and reduce the liability of debtors in case of

`excessive' interest. Implementation of the Act was hindered by, inter alia, a clear definition of what was excessive. The Act was, therefore, replaced by State Moneylenders Acts. Common features of most of these acts were (see Karkal, 1967 and Banking Commission, 1971):

- i. Registration and licensing of moneylenders.
- ii. Prescribed forms for account keeping by them.
- iii. The requirement that debtors had to be furnished periodical statements of account in prescribed formats.
- iv. The requirement that debtors had to be issued receipts for payments against loans.
- v. Interest rate ceilings on secured and unsecured loans.
- vi. Protection of debtors from certain actions of lenders.

A8.2.5 Not all these features are present in all moneylenders acts:

- i. The Assam and Coorg Acts do not provide for registration or licensing. In Maharashtra, Andhra Pradesh, Mysore and West Bengal moneylenders have to obtain licences which remain valid for 1 to 3 years. Bihar, Orissa and Punjab have registration but not licensing requirements.
- ii. The Bombay Moneylenders Act, 1946 does not require persons giving loans exclusively to traders to obtain licenses but does have an interest rate ceiling.
- iii. In Madras (now Tamilnadu) and in Kerala and Karnataka moneylenders acts apply only to loans below Rs. 10,000 and Rs. 3,000 respectively.
- iv. The Bengal Moneylenders Act, 1940 does not cover commercial loans, while in Punjab and Coorg transactions involving the sale and mortgage of immovable property are excluded.

A8.3 The Banking Laws (Miscellaneous Provisions) Act, 1963

A8.3.1 This Act was introduced in order to enable the Reserve Bank of India to supervise, control and regulate the activities of companies and institutions accepting deposits from the public. Thee Act amended the Reserve Bank of India Act, 1934. Chapter IIIB and IIIC of this Act are still in force and have been discussed in the main body of the chapter.

APPENDIX TO CHAPTER 17

REGRESSION A17.1

Ordinary Least Squares Estimation

```

*****
Dependent variable is INT
68 observations used for estimation from 1 to 68
*****
Regressor      Coefficient      Standard Error      T-Ratio
FI              -.0000001         .0000003             -.2337
SSI             .1484            .0129                11.5001
WHO             .1989            .0114                17.0328
RET             .1719            .0114                15.0980
TRA             .1267            .0113                10.8812
*****
R-Squared      .2289      F-statistic F( 4, 63)      4.6764
R-Bar-Squared .1600      S.E. of Regression        .0483
Residual Sum of Squares .1470      Mean of Dependent Variable .1612
S.D. of Dependent Variable .2533      Maximum of Log-likelihood 112.1729
DW-statistic   1.7211
*****

```

Diagnostic Tests

```

*****
* Test Statistics *      LM Version      *      F Version      *
*****
* A:Serial Correlation * CHI-SQ( 1)= 1.2606 * F( 1, 62)= 1.1711 *
* B:Functional Form * CHI-SQ( 1)= .5827 * F( 1, 62)= .5359 *
* C:Normality * CHI-SQ( 2)= 27.4438 * Not applicable *
* D:Heteroscedasticity * CHI-SQ( 1)= 6.5295 * F( 1, 66)= 7.0106 *
*****

```

- A:Lagrange multiplier test of residual serial correlation
- B:Ramsey's RESET test using the square of the fitted values
- C:Based on a test of skewness and kurtosis of residuals
- D:Based on the regression of squared residuals on squared fitted values

Ordinary Least Squares Estimation

```

*****
Dependent variable is KO
68 observations used for estimation from 1 to 68
*****

```

Regressor	Coefficient	Standard Error	T-Ratio
FI	-.0000030	.0000025	-1.2222
TOTCR	.0010551	.0005770	1.8285
SSI	-1.4181	.1712	-8.2831
RET	-1.9898	.1408	-14.1297
WHO	-2.4938	.2608	-9.5638
BI	-.5798	.3394	-1.7080
WE	-1.2973	.3419	-3.7942
UP	-.8115	.3159	-2.5686
DE	-1.1356	.3291	-3.4507
PU	-.9455	.3168	-2.9845
HA	-1.2212	.3209	-3.8056
RA	-.8122	.3165	-2.5666
CU	-.9432	.3193	-2.9539
MA	-1.2457	.3337	-3.7326
MP	-.8338	.3160	-2.6389
AP	-.9044	.3162	-2.8602
KA	-1.0562	.3199	-3.3020
TN	-1.1185	.3283	-3.4066
KE	-1.1566	.3189	-3.6270
AS	-.7138	.3365	-2.1210
OR	-1.1668	.3361	-3.4712
JK	-.9535	.3362	-2.8364
C	3.2773	.2530	12.9561

```

*****
R-Squared .8734 F-statistic F(22, 45) 14.1053
R-Bar-Squared .8114 S.E. of Regression .4115
Residual Sum of Squares 7.6205 Mean of Dependent Variable 1.0009
S.D. of Dependent Variable .9477 Maximum of Log-likelihood -22.0730
DW-statistic 2.2085
*****

```

Diagnostic Tests

```

*****
* Test Statistics * LM Version * F Version *
*****
* A:Serial Correlation * CHI-SQ( 1)= 1.0783 * F( 1, 44)= .7092 *
* * * * *
* B:Functional Form * CHI-SQ( 1)= 23.3773 * F( 1, 44)= 23.0510 *
* * * * *
* C:Normality * CHI-SQ( 2)= 18.1192 * Not applicable *
* * * * *
* D:Heteroscedasticity * CHI-SQ( 1)= 10.0720 * F( 1, 66)= 11.4755 *
*****

```

- A:Lagrange multiplier test of residual serial correlation
- B:Ramsey's RESET test using the square of the fitted values
- C:Based on a test of skewness and kurtosis of residuals
- D:Based on the regression of squared residuals on squared fitted values

REGRESSION A17.3

Ordinary Least Squares Estimation

```

*****
Dependent variable is LTOT
68 observations used for estimation from 1 to 68
*****
Regressor          Coefficient      Standard Error      T-Ratio
LSDP                .8203            .1886                4.3504
SSI                 -.8371           1.3370              -.6261
WHO                 .0768            1.3407                .0573
RET                 -2.5518          1.3407              -1.9033
TRA                 -2.6853          1.3407              -2.0029
*****
R-Squared           .8616            F-statistic F( 4, 63)  98.0326
R-Bar-Squared       .8528            S.E. of Regression    .5060
Residual Sum of Squares 16.1314        Mean of Dependent Variable  4.2665
S.D. of Dependent Variable 1.3189        Maximum of Log-likelihood -47.5706
DW-statistic        1.7501
*****

```

Diagnostic Tests

```

*****
* Test Statistics *      LM Version      *      F Version      *
*****
* A:Serial Correlation *  CHI-SQ( 1)=   .6078 *  F( 1, 62)=   .5591 *
* B:Functional Form    *  CHI-SQ( 1)=   .0823 *  F( 1, 62)=   .0751 *
* C:Normality          *  CHI-SQ( 2)=   .0670 *      Not applicable *
* D:Heteroscedasticity *  CHI-SQ( 1)=   .7118 *  F( 1, 66)=   .6981 *
*****

```

- A:Lagrange multiplier test of residual serial correlation
- B:Ramsey's RESET test using the square of the fitted values
- C:Based on a test of skewness and kurtosis of residuals
- D:Based on the regression of squared residuals on squared fitted values

APPENDIX TO CHAPTER 18

Estimate of the Number and Volume of
Business of Auto Finance Corporations, 1986

State/place	No. of corpora- tions	Average stock on hire per corporation (Rs.lakh)	Stock on hire at the end of 1986 (2x3) (Rs. lakh)
(1)	(2)	(3)	(4)
Tamil Nadu	<u>450</u>	-	<u>8450</u>
Namakkal	90	25	2250
Coimbatore	30	30	900
Madras	30	30	900
Salem	30	20	600
Trichy	20	20	400
Madurai	15	20	300
Nagercoil	15	10	150
Triuppur	10	10	100
Karur	10	10	100
Karaikudi	10	10	100
Rasipuram	10	10	100
Tirunelveli	10	17	100
Pollachi	10	17	100
Erode	5	10	50
Dindigul	5	10	50
Other places	150	15	2250
Kerala	<u>335</u>	-	<u>5900</u>
Trichur	50	20	1000
Ernakulam	50	20	1000
Calicut	30	20	600
Kottayam	30	20	650
Trivandrum	25	20	500
Quilon	30	15	450
Tallichery	5	10	50
Cannanur	5	10	50
Palaghat	5	10	50
Alwaye	5	10	50
Other	100	15	1500
Andhra Pradesh	<u>240</u>	-	<u>2800</u>
Hindupur	60	15	900
Hyderabad	20	15	300
Ananthapur	20	10	200
Chittur	15	10	150
Visakapatnam	10	10	100
Vijayawada	10	10	100
Madanapalle	10	10	100

APPENDIX TO CHAPTER 18 (CONTD.)

(1)	(2)	(3)	(4)
Kurnool	10	10	100
Guntakkal	10	10	100
Other Places	75	10	750
Karnataka	<u>145</u>	-	<u>2400</u>
Bangalore	30	20	600
Mangalore	20	20	400
Mysore	20	15	300
Belgaum	10	15	150
Tumkur	5	10	50
Other Places	60	15	900
Pondichery	40	15	600
Total for South India	1200	16.15	20150
Total for India¹	4800	-	80600

In South India, because of its extensive road network and predominant road transport industry is estimated to account for about one-fourth of the total number of auto finance corporations and their stock on hire.

Source: The data on number of corporations and their average stock on hire in 1986 for the places mentioned in the table were obtained through field enquiry; projections for the rest of the places in South India are made on the basis of information received orally from local Associations of finance corporations.

APPENDIX TO CHAPTER 20

TABLE A20.1

Place-wise Distribution of Respondents

Place	Number of corporations		Number of depositors		Number of borrowers	
	Selected	Responded	Selected	Responded	Selected	Responded
Ernakulam	3	4	5	5	2	2
Trichur	10	5	3	1	2	2
Kottayam	5	1	3	-	2	-
Trivandrum	4	-	1	1	1	-
Chengannur	2	1	-	-	-	-
Salem	8	8	2	2	5	5
Trichy	5	5	1	-	4	4
Coimbatore	4	4	1	1	2	2
Karur	5	5	-	-	1	1
Madras	2	2	3	3	-	-
Bangalore	7	7	1	1	1	1
TOTAL	60	42	20	14	20	17

**Non-Banking Financial Companies and Miscellaneous
Non-Banking Companies (Advertisement) Rule, 1977
Prescribed by RBI**

1. Every company intending to invite or allowing or causing any other person to invite or cause to be invited on its behalf, any deposits from the public, other than its directors, share holders or employees shall issue an advertisement for the purpose in a leading English newspaper and one vernacular newspaper circulating in the State in which the registered office of the company is situated.
2. No such company shall issue or allow any other person to issue or cause to be issued on its behalf any advertisement and inviting deposits unless such advertisement is issued on the authority and in the name of the Board of Directors of the Company and contains a reference to the conditions subject to which deposit shall be accepted by the company, the data on which the said Board of Directors has approved the text of the advertisement and certain specified information listed in the Advertisement Rules 1977.
3. An advertisement issued in accordance with these Rules shall be valid until the expiry of six months from the date of closure of the financial year in which it is issued or until the date on which the balance sheet is laid before the company in general meeting or where the annual general meeting for any year has not been held, the latest day on which that meeting should have been held, in accordance with the provisions of the Companies Act, 1956 (1 of 1956) whichever is earlier, and a fresh advertisement shall be made in each succeeding financial year for invitation of deposits during that financial year.

A: Glossary of Chit Fund Terms

1. **Chit fund:** Is the same as chitty, kuri or chit.
2. **Chit amount:** or chit capital is the chit subscription per instalment multiplied by the number of instalments/subscribers.
3. **Discount:** deduction offered on chit amount at auction or by tender.
4. **Prize amount:** Chit amount minus total discount (deduction).
5. **Dividend:** The portion of discount distributed among subscribers.
6. **Foreman:** The person or institution which conducts the chit fund.
7. **Subscriber:** Members who contribute subscriptions to chit.
8. **Foreman's commission:** Usually a percentage of chit amount for his services.
9. **Subscription:** Amount per instalment.
10. **Auction dividend:** Auction discount per member.
11. **Fixed discount:** A certain percentage of chit amount is deducted as fixed discount by the foreman usually for distribution among non-prized subscribers.
12. **Fixed dividend:** Fixed discount is distributed among eligible members as fixed dividend.
13. **Prized subscriber or prize winner:** A member who has taken the prize amount.
14. **Non-prized subscriber or non-prize winner:** a subscriber who has not taken the prize amount.
15. **Defaulting subscriber:** A subscriber who defaults in payment of subscription.
16. **Chit period:** or duration of chit = the date of first instalment payment to the date of last instalment payment whatever be the frequency of instalments.
17. **Chit bye-law or chit agreement:** The agreement executed between the foreman and subscribers.

TABLE A23.1

COMMERCIAL CHIT 1

Discount Distributed in the Subsequent Period
 Number of members/periods: 40
 Periodicity in months: 1
 Commission to foreman in percent: 5
 Subscription in rupees: 2500

(in Rs)

Period	Prize amount	Total Discount	Net Subscription per member	Discount as % of capital
1	100000.00	-5000.00	2500.00	-
2	53500.00	41500.00	2500.00	46.5
3	58000.00	37000.00	1462.50	42.0
4	56000.00	39000.00	1575.00	44.0
5	54700.00	40300.00	1525.00	45.3
6	58300.00	36700.00	1492.50	41.7
7	61100.00	33900.00	1582.50	38.9
8	64000.00	31000.00	1652.50	36.0
9	64000.00	31000.00	1725.00	36.0
10	67000.00	28000.00	1725.00	33.0
11	67500.00	27500.00	1800.00	32.5
12	75000.00	20000.00	1812.50	25.0
13	72500.00	22500.00	2000.00	27.5
14	74800.00	20200.00	1937.50	25.2
15	75000.00	20000.00	1995.00	25.0
16	72500.00	22500.00	2000.00	27.5
17	75000.00	20000.00	1937.50	25.0
18	76900.00	18100.00	2000.00	23.1
19	76900.00	18100.00	2047.50	23.1
20	77000.00	18000.00	2047.50	23.0
21	81000.01	14000.00	2050.00	19.0
22	81500.00	13500.00	2150.00	18.5
23	80500.01	14500.00	2162.50	19.5
24	87000.00	8000.00	2137.50	13.0
25	89000.00	6000.00	2300.00	11.0
26	91000.01	4000.00	2350.00	9.0
27	92100.00	2900.00	2400.00	7.9
28	93120.01	1880.00	2427.50	6.9
29	91000.01	4000.00	2453.00	9.0
30	89400.00	5600.00	2400.00	10.6
31	91520.01	3480.00	2360.00	8.5
32	92900.00	2100.00	2413.00	7.1
33	91900.00	3100.00	2447.50	8.1
34	93900.01	1100.00	2422.50	6.1
35	94000.00	1000.00	2472.50	6.0
36	95000.00	0.00	2475.00	5.0
37	95000.00	0.00	2500.00	5.0
38	95000.00	0.00	2500.00	5.0
39	95000.00	0.00	2500.00	5.0
40	95000.00	0.00	2500.00	5.0

TABLE A23.2

COMMERCIAL CHIT 2

Discount distributed each period
 Number of members/periods: 40
 Periodicity in months: 1
 Commission to foreman in percent: 5
 Subscription in rupees: 1250

(in Rs)

Period	Prize amount	Total Discount	Net Subscription per member	Discount as % of capital
1	50000.00	-	1250.00	-
2	30000.00	17500.00	1250.00	35.0
3	29900.00	17600.00	812.50	35.2
4	26600.00	20900.00	810.00	41.8
5	29000.00	18500.00	727.50	37.0
6	29100.00	18200.00	787.50	36.4
7	33000.00	14500.00	795.00	29.0
8	31700.00	15800.00	887.50	37.6
9	29300.00	18200.00	855.00	36.4
10	29400.00	18100.00	795.00	36.2
11	30500.00	17000.00	797.50	34.0
12	34000.00	13500.00	825.00	27.0
13	33700.00	13800.00	912.50	27.6
14	32800.00	14700.00	905.00	29.4
15	31900.00	15600.00	882.50	31.2
16	31200.00	16300.00	860.00	32.6
17	33900.00	13600.00	842.50	27.2
18	32800.00	14700.00	910.00	29.4
19	33900.00	13600.00	882.50	27.2
20	34300.00	13200.00	910.00	26.4
21	35600.00	11900.00	920.00	23.8
22	35900.00	11600.00	952.50	23.2
23	36100.00	11400.00	960.00	22.8
24	37300.00	10200.00	965.00	20.4
25	38020.00	9480.00	995.00	19.0
26	40900.00	6600.00	1013.00	13.2
27	41180.00	6320.00	1085.00	12.6
28	41500.00	6000.00	1092.00	12.0
29	41900.00	5600.00	1100.00	11.2
30	45380.00	2120.00	1110.00	4.2
31	42420.00	5080.00	1197.00	10.2
32	43100.00	4400.00	1123.00	8.8
33	43700.00	3800.00	1140.00	7.6
34	44420.00	3080.00	1155.00	6.2
35	44420.00	3080.00	1173.00	6.2
36	46900.00	600.00	1173.00	1.2
37	47500.00	.00	1235.00	-
38	47500.00	.00	1250.00	-
39	47500.00	.00	1250.00	-
40	47500.00	.00	1250.00	-

TABLE A23.3

COMMERCIAL CHIT 3

Discount distributed each period
 number of members/periods: 30
 periodicity in months: 1
 commission to foreman in percent: 5
 subscription in rupees: 500

(in Rs)

Period	Prize amount	Total Discount	Net Subscription per member	Discount as a % of capital
1	15000.00	-	500.00	-
2	15000.00	-	500.00	-
3	10290.00	3960.00	368.00	31.4
4	9930.00	4320.00	356.00	33.8
5	9240.00	5010.00	333.00	38.4
6	9090.00	5160.00	328.00	39.4
7	9780.00	4470.00	351.00	34.8
8	9300.00	4950.00	335.00	38.0
9	10560.00	3690.00	377.00	29.6
10	10440.00	3810.00	373.00	30.4
11	10500.00	3750.00	375.00	30.0
12	10440.00	3810.00	373.00	30.4
13	9990.00	4260.00	358.00	33.4
14	11640.00	2610.00	413.00	22.4
15	11490.00	2760.00	408.00	23.4
16	14250.00	0.00	500.00	5.0
17	12750.00	1500.00	450.00	15.0
18	13500.00	750.00	475.00	10.0
19	13200.00	1050.00	465.00	12.0
20	13260.00	990.00	467.00	11.6
21	13050.00	1200.00	460.00	13.0
22	13560.00	690.00	477.00	9.6
23	13320.00	930.00	469.00	11.2
24	13470.00	780.00	474.00	10.2
25	13950.00	300.00	490.00	7.0
26	14250.00	0.00	500.00	5.0
27	14250.00	0.00	500.00	5.0
28	14250.00	0.00	500.00	5.0
29	14250.00	0.00	500.00	5.0
30	14250.00	0.00	500.00	5.0

TABLE A23.4

COMMERCIAL CHIT 4

Discount distributed each period
 number of members/periods: 25
 periodicity in months: 1
 commission to foreman in percent: 5
 subscription in rupees: 400

(in Rs)

Per- iod	Prize amount	Total Discount	Subscript./member		Discount as a % of Capital
			Non- Prized	Prized	
1	10000.00	-	400.00	400.00	-
2	10000.00	-	400.00	400.00	-
3	7000.00	2500.00	298.25	320.00	30.0
4	7000.00	2500.00	297.30	320.00	30.0
5	7000.00	2500.00	296.20	320.00	30.0
6	7000.00	2500.00	295.00	320.00	30.0
7	7000.00	2500.00	293.70	320.00	30.0
8	7000.00	2500.00	292.25	320.00	30.0
9	7000.00	2500.00	290.60	320.00	30.0
10	7000.00	2500.00	288.75	320.00	30.0
11	7100.00	2400.00	290.70	324.00	29.0
12	7400.00	2100.00	300.30	336.00	26.0
13	8050.00	1450.00	325.55	362.00	19.5
14	9450.00	50.00	395.45	400.00	5.5
15	9250.00	250.00	375.00	400.00	7.5
16	9400.00	100.00	388.90	400.00	6.0
17	9000.00	500.00	337.50	400.00	10.0
18	9000.00	500.00	328.60	400.00	10.0
19	9500.00	0.00	400.00	400.00	5.0
20	9500.00	0.00	400.00	400.00	5.0
21	9150.00	350.00	312.50	400.00	8.5
22	9500.00	0.00	400.00	400.00	5.0
23	9500.00	0.00	400.00	400.00	5.0
24	9500.00	0.00	400.00	400.00	5.0
25	9500.00	0.00	400.00	400.00	5.0

TABLE A23.5

COMMERCIAL CHIT 5

Discount distributed each period
 number of members/periods: 50
 periodicity in months: 1
 commission to foreman in percent: 5
 subscription in rupees: 200

(in Rs)

Period	Prize amount	Total Discount	Net Subscription per member	Discount as a % of capital
1	10000.00	-	200.00	-
2	10000.00	-	200.00	-
3	6050.00	3450.00	131.00	39.5
4	5700.00	3800.00	124.00	43.0
5	5500.00	4000.00	120.00	45.0
6	5650.00	3850.00	123.00	43.5
7	5200.00	4300.00	114.00	48.0
8	6200.00	3300.00	134.00	38.0
9	5050.00	4450.00	111.00	40.5
10	5700.00	3800.00	124.00	43.0
11	5800.00	3700.00	126.00	42.0
12	6000.00	3500.00	130.00	40.0
13	5800.00	3700.00	126.00	42.0
14	6900.00	2600.00	148.00	41.0
15	6200.00	3300.00	134.00	38.0
16	6300.00	3200.00	136.00	37.0
17	6250.00	3250.00	135.00	37.5
18	6600.00	2900.00	142.00	34.0
19	6750.00	2750.00	145.00	32.5
20	6450.00	3050.00	139.00	33.0
21	6700.00	2800.00	144.00	34.5
22	6550.00	2950.00	141.00	33.5
23	6650.00	2850.00	143.00	33.0
24	6700.00	2800.00	144.00	35.0
25	6500.00	3000.00	140.00	29.0
26	7100.00	2400.00	152.00	34.0
27	6600.00	2900.00	142.00	30.5
28	6950.00	2550.00	149.00	26.5
29	7350.00	2150.00	157.00	30.5
30	6950.00	2550.00	149.00	28.0
31	7200.00	2300.00	154.00	28.0
32	7200.00	2300.00	154.00	27.0
33	7300.00	2200.00	156.00	30.5
34	6950.00	2550.00	149.00	28.0
35	7200.00	2300.00	154.00	20.5
36	7950.00	1550.00	169.00	20.5
37	7950.00	1550.00	169.00	15.5
38	8000.00	1500.00	170.00	13.0
39	7450.00	2050.00	159.00	10.0

40	8700.00	800.00	184.00	6.5
41	9000.00	500.00	190.00	5.0
42	9350.00	150.00	197.00	6.0
43	9500.00	0.00	200.00	5.0
44	9400.00	100.00	198.00	5.0
45	9500.00	0.00	200.00	5.0
46	9500.00	0.00	200.00	5.0
47	9500.00	0.00	200.00	5.0
48	9500.00	0.00	200.00	5.0
49	9500.00	0.00	200.00	5.0
50	9500.00	0.00	200.00	5.0

TABLE A23.6

COMMERCIAL CHIT 6

Discount distributed each period
 number of members/periods: 40
 periodicity in months: 1
 commission to foreman in percent: 5
 subscription in rupees: 625

Period	Prize amount	Total Discount	Net Subscription per member	Discount as a % of capital
1	25000.00	-	625.00	-
2	25000.00	-	625.00	-
3	12000.00	11750.00	331.25	52.0
4	10400.00	13350.00	291.25	58.4
5	11000.00	12750.00	306.25	56.0
6	10400.00	13350.00	291.25	58.4
7	13100.00	10650.00	358.75	47.6
8	14200.00	9550.00	386.25	43.2
9	14800.00	8950.00	401.25	40.8
10	12000.00	11750.00	331.25	52.0
11	13200.00	10550.00	361.25	47.2
12	13300.00	10450.00	363.75	46.8
13	16200.00	7550.00	436.25	35.2
14	15400.00	8350.00	416.25	38.4
15	15800.00	7950.00	426.25	36.8
16	16000.00	7750.00	431.25	36.0
17	18200.00	5550.00	486.25	27.2
18	17800.00	5950.00	476.25	28.8
19	18400.00	5350.00	491.25	26.4
20	17400.00	6350.00	466.25	30.4
21	18400.00	5350.00	491.25	26.4
22	17400.00	6350.00	466.25	30.4
23	18800.00	4950.00	501.25	24.8
24	19300.00	4450.00	513.75	22.8
25	19400.00	4350.00	516.25	22.4
26	18710.00	5040.00	499.00	25.2
27	21510.00	2240.00	569.00	14.0
28	23070.00	680.00	608.00	7.7
29	18990.00	4760.00	506.00	24.0
30	19310.00	4440.00	514.00	22.8
31	18510.00	5240.00	494.00	26.0
32	20910.00	2840.00	554.00	16.4
33	22790.00	960.00	601.00	8.8
34	21990.00	1760.00	581.00	12.0
35	22350.00	1400.00	590.00	10.6
36	22510.00	1240.00	594.00	10.0
37	22390.00	1360.00	591.00	10.4
38	23750.00	0.00	625.00	5.0
39	23750.00	0.00	625.00	5.0
40	23750.00	0.00	625.00	5.0

Figure A23.1

Net present value per rupee at 11% p.a.

Auction chit 1 (40 months)

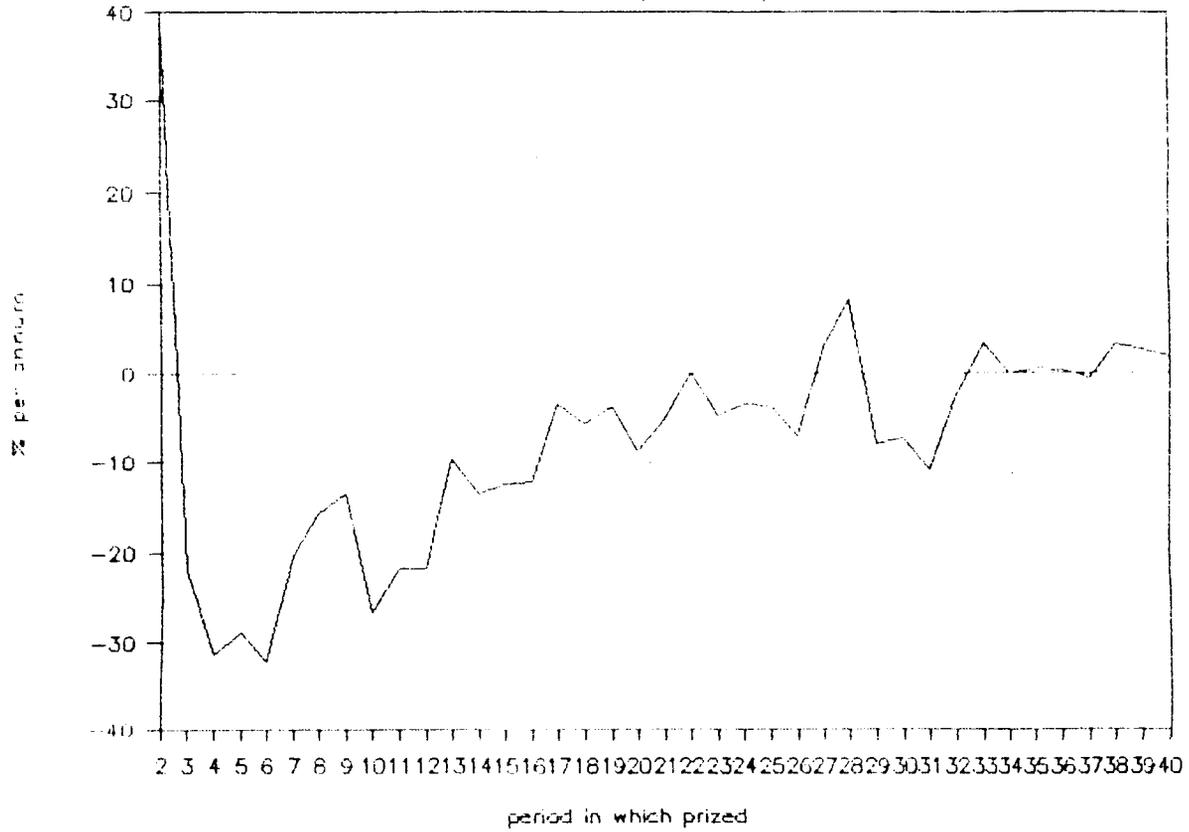


Figure A23.2

Net present value per rupee at 11% p.a.

Auction chit 2 (40 months)

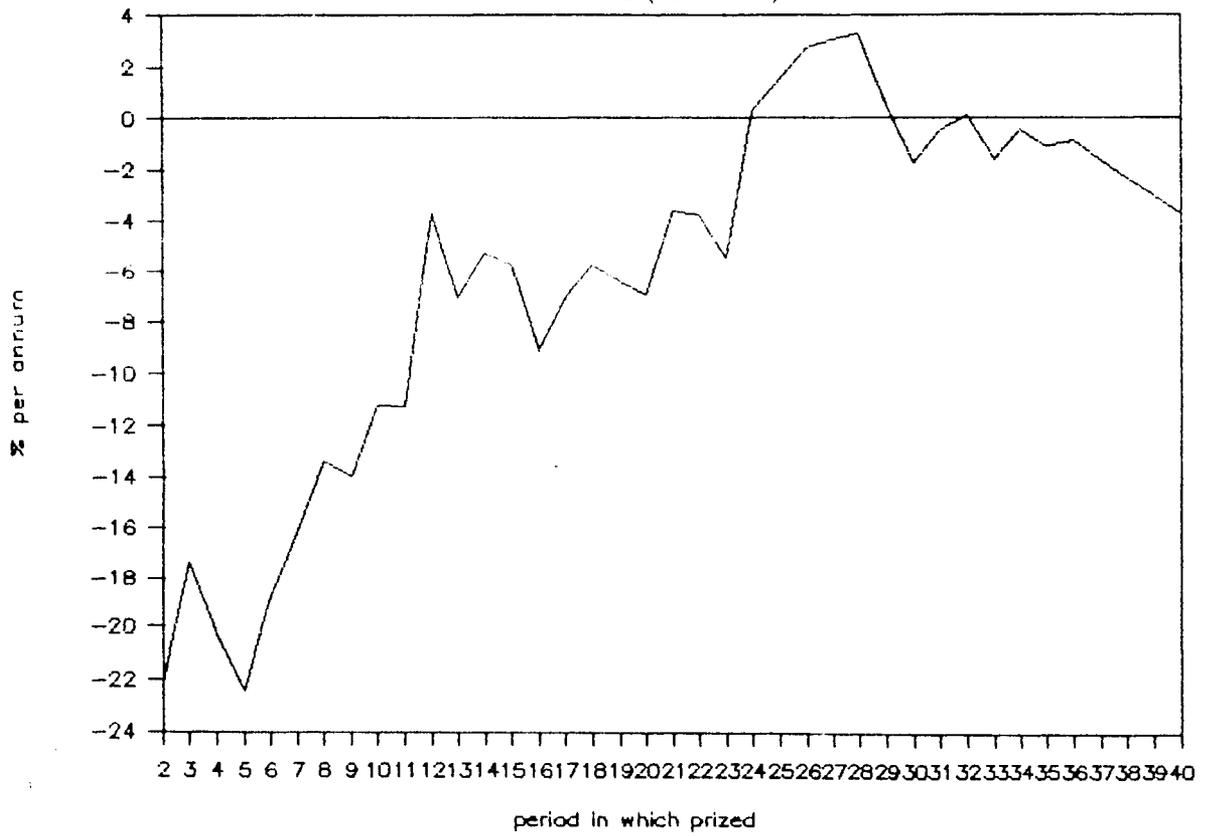


Figure A23.3

Net present value per rupee at 11% p.a.

Auction chit 3 (30 months)

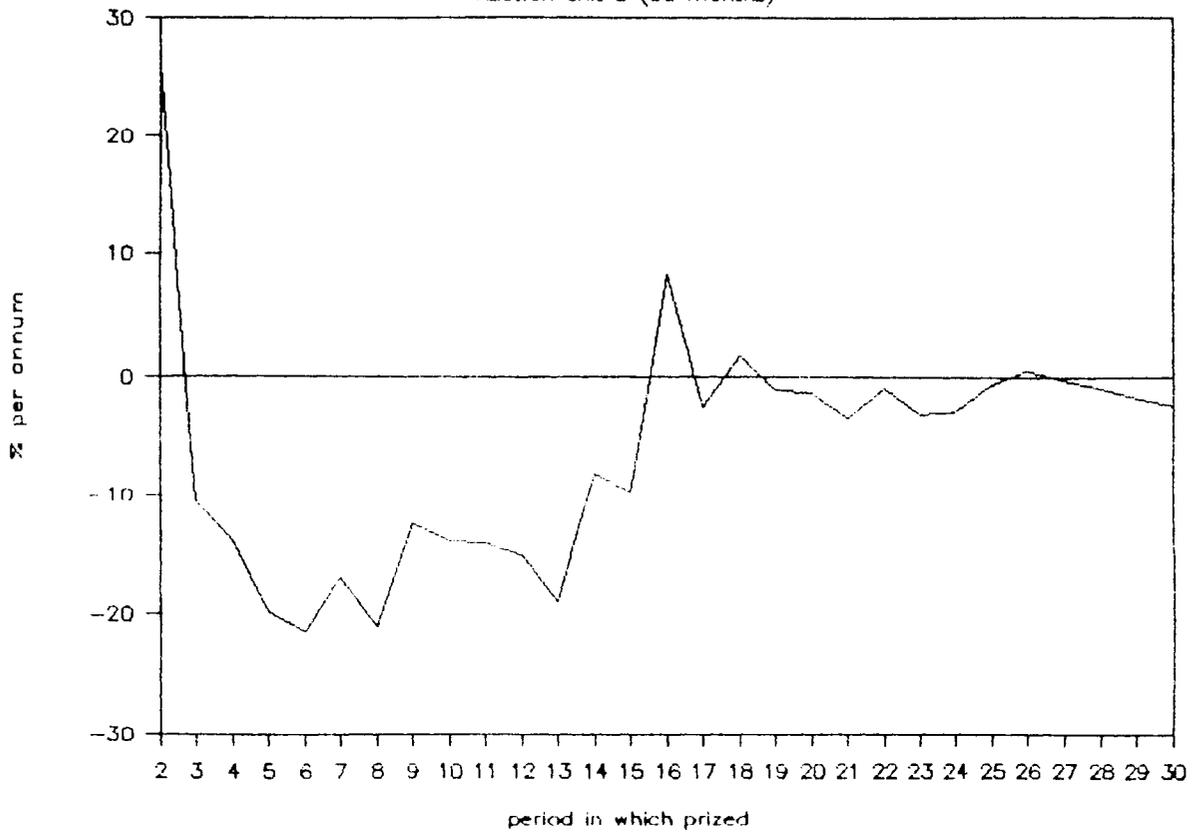


Figure A23.4

Net present value per rupee at 11% p.a.

Auction chit 4 (25 months)

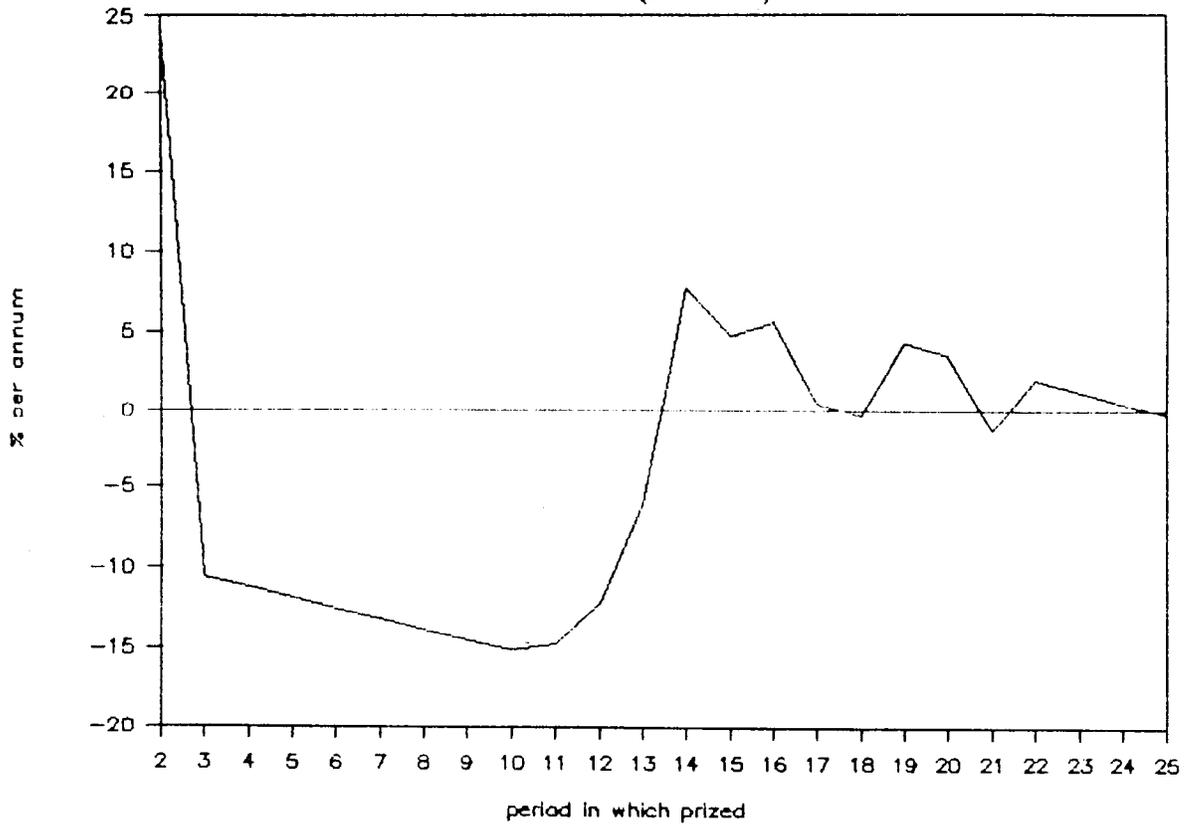


Figure A23.5

Net present value per rupee at 11% p.a.

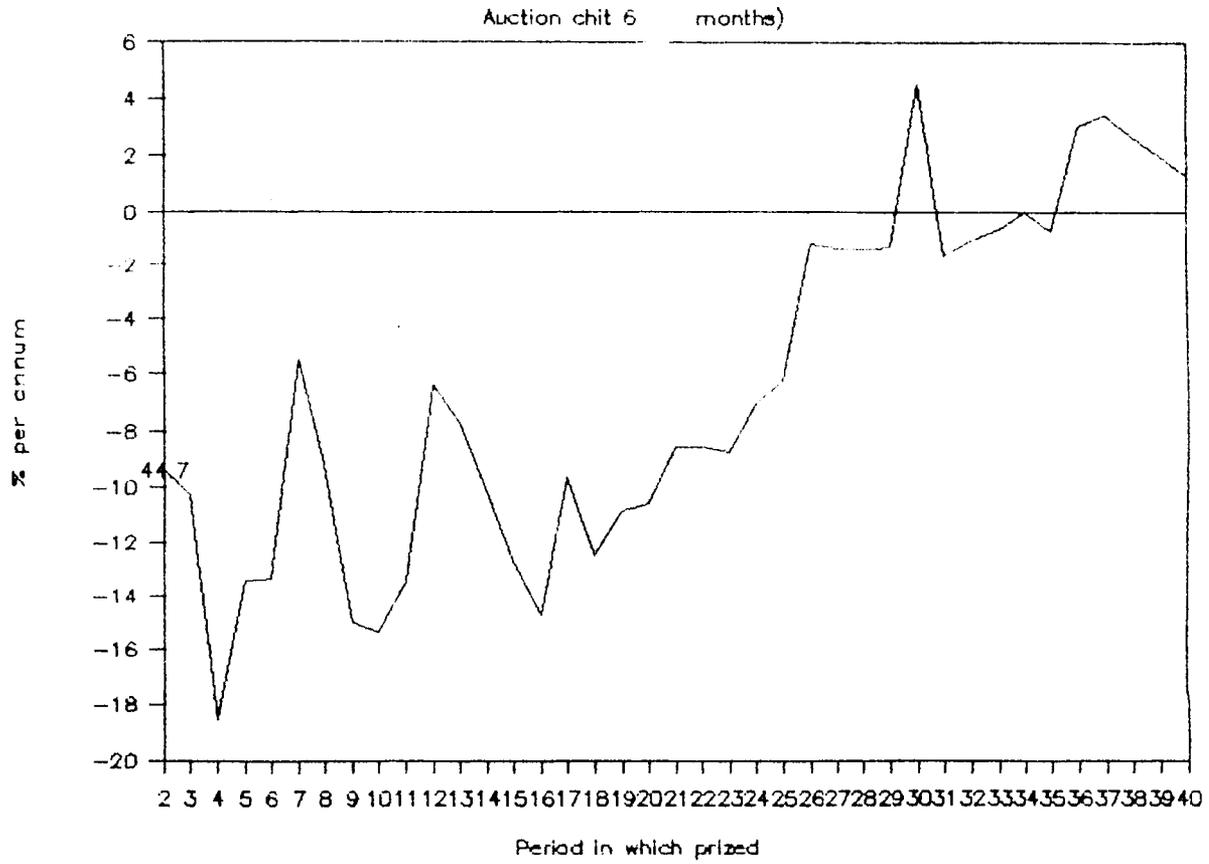


Figure A23.6

Net present value per rupee at 11% p.a.

Auction chit 5 (50 months)

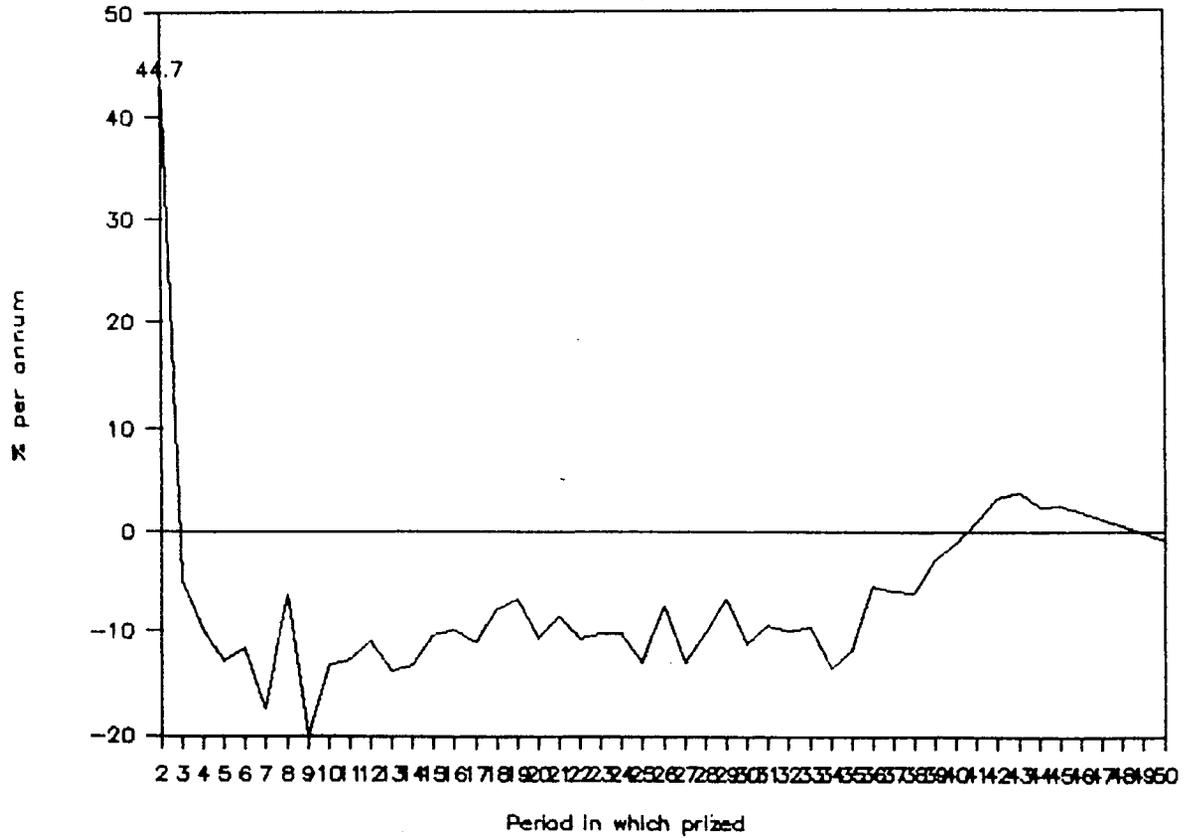


TABLE A23.7

COMMUNITY CHIT 1

Number of members : 15
 Per member subscription :Rs300
 Period : April 86 - June 87
 Description: Auction chit with the discount amount lent at 2% per month to members. Discount plus interest on loans distributed at the termination of the chit to all members.
 Fixed discount Rs 150/-

Period	Prize amount(Rs)	Auction discount(Rs)	Fixed discount(Rs)
1	3675	675	150
2	3640	710	150
3	3795	555	150
4	3680	670	150
5	3820	530	150
6	3840	510	150
7	3885	465	150
8	3930	420	150
9	4040	310	150
10	4200	150	150
11	4220	130	150
12	4255	95	150
13	4290	60	150
14	4350	0	150
15	4350	0	150
TOTAL		5280	2250

Total interest from loans: Rs 239
 Total available for disburasal at end of chit: Rs 7769
 Dividend per member: 517.93

TABLE A23.8

COMMUNITY CHIT 2

Number of members: 12
 Per member subscription : Rs 200
 Period : April 86 - March 87
 Description : as for Chit 1
 except fixed discount: Rs 100

Period	Prize (Rs)	Auction discount (Rs)	Fixed discount (Rs)
1	1865	435	100
2	1925	375	100
3	2030	270	100
4	1895	405	100
5	2070	230	100
6	2100	200	100
7	2270	30	100
8	2195	105	100
9	2200	100	100
10	2250	50	100
11	2300	0	100
12	2300	0	100
TOTAL		2200	1200

Total interest from loans: Rs 146
 Total available for disbursal at end of chit Rs 3546
 Dividend per member: Rs 295.50

TABLE A23.9

COMMUNITY CHIT 3

Number of members: 14
 Number of tickets: 24
 Number of month : 24
 Per member subscription: Rs 500
 Period Oct. 86 to Sept. 88
 Description: Discount distributed to
 all members fixed discount Rs 500/-

Period	Member	Prize (Rs)	Auction discount (Rs)	Fixed discount (Rs)
1	1	3350	4850	500
2	2	7500	4000	500
3	3	7300	4200	500
4	4	7900	3600	500
5	5	8900	2600	500
6	6	8300	3200	500
7	7	8450	3050	500
8	8	10000	1500	500
9	9	9900	1600	500
10	9	9900	1600	500
11	10	9900	1600	500
12	8	9700	1800	500
13	3	9400	2100	500
14	8	9750	1750	500
15	11	9650	1850	500
16	12	10050	1450	500
17	5	10450	1050	500
18	10	10650	850	500
19	13	11000	500	500
20	11	10850	650	500
21	12	11250	250	500
22	13	11350	150	500
23	11	11500	0	500
24	14	11500	0	500

TABLE A23.10

COMMUNITY CHIT 4

Number of members: 12
 Number of tickets: 15
 Number of months : 15
 Per member subscription: Rs 100
 Period: February 1987 to April 1988
 Description: Discount distributed to
 all members. Fixed discount Rs 150

Period	Prize amount (Rs)	Fixed discount (Rs)	Auction discount (Rs)
1	1000	150	350
2	1000	150	350
(member 1)			
3	970	150	380
4	1100	150	250
5	1100	150	250
6	980	150	370
7	1105	150	245
8	1300	150	50
9	1350	150	0
10	1330	150	20
11	1320	150	30
12	1315	150	35
(member 11)			
13	1350	150	0
(member 10)			
14	1350	150	0
15	1350	150	0

TABLE A23.11

Key to Location Codes

Location	Code
Trichur	101
Ernakulam	102
Kottayam	103
Trivandrum	104
Madras	201
Nilgiri	202
Madurai	203
Salem	204
Trichy	205
Nogapattanam	206
Coimbatore	207
Tiruchirapalli	208
Hyderabad	301
Secunderabad	302
Anantapur	303
Adoni	304
Nellore	305
Bangalore	401
Bellary	402
Bombay	501

**DOCUMENTARY INSTRUMENTS OF INDIGENOUS BANKERS
AND MONEYLENDERS****A32.1 Introduction**

A32.1.1 The instruments most commonly used in Indian ICMS are short term credit bills such as promissory notes and hundis. Promissory notes are similar to that defined in section 4 of the Negotiable Instruments Act and are either payable on demand or after a specified term. Instruments used by moneylenders and indigenous bankers are now described.

A32.2 Instruments used by moneylenders

A32.2.1 Moneylenders usually lend against promissory notes. These are normally supported by other documents. A `rasid` is a simple receipt given in acknowledgement of debt. A `dastavez` is a bond executed on a stamped, legal form with all terms and conditions duly stated including the interest rate and default penalty (Banking Commission, 1971). For illiterate borrowers, `bahis`, or stamp books, are maintained. The signature or thumb impression of the borrower is recorded there as evidence of debt. In such cases, terms and conditions are not recorded. Traders and moneylenders also give market loans under the `kist` system under which daily or monthly repayment is specified.

A32.2.2 `Rahan`, or mortgage of landed property is another common instrument used by moneylenders. Such a mortgage deed, containing terms and conditions of the advance and relevant dates, has to be registered with the Registrar for the district in which the property is located. There are two types of mortgages: ordinary and usufructuary. Use of the land stays with the borrower with the former. With the latter, use rights for a specified fraction of the mortgaged land are given to the lender. Under the `zarpeshi` usufructuary mortgage surplus income from the land with the lender, over and above stipulated interest, stay with the lender. Otherwise such income accrues to the borrower. Loan durations are seldom specified in ordinary mortgages. (Banking Commission, 1971).

A32.3 Instruments used by indigenous bankers

A32.3.1 The hundi is the instrument generally used by indigenous bankers. By the late seventies, however, Timberg and Aiyar, (1980) noted the use of hire purchase agreements, demand promissory notes, installment notes and security such as mortgage deeds. They also noted the use of scraps of paper, commonly known as `ruka` or `chilka`, in use as deposit receipts by some informal deposit accepting agencies. These scraps were to avoid problems with tax authorities and ensure the anonymity of deposits, presumably from

black funds. The chief aim of this section is to briefly describe the ancient and versatile hundi. More detailed discussion as well as replicas of hundis are to be found in Karkal (1967), Banking Commission (1971) and Timberg and Aiyar (1980)¹.

A32.3.2 Hundis are used to raise funds, to effect remittances and to finance inland trade. Most hundis are easily transferred by endorsement and delivery and so are occasionally used in some market segments to make payments. The `darshani` (sight) hundi, used first by Gujarati shroffs, and the `multani`, `muddati` or `thavanai` hundi, used first by Shikarpuris, are the two broad types of hundis. The former is a sight or demand instrument while the latter is payable after a stipulated period.

A32.3.3 **Muddati hundis** are rarely for more than 1 year, the normal tenure being 30, 60, 90 or 120 days. These hundis are like promissory notes and hundi paper is sold by the Stamp Department of the Government. In Bombay it is usually an undertaking to pay a stated amount on the completion of 86 days with 3 days grace. In South India and West Bengal the normal period specified is 90 days without a grace period. (Karkal, 1967 and Banking Commission, 1971)

A32.3.4 **Darshani hundis**, which were widely used to finance inland trade and effect remittances up to the late seventies, are of six types.

i. The **Shah Jog Hundi** is repayable only to a `shah`. A shah is a person whose creditworthiness and good reputation are established after proper enquiry. Proof of this is usually membership in an established firm and membership of a commercial association. The drawer can sue the drawee of the hundi for repayment of the amount specified there if due precaution to establish the payee's status is not taken. The instrument is thus much like a `cross and order` cheque with the additional safeguard that the payee is a shah.

ii. The **Nam Jog Hundi** is payable to the party named in the bill or to his order.

iii. The **Dekharnar Jog Hundi**, evolved at the turn of the century unlike the other forms of the hundi which are centuries old. It is a bearer instrument unless endorsed in which case it is treated much like a shah jog hundi.

iv. The **Farmani Jog Hundi** is payable on order to an endorsee provided all endorsements are in order.

v. The **Jokhmi Hundi** is drawn against goods despatched and contains certain conditions under which the drawer or holder suffers a loss if the goods are lost or damaged in transit.

vi. The **Dhani Jog Hundi** is payable to the `dhani` or pur-

1. The discussion below is largely based on Banking Commission (1971a).

chaser of the hundi. However, verification of the identity of the presenter by the banker is not required.

A32.3.5 There are a number of usages commonly followed with darshani hundis. When a hundi is drawn on a correspondent banker in another centre, a `nakal` giving particulars of the hundi and the drawer is usually sent to the correspondent. If the advice is not received, the drawee keeps the hundi in suspense or `khadi` for up to three days without it being discounted. Some other usages, which are reckoned superior to provisions under the Negotiable Instruments Act, are the following:

i. The date of presentation is noted on the instrument by the drawee. While providing proof of presentation, it does not impose any liability of subsequent payment on the drawee.

ii. In contrast to the nakal/khadi procedure, a bill of exchange, if not paid on the day of acceptance or payment, must be retired under the Negotiable Instruments Act.

iii. Costs of `noting or protesting for dishonour` are much lower than for a bill of exchange.

iv. Hundis are easily discounted any number of times by endorsement and delivery.

v. An additional drawee or `jikriwala` can be specified by the drawer of the hundi to guard against the possibility of non-payment by the drawee.

A32.3.6 As this brief description shows, the hundi is a versatile and useful financial instrument.

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October 2, 27, 29, November 18, 23, 29, December 18
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January 17, 23, 28, 31, February 12, March 10, 14, 19, 22
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March 1, May 30, June 29, July 4, September 30
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