Chapter II

Issues Relating to Non-institutional and Institutional Credit

2.01: Definition and Characteristic of non-institutional Credit:

The non-institutional credit sources comprise of professional and non-professional moneylenders, agricultural money lenders, friends, relatives, traders/shopkeepers, employers, landlord etc. (A. Kumar *et. al*. 2017). Generally, the non-institutional credit providers refer to the two main constituents of our financial system and they are Private Moneylenders and Indigenous Bankers. The private moneylenders are the individuals who provide credit to the people on their requirement and charge interest. While the indigenous bankers are the individuals having the licence of money lending and who not only provide credit and charge interest but also provide the facility of hundi and also accept deposits from people. These moneylenders can be broadly subdivided into two categories:

i) Professional moneylenders – They are the people for whom money lending is the main activity and source of income generation for their livelihood. In our country, some communities like – Baniyas, Vysyas, Mahajans, Shahukars, Seths, Chettiars can be found who have been in the business of money lending from generation to generation, with or without holding the licence of money lending.

ii) Non Professional moneylenders are those individuals who lend but money lending is not their main activity for income generation. This category includes people like landlords, farmers, merchants, goldsmiths, contractors, etc.

2.01.01. Role of moneylender: Vyas (2007) stated that a significant role had been played by the moneylenders in meeting the credit needs of rural regions in India. He quoted the data of AIDIS and stated that the share of moneylenders in the total dues of rural households rose from 17.5% in 1991 to 29.6% in 2002. The share of credit of the non-institutional category (mainly moneylenders) had actually risen in the rural areas between 1981 to 2002, and about 45% of the credit lending in rural areas was by moneylenders and 25% of the urban indebtedness was because of moneylenders. In rural areas, the dependence of non-cultivators on moneylenders was found to be nearly 54% in 2002 and of the self employed in urban areas, it was found to be 33%. The interest rate that moneylenders charged was higher and that, about 40% of the total lending by

moneylenders found at 'above the interest rate of 30% per annum' in the rural regions in 2002. The reason was that the bank could not match moneylenders in getting information about the borrower's creditworthiness and the timely payment of credit. Moneylenders collect information on borrowers, monitoring the action of borrowers and ensure the timely repayment of their dues. The timely credit is too important for borrowers than the associated cost. The moneylenders reach the borrowers better than banks. To reduce the role of moneylenders, Vyas advocated for incorporating some factors such as flexibility, easy accessibility, better information and monitoring in the banking system.

The credit / loans extended vary between regions and countries based on the degree of institutional and non-institutional credit. Anand G. Chandavarkar (1985) described the nature and characteristic of the non-institutional financial sector in developing countries in two different segments: i) organisational, and ii) functional and operational. According to him, measuring the size of the non-institutional financial sector in any country was difficult and it would be better to find out the significant characteristic of non-institutional financial sector in developing countries. While discussing the organisational characteristics he stated that, the ownership of the non institutional financial bodies were divided into three categories : i) proprietary, which included moneylenders, pawn brokers and indigenous bankers etc., ii) mutual, i.e. like the rotating savings and credit associations prevailing in the countries of Africa, Asia and Caribbean where the average scale of operation was smaller than the institutional sector and the overheads, i.e., staff, premise and equipment were also low and minimum, and iii) the formal requirement of registration was minimum, nonexistent or was evaded. As there was no resistance to the entry in the market or exit from the market and the process was of complete ease with the lenders and the borrowers enjoying complete freedom and due to this, the market of non-institutional financial market has the nature of 'perfectly contestable market'. The functional and operational characteristics of non-institutional sector had been pointed out by Chandavarkar as the following:

i) The cost of transaction and information was low due to the informality of transactions and the personal knowledge of borrowers on the part of lenders. He also emphasised on the 'trust' and firsthand knowledge of customer.

ii) Loan transactions are more dominant than deposit transactions and most lenders work with their own savings and capital.

iii) Freedom from the policy and control of the Central Bank in respect to liquidity ratio, cash reserve ratio, interest rates etc.

iv) The effective rates of interest in informal sector are higher than the interest rates charged by the formal sector and sometimes it crossed the limit of usury laws but identifying of the same and monitoring and implementation of usury laws in the informal sector is difficult.

v) The informal sector escapes from the tax burden of the institutional sector.

vi) The end uses of informal credit are the mixture of consumption and investment in which the consumption is predominant than the use of credit taken from the formal institutions.

Some of these above factors remove a large part of the so called financial dominance of the institutional sector and give rise to elements of perfect competition and provide a competitive advantage to the non institutional sector. Conversely, there is a considerable degree of oligopoly, oligopsony among lenders due to their grouping of money lending and trading functions, which also detracts from otherwise powerfully competitive nature of the market. The informal financial sector presents a contradictory combination of both highly competitive, as well as oligopolistic elements.

Again, as Chandavarkar points out that, too much regulation of informal sector would be more likely to result in its disappearance without having the adequate alternative of formal sector. The proper strategy for the formal financial sector should be to adopt the desirable feature of the informal sector specifically for the small savers and small borrowers. The author suggested some of the elements of such features:

i) Creation of panel of guarantee brokers who would be drawn from the rank of non-institutional lenders to work in formal institutions on salary and commission basis. Their main job would be to guarantee loans to small and risky borrowers.

ii) Credit risk insurance system for the institutional sector to be created so that insurance of the loans to small and risky borrowers can be done.

iii) Provisions of rediscount or refinance facility to be made by the Central Bank for informal sector's credit instruments by taking guaranty from authorised brokers.

iv) Institutional lenders like rural cooperatives should keep aside a portion of credit for their indispensable consumption purposes.

v) The procedure of lending along with the working time of the institutional lenders should have to be more flexible and informal and the attitudes of the bank employees should have to be more in tune with the local environment and the needs of the local community.

To monitor the borrowers' activity, 'peer monitoring system' can be utilised efficiently (J.E. Stigliz- 1990) for the formal sector so that the likelihood of repayment of loan by the borrower can be enhanced. Local informal moneylenders have the information regarding the borrowers as well as about the project where the borrower invests the loan money and through this information the lender can understand the risk of the money lending whether high or low and on the basis of this, the lender fixes the rate of interest which is always at higher rate due to non competitive market situation. He pointed out three reasons of higher rate of interest : i) the high rate of default ii) high correlation among default iii) high cost of screening of application of loan and pursuing delinquent borrowers. Though the lender of the informal sector charges high interest rate and it is thought that they are less efficient so there has been a possibility that the modern institutions would drive out these less efficient money lenders, but in the actual scenario, there is coexistence of the formal and the informal lenders where the formal sector often suffers a huge loss. Nevertheless, local moneylenders have not only survived but also extended their business year after year by lending to borrowers where the formal sector is unable to reach or unable to provide credit. He illustrated that the Grameen Bank of Bangladesh used peer monitoring by exploiting the knowledge of the members of the loan group and that the process of peer monitoring can be an effective way of acquiring information regarding borrowers as interdependence among the member of the borrowing group is created artificially and the members have been involved to share more risk.

Aleem (1990) worked on imperfect information, screening and the other cost of informal lending in rural credit market of Pakistan. According to Aleem, both demand side

and the supply side of informal credits are affected by imperfect information. The lending cost and the product differentiation are both affected by imperfect information. He observed that through the casual observation determination of risk associated with the loans cannot be imagined correctly. The lender offer loans after making critical analysis of the portfolio of the borrower regarding the credit history and the market reputation of the borrower and the project where the borrower will invest the loan money. The lender needs all these information before sanctioning the loan as all informal loans are usually unsecured. To collect this information lender invests much of his time and other resources on screening the loan applications to reduce risk of default by borrowers. The borrower on the other hand, the party of the demand side of informal credit, lacks information regarding the informal credit as the contract of credit, normally, is done informally.

To reduce the risk of default, the lender gives efforts for collecting information about the applicant borrower as the loans generally are collateral free and the borrower does not have anything except the land to surrender before the lender but the land becomes a big issue due to the involvement of its heavy cost of selling and the legal problematic procedure. The author interviewed 14 non-institutional lender of Chamber area in Pakistan and found the following as common:

i) Lenders did not entertain borrowers who did not have any previous loan history from the same lender.
ii) Further enquiry was conducted for getting the actual information about the borrower regarding his indebtedness and the reputation of the borrower in the market.
iii) On obtaining satisfactory information on the above two points, the borrower was extended the first loan of a very small amount.

The sequence of steps used by the non institutional lenders to obtain the information about loan applicants:

Step 1: Assessment of the borrowers was done through his dealing in other activities.

Step 2: Asking the applicant borrower to provide reference of his villagers who are known to the lender or for providing personal surety.

Step 3: Making inquiries of other farmers in applicant’s villages and in the market.

Step 4: Visiting the applicant's farm.

If the result of these above points comes positive then lender go for the next step.

Step 5: Testing the borrower by giving small amount of loan initially.

For continuing with all these lengthy processes for issuing credit to borrowers lenders has to incur the associated cost and this cost is included in the charge of credit i.e., interest and the rate of interest became high.

According to Aleem, the interest becomes the cost of taking loan or the income of providing loans. The rate of interest charged by the lenders becomes high as the cost of screening of rejected applications is borne by the successful applicants of loan and they are to bear with the high charges of interest. He further observed that in Chamber area of Pakistan, the rejection of loan application was not due to scarcity of loanable fund as the lenders were very much capable to cope up with the increase demand by taking fund from another lender. He also pointed out that the main risk that was faced by the non institutional lender of Chamber in Pakistan was not arose from non recovery of debt as it was found that only 2.7% of the total loans extended by the lenders, from the inception of his lending business, had not been recovered and according to the author, the process of screening of loan applications applied by the informal lenders helped them in resisting the increment in the quantum of bad debt.

2.02: **Non-institutional credit in India:**

A. Bhadury (1973) pointed out that the characteristic of semi feudalism existed in production relation in Indian villages as the moneylender took the Kishan's share of harvest as repayment of past loan and interest and the least privileged category of farmers were usually compelled to borrow again for their consumption needs.

Platteau et al. (1980) stated two points of consideration by the borrower regarding the source of preference of borrowing. These points are personal relationship with the lender and quick disbursement of money. The borrower gave high value to the quick disbursement of loan.

In case of informal lending in India, S. Ghatak (1983) worked on the inter-regional variation in rural interest rate in India. He found high inverse correlation between the level of income and the rate of interest in the rural sector. The rate of interest was very high and it varied between 24% to 150% in different districts of West Bengal. He specifically pointed out that in Burdwan district of West Bengal, the average rate of interest in rural areas was between 36% to 84% per annum charged from casual labours, tenants, and agricultural labourers but the rate of interest in Nadia district of West Bengal varied between 72% to 150% per annum though it was a relatively poor district than Burdwan of West Bengal. He stated that there was little activity of moneylenders in Punjab during his survey period (1978) but in West Bengal the activity of moneylenders was enormous and was the major source of rural credit during 1975-76. The author concluded that the growth of income was a major factor in the fall of rural interest rate.

Hemant K. Pradhan and B.L. Dinakar (1990) evaluated the changing pattern of rural credit in India. The evaluation was done after taking into consideration the various aspects of credit demanded by the rural cultivators namely, i) the incidence of rural debt, ii) the supply of credit sources, iii) the demand for credit according to the purpose and iv) interest pattern of debt. They have taken into consideration the reports of the three All India Rural Credit Surveys held on 1961-62, 1971-72 and 1981-82. Out of these three surveys, 1971-72 and 1981-82 surveys were made more comprehensive and included the urban sector also. They opined that the pattern of rural credit in India had undergone significant changes following the adoption of production-oriented lending programme in the early fifties. The institutional agencies stepped up their role in meeting cultivators' demand for production loans up from one fifth to three fifth during 1961-1981 and the Cooperative and the Commercial Banks emerged as the most competitive agencies in this field. The growing state of institutional agencies reduced the interest rates charged by the moneylender. The performance of the institutional agency was not universal always but the cultivators of regions with irrigation facilities mostly took loans from institutional agencies. The region with higher poverty and unemployment where maximum loans were taken for subsistence purpose of the family, were mostly taken from private moneylenders. He pointed out irrespective of that, the institutional credit was concentrated among the cultivators holding higher asset base and the small cultivator borrowers from non institutional agencies at a higher rate of interest.

2.02.01: Informal Credit for subsistence:

K. Basu (1983) stated that informal credit is important in less developed countries as the marginal section depends on informal credit heavily. Large farmers with better conditions were offered loan in better terms and condition than the marginalized farmers. This was also the reason of getting formal loan easily as large borrowers are powerful and influential. Bank workers also help the large farmers for getting a gift or bribe from them. The author pointed out that default in informal lending is less as the lender lends only to those farmers on whom he has control.

Anita Abhraham (1985) surveyed the Poovar district, a fishing village in Kerala and enumerated the role of credit among the villagers for their subsistence. She defined this subsistence credit as net activities of informal credit relations among the families of the village, for the purpose of their basic consumption need, the transactions of which involves no interest charges upto a limit of Rs. 100. The specific feature of subsistence credit is that the credit givers and credit takers cannot be separated from one another. At any time, the borrowing households can be a lender. In subsistence credit system, the frequency of lending cash and the amount to be lent depend on the generation of income but not a strict function of higher income or surplus incomes. Further, it was found that money was lent by the households even when they were unable to make ends meet and were forced to borrow. Households, after meeting their day's needs, use to sub-lend the surplus to households which were in need of credit. The system of subsistence credit was not oriented towards making profit and thus no interest was charged from the borrowing households as long as the quantum of loan was small and up to Rs.100/- from one lender and as the amount loan was so little, it was not only interest free but also there was no requirement of collateral security. The author pointed out that a house took loans from close friends in order to help another friend. If the loan requirement amount was large i.e., more than Rs. 100/-, then, respecting the norms of Rs.100/- per lender, loans from several households @ Rs.100/- per household were taken to avoid the payment of interest. The repayment of subsistence loan, for a villager, was the social duty rather than economic obligation as it helped the needy household during their consumption starving days. The chance of defaulting of loans was very less as the debtor could not flee from the village as the social cost of that was much higher than the temporary gains through defaulting. According to the author the subsistence credit is not only a transaction of credit but it is an

example of village solidarity and effective cooperation in facing common problems which did not depend on any ideological belief of cooperation.

Ramachandran and Swaminathan (2002) have described the financial liberalisation as a key component of the globalisation agenda imposed by the developed countries on the developing countries. In financial reforms, the removal of control on interest rate and abolition of directed credits were also included. The authors have analysed the effect of liberalisation in financial sector of India on rural banking and on rural credit with reference to landless labourers in their article 'Rural Banking and landless labour households: Institutional reform and rural credit market in India'.

The exploitation of rural people in the credit market is one of the most common and constant features of Indian rural life. According to the authors, rural people need credit for meeting the requirement of working capital or for investing in agriculture and for other income generating activities. In rural areas, the agricultural and non-agricultural activities are seasonal and credit is required by the rural people for smoothening the seasonal fluctuations in earning and expenditure. Ramachandran and Swaminathan pointed out four major problems associated with the supply of credit to the poor people namely, inadequate credit supply by formal institutions, imperfect and fragmented credit market, and, unequal distribution of formal credit in respect to class, region, gender etc. In particular, the formal credit should reach backward areas, less income generating households, poor people of oppressed caste and tribe and women. Finally, there has been an extensive progress of informal credit to the income poor people with a very high rate of interest. The authors' survey of Gokilapuram village in May 1999 revealed that for the category of 'landless hired labour households with no other sources of income', only 5.8% came from the formal source of credit and 94.2% was from the informal sources. For ' landless hired labour with other sources of income' – 8.8% was from formal sources and 91.2% came from informal sources, and for all landless hired labour households , only 7.7% was from formal credit sources and 92.3% came from informal sources. The important findings from the above is that in case of all the three categories of farmers, the contribution of informal credit source was more than 90% i.e., high rate of interest of informal credit does not act as a barrier to the borrower from loaning from moneylenders. According to the authors, an informal loan is subject to no regulation but the formal loans are allotted on the basis of specific rules and regulations fixed by the institution or

Government. Informal loan is a personalised transaction which depends upon the specific relation of power between the two parties i.e. lender and borrower.

Ramachandran and Swaminathan (2002) further pointed out two trends in money lending as an occupation:

i) The class whose major occupation is money lending as primary activity.

ii) Money lending is a part time occupation or the secondary source of income.

In the surveyed village they observed the activities of money lending association which was known as Sangam. It was a group of 5 to 25 subscribers. The members of Sangam, generally, were from the same caste who paid a fixed amount at a regular interval and from the accumulated amount the loan was given to members at 60% rate of interest. The loan was extended only after getting someone who would act as surety.

The exploitation of borrowers who took various types of loan from the informal sources, particularly from the moneylenders has been cited below as example for better understanding:

i) Kanthu Loans: If borrower wanted a loan of Rs. 1000/- , he would have been given Rs. 900/- for his Rs.1000/- loan amount and the borrower would have to repay the loan at a rate of Rs.10/- per day for 100/- days. The starting deduction was in direct proportion with time. If the repayment time would increase, the starting deduction would increase but the instalment per day would decrease. For a Rs. 1000/- loan, if Rs. 800/- was given to borrower then the loan would have been redeemed at Rs.5/- per day for 200 days.

ii) Monthly Interest Loans: These were the loans given to the people whom the moneylender trusted. The rate of interest was fixed on the criterion of trust. The size of loan was also a factor of fixing rate of interest – higher the size of loan amount, lesser was the rate of interest and vice versa. Monthly interest loan was the main form of loan in Gokilapuram village in which the interest rate generally charged was 10% to 12% per month as the lender always wanted to get back his principal amount within a year.

iii) Weekly Interest Loans: It was like Kanthu loans but with a higher rate of interest. The origin of the loan was in the cattle trade where loan was repaid after a week. In this case, the loan repaid along with a part of principal in

weekly basis. If lender lent Rs.1000/- to a borrower, then the borrower would have to pay Rs. 125/- per week for 10 weeks for repaying the loan. Weekly interest loan was observed in Gudalur village by the authors.

iv) Daily Interest Loan: it was observed in Gudalur village. In case of daily interest loan, the rate of interest was in between 30 paisa to 50 paisa per day per Rs.100/- in 10 days to 1 month, the principal amount of the loan was normally paid back. It was normally used (70%) by the people engaged in illegal activities like smuggling, bootlegging or in any auction etc., 30% of this type of loan was used by people who had the emergent need of credit for medical treatment , obsequies etc.

For every loan given by the lender, the borrower must sign his name on a blank sheet of paper on a revenue stamp. If any surety is accompanied, then that surety had to sign also. In case of married borrower, the lender would make himself sure that the wife of the borrower knew about the incident of taking loan and informed her about the repayment record.

Ramachandran and Swaminathan also analysed the money lending activities from the point of view of the lender and stated that providing loan was an easy matter but collecting the interest on regular basis and getting back the principal amount of loan was a matter of waiting for months and years. There is every possibility of losing the money which has been extended as loan if the lender is unable to keep him in an efficient mode. When a borrower becomes unable to pay back the amount what he has received as loan becomes bad debt for the lender. This bad debt is nothing except the accumulated fund or working capital or any collected money by taking loan from another moneylender if it seen from the point of moneylenders. The bad debt is not very easy thing to digest for the moneylenders. The situations arise from this event are to be dealt by moneylenders with their patience, energy, own money and lastly with the help of power. Money lending is a tough job and the group of moneylenders is also tough. On non-payment of interest and principal, shouting on debtors or borrowers in public places has been a regular observing event. Authors observed in Gokilapuram that there was no occasion of beating for non payment but the event of seizer of debtor's valuable and useful assets was observed. The story of Gudalur was different and the event of collection of interest and principal was full of threats and beatings and

the seizer of borrower's movable properties, useful assets, utensils, furniture by the lenders were observed.

The types of lender in informal sectors which they found in Gokilapuram village in 1977 and 1999 are manufacturers, merchants and millers, landlords, In Gokilapuram village, the share of moneylenders increased from 27% in 1977 to 42% in 1999. The same trend was also observed in the share of miscellaneous part-time lenders. The share of miscellaneous part-time lenders had increased by 13.2% during 1977 to 1999.

2.03: Institutional Credit: The credit which is supplied by the institutional agencies is called Institutional credit. In India, the institutional agencies include Scheduled Commercial Banks, nonbanking financial institutions, cooperatives, Regional Rural Banks, self-help groups, microfinance institutions, and other government agencies (A. Kumar et. al., 2017) through which the credit is supplied throughout the country.

2.03.01: **Definition of Small Borrower:** Sudarshan Lal (1976) explained elaborately the term small borrowers. He also explained the credit facilities extended to small borrowers. He mentioned the following types of small borrowers:

i. Artisan and Craftsman
ii. Small Borrowers and Self Employed Persons
iii. Transport Operators
iv. Agriculturist and Person engaged in allied activities
v. Persons belonging to the low income groups.

Artisan and craftsman were granted loan by the State Industries Department for working capital requirement upto Rs. 1000/- against personal bond, while loan exceeding Rs, 1000/- but not exceeding Rs.5000/- were granted against security. Commercial and Regional Rural Banks extended loans to artisan and craftsman under rural artisan scheme or rural craftsman scheme. Normally these credit institutions granted financial assistance ranging between Rs. 2500/- to Rs 7500/- but for an educated self employed person the maximum amount of admissible assistance was Rs. 20000/- . The rate of interest was a variable one and ranged between 10 percent to 15 percent per annum normally but in case the borrower belonged to low income group the rate of interest was lower and the borrower could get assistance of interest rates which was reduced to 4 percent per annum also. The loan amounting to Rs. 5000/- was extended to the borrowers only after taking

mortgage of borrower's property like land, factory premises, stock machineries, equipment etc.

The author mentioned here that loans were also extended to small borrowers by the commercial banks even when the bank had no such specific scheme for the purpose. Bank treated the borrowers as small borrowers and had made 'small borrowers' as a category of lending small amount of loan. He explained the matter with the example of Bank of Baroda which had an omnibus scheme known as ' Multi Service agency' under which the loan facilities were granted to tailors, launders, vegetable vendors, hair dressers, cobblers, photographers, book binders, etc. The term professional and self-employed persons were applied to trained personnel in art and crafts or who held either a degree or a diploma from any recognised institute including dentist, chartered accountant, surveyor, persons who were technically qualified or skilled in the field in which they were employed. Banks allowed them loan depending on their business profession and charged interest, normally 12 % to 15.5 % per annum and booked their entire stock on hypothecation. These loans were repaid in one to three year period on monthly instalment basis. While disbursing the loans, banks sometimes directly paid the supplier of the equipments etc from whom the borrower wanted to purchase the assets of his business. In all cases, the bank extended the loans only after being satisfied by the proposal of the borrowers in which the margin money was a specific factor.

The definition of small borrowal account as per the RBI is- an account that has a sanction limit of Rs. 2,00,000/-. The limit set for a MFI loan to the customer is the maximum of Rs. 1,00,000 as per the NBFC-MFI master circular issued by RBI in 2014 (Sriram-2015). In 1975, the cut off limit of this small borrowal account was Rs. 10,000/- which was increased to Rs. 25,000 after June 1983 and since April 1998, the cut off had been set to Rs. 2,00,000/-.

The relation between the borrowing cost and the demand of rural credit has been enumerated by Adams and Nehman (1979) in their article 'Borrowing Cost and the demand for Rural Credit'. According to them that in the low income countries the supply of agricultural credit from formal institution increased rapidly. The government of many countries tried to provide additional fund to the rural poor but very little of this additional loanable funds reached to the poor people of rural area. They cited the work of some

authors to explain the reason of lack of formal credit to the poor people of rural areas as: i) conspiracy of urban people against rural people and resisting them from the access of formal credit;, ii) widely used concessional interest policy along with their loan transaction cost for serving small borrowers discouraged financial institutions to lend rural poor; iii) due to lack of profitable investment opportunities and lack of awareness of benefits of formal credit rural poor people do not demand formal credit but the authors have proposed a different view on the issue and fixed their point on the borrowing costs charged by the formal institutions. According to them the rural poor people show their unwillingness of borrowing from formal lender due to the differential borrowing costs. They pointed out three kinds of borrowing costs: i) beyond the interest payment on loan, the other charges collected by lender such as application fees, service fees, etc., ii) in many countries rural people were forced to negotiate with agents, leaders etc., before the sanction of their loans and sometimes they had to bear the expense of the person who inspect their business and sometimes they have to settle the loan approvals by offering bribes iii) the cost associated with the travelling expense for getting their application sanctioned. The authors have suggested that for achieving the objective to reach the rural poor with formal credit, transaction cost of borrowers are to be minimised. The travelling cost may be reduced by making easy policy of granting formal credit so that borrowers may not require to visit the institution frequently for getting his/her loan sanctioned and there by the reduction of borrowing cost may be possible.

L. Menkshoff *et al.* (2011) examined the collaterals that were required for extending loans to poor households. Collateral always act as the most important instrument in lending whether it is from formal institution and from informal institutions. The collateral accepted by the lender in an anticipation of that in future it will resist the loss of lenders that may occur from the default in repayment by the borrowers and the incentive of borrowers due to default in repayment can be minimised. The collateral has become a major problem for the poor households for not having it in adequate quantum. The authors have shown the following main findings for solving the puzzle of collateral:

i. Conventional collateral was rarely used and that for receiving loans poor do not always require tangible assets as collateral. The lack of assets (collateral) were not the

only reason of not getting loans by the poor people, the other means of dependence of lenders i.e., substitute of collateral can be used.

ii. The lender can provide collateral free loans if someone gives the guarantee of repayment on behalf of the borrower on his failure to repay. This process is popularly known as third party guarantee. Besides the above two, the relation of borrower with the lender effects the requirement of collateral and sometimes need becomes less or no collateral.

Menkshoff *et. al.* found that the importance of guarantee is high than the lending based on relationship. The importance of third party guarantee is more used in formal institutions.

The incidence of collateral and guarantees in small firms can be understood form the table (No. 2.3) below:

Table 2.1: The incidence of collateral and guarantees in small firms

<table>
<tr><th rowspan="2">Sample</th><th rowspan="2" colspan="2">Loan type</th><th colspan="3">Percentage of loans secured by collateral and guarantees</th><th rowspan="2">Percentage of unsecured loans.</th></tr>
<tr><th>Business & personal collateral</th><th>Personal guarantee</th><th>Total</th></tr>
<tr><td rowspan="4">US NSSBF 1993: 4637 small firms (<500 empl.)
(Avery et. Al., 1988)</td><td rowspan="2" colspan="2">Total Loans</td><td>Without guarantee:49.5</td><td>Without collateral: 10.9</td><td rowspan="2">90.4</td><td rowspan="2">9.6</td></tr>
<tr><td>With guarantee 30.0</td><td>With collateral: 30.0</td></tr>
<tr><td rowspan="2">Loans to unincorporated firms:</td><td rowspan="2">-Lines of credit</td><td>Without guarantee : 10.3</td><td>Without Collateral: 31.7</td><td rowspan="2">49.4</td><td rowspan="2">50.6</td></tr>
<tr><td>With guarantee: 7.4</td><td>With collateral : 7.4</td></tr>
</table>

		Mortgage	Without guaranty: 34.6	Without collateral : 15.9	73.7	26.3
			With guaranty : 23.2	With collateral: 23.2		
		Equipment loans	-----------	Without collateral : 31.4	-----	--------
Italy 2005: 300,000 firms Sole proprietorships, consumer households (Calcagnini et al., 2009)	Loans to all customers		42.7	15.7	58.4	41.6
	Loans to firms		32.2	23.6	55.8	44.2
	Loans to sole proprietorship		45.4	28.0	73.4	26.6
	Loans to consumer households (mostly mortgage loans)		72.6	5.4	78.0	22.0
Germany 2002: 230 Professionals (Neuberger and Rathke, 2009)	Investment Loans		Real Estate: 63.0	20.0	84.0	16.0
			Other assets: 20.0			
Belgium: 248 small firms (mean number of empl.: 40) (Voordeckers and Steijvers2006)	Total loans		Business Collateral : 57.206	Personal collateral and guarantees 30.34	87	12.4
Thailand 2006-2007: 2186 Rural Households (Menkhoff L. Et al. 2011)	Total Loans		15.0	71.0	86.0	14.0
	Agricultural Production loans		Land :14.7			
			Other assets: 0.7			
	Non Agricultural Production loans		Land: 19.8			
			Other assets:			

		4.9			
	Consumption loans	Land : 8.2			
		Other Assets: 2.2			

Source: Menkshoff L. *et al*. 2011

The above table as showed by Menkshoff *et. al.* (2011) to compare the result of others with his study on Thailand. They find that the incidence of collateral is lower, but the probability of pledging personal guarantees is higher for the households in Thailand than for micro or small enterprises in mature markets due to lack of collateral assets or lower cost of using personal guarantees instead.

G. Herath (1994) stated that there is a difference between rural credit markets and classical monopoly and competitive markets. Traditional monopoly or competitive markets unable to express the features of rural credit market in toto as the coexistence of the formal and the informal lending, credit rationing, interlinking etc. are not properly explained. The credit market is unique due to its transaction costs, information costs and risk which are not important in markets for other goods. The credit markets engage two parties for contract to be executed over time and hence these factors are important. While stating about credit liberalization or regulation, the author opined that viability of banks would be affected if the real interest rates are not realized.

The opinion of N.A. Mazumder (1995), is that, "the new banking culture nurtured by the economic reforms is alienating not only the small borrowers but also small sever". He opined that the new banking culture has changed the profile of public sector banks and profitability has emerged as the single most criterion for judging the operational efficiency. Most public sector banks are attempting to cast themselves in the image of foreign bank and consciously neglecting the priority sector. He also mentioned that this mindset of the public sector bank would be disastrous for the future growth of economy unless Reserve Bank of India takes steps to make the new banking scenario compatible with small borrowers.

H. S. Shylendra (1995) studied the impact of low or cheap interest rate policy on the lender vitality and lender behaviour in a south Indian regional rural bank to test the

proposition that the failure of specialised institutions that extend credit in rural sector must be self sufficient under the cheap interest policy which ultimately deviate the institution from their set up objective of lending to the poor rural people. He stated that in developing countries cheap interest rate policy was based on some assumptions like rural people are poor and they unable to save, rural people lack capital and therefore they need cheap credit. These were wrong assumptions and due to the wrong assumption the result of adverse consequences would have been observed. It was observed that cheap interest rate not only increased the demand for credit but at the same time that also increased the cost of lending to small borrowers. Due to the unrecoverable lending cost, the shift of small borrowers to the government institution for cheap interest credit and deviate from their pre-laid objective of helping poor people of rural sector and concentrate to provide credit to only rich and well off by taking adequate security. The author studied activities of Tungabhadra Gramin Bank and supported the above proposition about the lender behaviour under cheap interest rate policy.

Ben Rogaly (1996) stated that the subsidized credit model was under criticism from mid-seventies as donors and other resource allocators shifted their interest from state based to market based solutions. According to policy makers there is no difference between credit and debt and oversupply of subsidized credit without pragmatic appraisal of people's ability to repay the debt in total could ruin many borrowers.

According to Rawal & Swaminathan (1998) the organisational support to agriculture in the product and the credit market did not show any significant improvement during 1980s. The amount of advance extended from the commercial banks and the cooperative banks were less in amount in 1980s than from 1970s. The authors had shown that the states of eastern India including West Bengal were receiving a lower share of institutional credit but the All India Debt and Investment Survey (AIDIS) data for 1981 showed that the share of institutional credit in total outstanding debt of a household observed in West Bengal was more than the average for India. In West Bengal, the higher proportion of Institutional credit went to the low asset holding class than in rest of India during 1971 to 1981.

He has mentioned about some measures to substantiate the anti poverty image of post 1991 economic reforms. Out of his three, following two relates to the small borrowers:

i) Concession in the interest structure which was the bedrock of interest rate regime was virtually abolished. Small borrowers had to pay more rate of interest than earlier.

ii) Provisioning had become essential even for small loans. Banks, considering their transaction costs had become reluctant to extend loan to numerous small borrowers, rather, they had shown their interest to extend the hand to the lenders of the small borrowers. The term that he had used for them is 'New Multanies' i.e., non Banking Financial Corporations which charge more lending rate from the small borrowers or from the marginal section of the society.

According to the author, if banking system has to play a role of catalyst of development , a new credit delivery system has to be forged involving voluntary organisations , NGO and self help group and the banking system should refocus their attention on lending to the priority sectors, small borrowers micro enterprises.

T. Jappelli *et al.* (2005) explained the effect of judicial enforcement on credit market and found that the cost of judicial inefficiencies in credit market is very high. They tried to explain that by analysing the effect of inefficient judicial system on cost of credit. They illustrated that the reduction of credit constraint and the increase of the volume of lending could have been done through the efficient judicial system. The competitive structure of bank determines the increase or decrease of interest rates but the ability of repossession of borrower's collateral by the lender can be eased by improving the judicial system. According to authors 'greater judicial efficiency can open up the credit market to low grade borrowers previously judged not creditworthy'. They observed that in case of large of backlog pending trial, the availability of credit is less wide.

Anjani Kumar *et.al.* (2010) through their studies on institutional credit to agricultural sector for finding the performance and the determinant of credit which was based on secondary data found that, i) the decision maker's age can influence the quantum of credit, ii) female headed households were the less recipient of formal credit than the households headed by male, iii) the higher the level of education, more the chance of getting formal credit. According to them that, through the knowledge of education the borrower can make himself wiser for taking the decision of not to take credit from non-institutional sources at the higher rate of interest. Their study also showed that the flow of

institutional credit had been increasing since the past four decades with different pattern of growths and with some regional disparity in disbursing agricultural credit. Their suggestion was for imparting training for the capacity building of borrowing farmers and for the procedural simplification for providing of institutional credit to lee literate weaker section people.

2.04: The difference between Formal and Informal Financial Sector: The difference of the financial sector in respect of formal and informal can be understood from the following:

Table 2.2: The difference of formal and informal financial sector

Sl no	Formal Financial Sector	Informal Financial sector
01	Formal Financial institutions ignore small farmers, Lower- income households and small- scale enterprises. It is in favour of a large scale, well off and literate clientele which can satisfy their stringent loan condition.	The informal financial sector provides savings and credit facilities for small farmers in rural areas and for lower income households and small scale enterprise in urban areas.
02.	Complex administrative procedures are beyond the understanding of the rural mass and small savers.	The procedures for informal schemes are usually simple and straightforward as they emanate from local culture and custom, they are easily understood by the population.
03	Formal financial institutions do not mobilize rural savings or small scale deposits. Commercial banks could contribute to rural and small savings mobilization if they had adequate branch networks and they adopted the relevant procedure.	The informal sector mobilizes rural savings and small savings from low income urban households.

04	The working day and opening hours of formal financial institutions do not take rural work schedule into account; banks are open at the times when farmers are at work in their field.	Informal groups operate at times and on days which are convenient for their members.
05	Formal sector institutions are selective regarding clientele, so as to avoid having clientele who make only small deposits. Their financial technology is not suited to the management of modest sums from large number of saver.	Informal sector associations accept any amount of regular savings, even the most modest sums which a saver can afford to set aside. The financial techniques on which such informal groups are based lend themselves to the management of a large number of small accounts.
06	Loan application procedures are complex and require reading and writing skill so that a file on the borrower may be established	Access to the credit is simple, non bureaucratic and little based on written documents. Literacy is not a requisite.
07.	Processing of loan request is complex, resulting in long delays before final approval or rejection. Even when approval is obtained, loan delivery is slow.	The simple and direct processing of loan requests allows for their prompt approval and a minimum delay in disbursement. Rejections are rare but the level of risk is reflected in the interest rate charged.
08.	Collateral requirements correspond to the situation of relatively well off urban-dwellers: deposit or savings accounts in a commercial bank, property which can be mortgaged.	Collateral requirement on loans are based on local conditions and borrowers capacity. The condition may be based either on regular contributions to ROSCAs or on precise knowledge of farm size and /or crops harvested so as to determine the borrower's capacity to repay a loan.
09.	Transaction costs are high	Transaction costs are low

10.	Repayment rates are low	Repayment rates are high
11.	Formal sector institutions do not have close contact with the environment in which they operate. Sometimes they prosecute defaulters, which can have negative social repercussions.	Because they emanate from local environment, informal groups are aware of the problems that the members may be confronted with, and therefore they can deal with repayment difficulties in a pragmatic manner. Debt rescheduling is possible.
12.	Unfamiliar with the grassroots environment, formal institutions are ill- served by mediocre supervisory and monitoring network and are unable to gain insight into the activities of their clientele.	The informal sector has a dense and effective information network at the grassroots level for close supervision and monitoring of borrower activity-particularly their cash flow – whether they are member of an informal association or not. This contributes to the efficient mobilization of savings and ensures high loan repayment rates.
13.	Formal sector institutions do not have a good network for dissemination of information. In addition, they are out of touch with the rural masses and make little to seek ways of reaching them.	Within the informal sector, information is widely diffused. The regular meeting of informal savings and credit associations serve as a forum for dissemination of information.
14.	Some institutions of the formal sector do not even offer saving facilities. Other apply low or sometimes even negative- real interest rates, thus putting off many a potential saver.	The interest paid on the deposit in the informal sector compares favourably with that paid in the formal sector, thus providing an incentive for rural and small urban households to save.
15.	Public institutions charge very low-	The informal sector charges competitive

	sometimes negative – real interest rates on loans. Commercial banks apply moderate lending rates which are nonetheless considerably higher than the interest paid on savings. The link between deposit and lending rates is week.	lending rates, though they are sometimes high, this reflects the scarcity of loanable funds. There is little connection between deposit and lending rates.
16.	There are investment opportunities for savings which have been mobilized but which have not been lent	There are no investment opportunities for savings which have been mobilized but which have not been lent
17.	The formal sector keeps written record on the activities of clients, although the information recorded is sometimes irrelevant.	The informal sector usually does not keep a written record on the borrowing and/ or saving activities of its clientele. When it does, the procedures are relatively simple.
18.	The formal sector regularly has loanable funds available.	The volume and the availability of loanable funds are subject fluctuations.
19.	Formal sector institutions are subsidized by the government and may also receive grant or other support from donor agencies.	The informal sector is not subsidized by the government, nor does it receive grants or other forms of support from donor agencies.
20.	A regular supply of funds allows the formal sector to lend at any time of the year. This is not the case with government lending institutions, which are deprived of sufficient because of high default rates on their loans.	Savings and credit mechanism in the informal sector are not geared towards accumulating funds before the peak session when loan request are highest.
21.	Formal sector institutions could reach a widely dispersed rural	Despite the widespread dissemination of information within the informal sector,

	clientele by collaborating with government extension units. In practice, though, they do not resort to such intermediaries and do not provide financial services in rural areas.	informal groups are often unaware of new farming methods, and so members do not learn of new techniques which would allow them to increase production levels and raise their standard of living.

Source: Germidis *et. al.* (1991)

2.05: Interaction between formal and informal credit:

Sarbajit Chaudhury (2001) has shown in his paper by developing a model of interaction of formal and informal credit market where the author has shown that the bank officials, the formal credit suppliers' agents create constraint of lending by charging of unethical bribes from the borrowers for delivering the loan amount. For getting the bribe they do not disburse the loan amount to the actual potential borrowers and thereby they actually help to create the market of informal credit suppliers. The relation of bank officials and the informal credit suppliers are non cooperative with the borrowers for fixing the amount of bribe and the rate of interest of informal credit supply. The author has shown that an agricultural credit subsidy policy may be counterproductive even when formal and informal credits are substitutes and not complementary to each other. The author took three propositions: (i) the effective price of formal credit (incorporating the bribe) is equal to the price of informal credit in equilibrium. (ii) A price subsidy policy and / or a credit subsidy policy , where the latter is adopted through the reduction in the formal interest rate, raises both the informal interest rate and the bribing rate but lowers the numbers of farmers among whom the formal credit was disbursed. On contrary, a credit subsidy policy, if undertaken via an increase in aggregate supply of formal credit, lowers both the informal interest rate and the bribing rate in the new equilibrium. The effect on the number of farmers receiving the formal credit, however, remains indeterminate. (iii) A credit subsidy policy adopted through a reduction in the interest rate on formal credit, leads to a decrease in the agricultural productivity. The borrowers become worse off while both the formal and informal lenders become better off in the new equilibrium. On the contrary, if a credit subsidy policy is undertaken via an increase in the aggregate supply of

formal credit, the agricultural productivity as well as the welfare of the farmers improves. The moneylenders become worse off. However the welfare of the bank officials may improve. On the other hand, a price subsidy policy makes the bank officials and money lenders obviously better off. The agricultural productivity and the welfare of the farmers may also improve as a consequence.

Rosemary Atieno (2001), while assessing the role of institutional lending policies of formal and informal credit institutions for finding the accessibility and the utilisation of credit facilities by the small business borrowers in Kenya found that among the credit takers, 51% was the first time credit user and out of these 51% , the major part i.e. 67% has taken credit from informal sources and the main reason of non seeking credit was the non availability of proper information of availability of credit in the market and lack of security required for taking credit. When credit availability was seen in terms of rationing behaviour of lenders, both in formal and in informal credit market, they found that 15% had the credit constraints, although , the percentage of borrowers who ever applied for credit was 49% only, and , there was a significant difference in the applied amount of credit and the amount received as loan. The terms and conditions for disbursing loans were significantly different for formal and informal credit market. The rationing of credit in the formal market was dependent on lending terms and conditions while the same was dependent on the resource base of the lender in case of proving informal credit. The limited access of credit is was seen as a constraints of supply side not constraint of demand side as there were households, with higher wealth, who were in need of credit but unable seek that due to the terms and conditions of providing credit of formal sectors and the credit gap. The conclusion that he stated that lack of supply of credit was one of the reasons of lack of demand of credit. He stated that informal credit source provided the easy access of needy credit to small and microenterprises and the main reasons of that were the lending terms and conditions including the collateral, application procedure and the repayment period.

Catherine Guirkinger (2008) illustrated the coexistence of formal and informal credit market in Piura, Peru with econometric analysis of sectoral choice, exploration of sectoral differences in terms of loans and the differences in lending technologies and recovery strategy of loans by the lenders. He pointed out towards a survey which classified the households into the following rationing categories of formal sectors:

i) Price rationed with loans (PRwl) – user of formal sector loans

ii) Price rationed without loans (PRwol) - non user of formal sector loans

iii) Quantity rationed (QR) - Borrowers who applied for formal loans but rejected or would be rejected or obtained less amount of loan than desired.

iv) Transaction cost rationed (TCR)- borrowers who due to high transaction cost, formal loan was not applied.

v) Risk Rationed (RR) - Borrowers did not apply for formal loan because of the high risk implied in the contract

The outcome which he has showed is the informal loan used by the formal sector is:

Table 2.3: The formal sector outcome through use of informal loans

Formal sector outcome	Frequency	Percentage using informal loans
PRwl	220	16
PRwol	224	25
QR	292	50
TCR	105	45
RR	157	41
Total	998	35

Source: Guirkinger & Boucher (2008)

The above information was analysed and found that that only 16% of the borrowers in the formal sector and 25% of the borrowers who did not have any formal loan project, applied for informal loan. Other categories like QR, TCR, RR are 41% to 50% who used informal loans which showed that the borrowers who did not have access to formal loans (QR) or the borrowers who were unable to pay transaction cost (TCR) or

unable to take the risk of formal loans were more likely to seek informal loans than price rationed households. The result of survey suggested that " households who did not have the access to the formal sector because they were denied or did not get their desired amount of loan in the formal sector were 39% more likely to use an informal loan than priced rationed household in the formal sector and the households who did not go for formal loan due to high transaction cost were 27 % more likely to use informal loan while borrowers who did not take formal loan for its risk sharing rule were 33% more likely to be involved in getting informal loan than the household in the base category. The analysis showed a strong positive correlation of the probabilities of using informal loan and the probability of being non price rationed in the formal loan sector.

While analysing the exploration of sectoral differences (Guirkinger & Boucher, 2008) the data on interest rate, cost of application of loan, loan amount and the maturity of the loans were considered. The collateral was also considered as collateral is the indicator of what borrowers can lose on his default of paying it off and found that the difference between formal and informal loans in regard to the amount, interest rate and maturity were large. The maturity (average) of an informal loan was six months and formal loan had a higher maturity.

While analysing the differences in the lending technologies, the selection of loan application, loan monitoring and recovery and the economics of scope, locational advantages and the access of funds have been given due consideration and found that the formal sector was more standardised than informal sector while considering loan applications. For applying formal loan, borrowers should have at least one hector of land in his / her name and there should not be any adverse remark in the borrowers' credit history. But, informal lenders issued loans on the basis of their prior knowledge about the borrowers. In the beginning, the informal lender provides small amount of loan to the borrower and then progressively amount and condition of issuing loan improves in the subsequent loans. Borrowers, who lack any of the conditions of formal loan sector, prefer to obtain loan from informal sectors. The author pointed towards the vast difference of the recovery technique of loan between the formal sector and the informal sector. When the loan from formal sector becomes unpaid after the due date of payment of loan, the judicial process is initiated to seize the collateral of borrowers, if the negotiation fails. But, in case of informal sector, there is variety of recovery practices, but, the lender of the informal

sector get to place his claim on the product first. The informal lender offer loans at a lower risk than the formal sector loans. The borrower, in spite of high interest rate charged by the informal sector, prefers to go with informal sector because of the screening process.

The effect of intermediation between the institutional lender and the informal money lender was discussed by Clive Bell on the terms and condition of loans (Clive Bell, 1990). He stated that a fall in the moneylenders' cost of fund would result in a fall in the interest rate of loans if there was no uncertainty, irrespective of the market situation whether it was competitive or monopolistic. He pointed out that the arbitrage process was operative in the formal and informal segments in the credit markets. Borrowers who obtain loans from the formal sector can relend the money to another borrower at a higher rate of interest and thus the formal borrower can be the informal money lender. The process of arbitrage is restricted by the following factors: i) individual access to the loanable fund is limited, ii) knowledge regarding borrowers' situation is required for relending, and, iii) other activities, like cultivation, might be more attractive at margin than money lending. It was found that the informal money lenders preferred to extend loans only to their longstanding clients and took new clients only after getting desirable information about the new borrowers. The game between a borrower and the moneylender, from whom the borrower took loan, was normally repeated over a good period of time as switching to other lenders became costly for the borrowers. As the lenders and the borrowers in the informal sectors reside in the same region that is why the lender can differentiate between the good and bad performance of the borrowers and this is one of the reasons of mitigating the problem of moral hazard of the lender. The moneylender of the informal sector, on default of the borrowers, exercises his first claim on the proceeds of the borrower if the product is sold through him. If borrower sells his products through a trader other than one from whom the borrower had taken loan, the trader also deduct the amount of principal and interest of the loan and handover the same to the lender from whom the borrower had taken loan.

Some interesting result has been shown in the literature on formal and informal credit in Egypt (Mohieldin, 1994). A survey was conducted on 200 households in an Egyptian village during December 1992 to April 1993. The result of the survey showed that 22.5% households had either deposit or current account in the formal sector bank and 30% have formal sector loans. Only 6% of the households had formal loans and deposits

simultaneously. The most interesting thing that has come from this survey is that the higher proportion of the sample had links with the informal sector. It showed that only 13% borrowed and lent in the informal sector simultaneously. 27% of the household's extended informal credit to others without borrowing, and, 29.5% borrowed from others without lending. In total 69.5% of the households were involved in the informal sector. The survey reveals that 86% out of 200 households borrowed or lent in either of the two segments.

Table 2.4: The Formal and informal transaction

	Formal sector		Informal sector	
	Borrowed	Did not borrow	Borrowed	Did not borrow
Lent	6	16.5	13	27
Did not lent	24	53.5	29.5	30.5

Source: Mohieldin- 1994

They further found that the relative size of the informal credit obtained by the households was small than the size of formal sector credit. Survey found that the informal loans are smaller than formal loans and the quantum of the informal credit was approximately 48% of the total credit. The following data was given on the purpose of loans which were borrowed from formal and informal sectors:

Table 2.5: The Purposes of credit

	Informal Sectors					
Formal sector	None	Production	Consumption	Emigration	Social	Others
None	83	0	27	4	14	2
Agricultural Operation	21	5	2	1	2	0
Trade	3	5	0	0	1	0
Industrial	0	1	1	0	0	0

Housing	0	0	0	0	0	0
Consumption	3	0	3	0	0	0
Social	2	1	0	0	1	0
Others	3	1	1	0	1	1
Total	115	23	34	5	19	3

Source: Mohieldin- 1994

Some results that have come out from the above data were that the people who borrowed from one market did not borrow from other financial sector for the same purpose. The borrowing was from the formal financial sector when it was for business purpose. Large proportion of the loans was for consumption and social purposes when it was taken from informal sector.

According to A. Kumar *et. al.* (2017), the right to use institutional and non-institutional credit depends on land size. The use of formal credit is not scale-neutral though several measures have been taken to encourage financial inclusion in India but large segments of agricultural households are still remaining out of the formal credit system. Poor families are excluded frequently from getting the access of formal credit for not having required collateral or guarantors. He found that there is a positive relationship between land size and access to formal credit. The households having better resources get the access of formal credit easily compared to households with smaller amount of resources. They showed that a *'total about 7 percent of agricultural households, account for about 12 percent of agricultural households that borrow exclusively from formal sources, and they account for 24 percent of the total formal credit issued to agricultural households. In contrast, marginal households, which are 40 percent of farm households, account for 26 percent of borrowing from formal sources, and their share of total formal credit is about 17 percent'*. The complete reverse scenery has been found in case of informal credit. They observed that 'marginal farmers comprise 53 percent of agricultural households that borrow from informal sources, and their share of total informal credit is about 24 percent. Large farms, in contrast, account for only about 4 percent of households borrowing informally, and their share of total informal credit is about 18 percent'. The conclusion that they made is that *'the access to institutional credit increases as land size increases, while credit from non-institutional sources decreases as land size increases'.*

2.06: Credit on Virtual system:

Virtual Credit intermediary: Rajkamal Iyer *et.al.* (2009) evaluated the opportunities of new online peer to peer lending market of small borrowers using the data of Prosper.com, a credit intermediary. Peer to peer online lending models provide a non hierarchical, market based system that facilitates the screening by gathering all the information on the credit worthiness of borrowers over multiple individual lenders by observing both standard financial information and non standard information about the quality of the borrowers. According to them the lenders use the soft information, and that become more important information when they screen lower credit quality borrowers. Their result showed that lenders in peer to peer markets were competent to understand efficiently about borrowers' credit worthiness using the valuable information that these market supplied. They found that, in these markets, the interest rate set by the lenders perceived borrowers default 45 percent more precisely than the exact credit score. The use of credible signals that were soft and non standard in banking process suggested that enhancing the chance for borrowers to post credible signals can facilitate the screening process. Their findings reassured that these markets partially gather true credit worthiness and were not totally influenced by 'cheap talk, there was the caveat that lenders in these markets sometimes appear to make incorrect inferences'. To show that how these peer to peer markets can complement traditional lenders such as bank, they showed direct evidence that these markets are able to infer dimensions of credit worthiness beyond credit score. While lenders depended on standard banking inputs for their conclusion, they also get considerable extra assumptions from credible soft, subjective or non standard information. According to Iyer *et. al.* (2009) that, '*the uncollateralized nature of lending and the ability of lenders to partially screen suggest that peer to peer market can indeed complement existing lending models and improve access to credit, partially for small individual borrowers who may otherwise be limited to costly sources of finance, like pay lenders and credit card debt*'.

Virtual lender: The lending to small business borrowers, in an alternative virtual way, has been described by the Lipman & Wiersch (2015) in their special report on alternative lending. They defined the alternative lenders as non bank credit providers, operating online, to serve small business borrowers including the merchants cash advance companies that allows business to borrow against future sales and to repay with a fixed

percentage of receipts through daily credit cards. These virtual lenders are using non-traditional methods to see the credit worthiness of borrowers such as the rating by their customers on social media. According to the report that online alternative lenders provide variety of products namely business loans, peer to peer loans, funding programs, capital advance etc. The amount of payments may be fixed on instalment based on a sale's percentage to be paid daily, weekly, bi-monthly, or monthly. It was reported that small business borrowers are increasingly moving to alternatives, in every one in five borrowers i.e., 18% approximately of those who applied for loan, applied the credit to an online lender.

2.07: **Critic on lending policy:**

R. Dasgupta (2009) suggested a new dimension to priority sector lending. He advocated for: i) incentives for credit flow improvement to small scale industries and food corps agriculture, as well as, ii) temporary credit to assure new industries and new professions.

R. Dasgupta (2001) critically reviewed the recommendations of committees having a bearing on rural banking and credit. The author mentioned that the rural credit was too some extent neglected in the post 1990 period, and, the Ministry of Finance, Government of India constituted a committee under the chairmanship of N. Narashimham in December 1997 to i) review the progress of banking sector with particular reference to the recommendation made by the earlier Narashimham Committee Report (1991), ii) chart a banking sector reform program to strengthen India's system, and, iii) make detailed recommendations in regard to banking policy , institutional supervisory, legislative and technological dimensions. The author has mentioned here that in 1998, the report of the higher level committee on agricultural credit (R.V Gupta Committee, 1998) put forth 42 recommendations in two groups, i) operational issues, and, ii) policy matters. The author raised the points on the procedure, scale of finance, no dues certificates, stamp duty and mortgages, margin and security arrangements. The Author also discussed some recommendations of Narashimham Committee (1998) which were directly related to the rural credit under four groups namely, i) approach to credit management, ii) operational aspect of credit management, iii) human resource management, and, iv) government support and policy issues. While discussing the above mentioned points he emphasized the

recommendation of R.V. Gupta Committee on: i) lender borrower relationship and mutual trust, ii) the coverage of loan simplification of documents, iii) designing of suitable micro credit product, and, iv) branch level efficiency etc. The author also raised his voice against R.V. Gupta Committee's silence of making a bridge between the gap of meeting huge demand of small and frequent loans and providing few of the loans by the institutional sectors due to their cost and logistic constraints resulting the entry of informal credit market players who charged a very high rate of interest.

S. Bose (2005) cited Chandrasekher and Roy for stating that, at the beginning, the Indian financial reform strategy involved four major initiatives:

i). Reduction in the cash reserve ratio and statutory liquidity were allowed to increase the capacity of creating credit by banks.

ii). In order to create competition among foreign banks, structural changes were made.

iii). Banks were permitted to fix their asset portfolio and also allowed them for some extra spaces for altering the target of priority sector lending.

Iv). The Government fixed new capital adequacy norms for banks for protecting the system from the associated force of deregulation.

According to the author that, by increasing the limit of credit ceiling and widening the coverage to include many non-priority sector heads, the definition of priority sector was diluted, non fulfilment of target of priority sector lending was overlooked and commercial banks were given option to invest in special bond of certain specialised institutions. The rate of interest regulations under priority sector were removed except from the cases of small borrowal lending placed the rural bank on the same footing like as commercial banks.

According to Priya Basu (2005), the policies that were framed to increase the accessibility of credit to the marginalised section of society did not deliver the desired result. To improve the competence of the rural formal credit, both, the institution and the market, need to be redesigned. The Government of India, almost in all National Plans, emphasised for equitable growth by focusing the vast number of rural poor, but, the desired result of the action was not achieved properly, and, due to non-achievement of the desired result, the drive for nationalisation of Commercial Banks in 1969 was executed by

the then Prime Minister Mrs. Indira Gandhi. The priority sectors were given more attention and service area approach was adopted to focus bank before their client. During 1990s, due to liberalisation, the competition increased and the openness of financial sector was observed through the interest rate deregulation. But, the mind set of rural Indian people did not change as it was expected. The competition in banking sector increased. But, the dominating power remained with nationalised banks, particularly, in the rural area, even though, some restrictive provisions of service area approach were in action to help the entry of new bank branches in rural sector. Basu (2005) further assessed the social banking on poor people for post independence period. Basu pointed out that the social banking, as defined, has a belief that small borrowers are not really bankable and that the rural people and the small scale industry will be served by the banks, only if they are bound to do so.

The author analysed Rural Finance Access Survey (RFAS-2003) data and pointed out the following:

i) 59% of rural households did not have deposit account and 79% of rural people had no access of credit from formal sources.
ii) In rural areas, the service of bank was primarily for the rich borrowers and 66% of large farmers had a deposit account and 44% had the access of credit.
iii) 70% of the marginalized farmers did not have bank account and 87% had no access of credit from formal sources.
iv) Bribe was the common feature of credit from formal source in rural areas.
v) The effective cost of taking loan for the Commercial Banks was too high as it included the bribe and other costs, and, waiting time for approval of loan was also maximum, on an average 33 weeks.
vi) The bank demands collateral security for approving loan which the poor people lack. Basu pointed out that 87% of the households who took loans from Regional Rural Banks and 87% of the households who took credit from Commercial Banks had to give collateral securities. Land was the pre dominant collateral security with a very less execution.

On the basis of the above problems, Basu (2005) suggested the following for improving and making competitive and efficient financial market:

i) Making the priority sector lending tradable for benefitting both rural poor people and banks by allowing competitive lender to spread in the rural area.

ii) The appropriate rate of interest and deposit rate to be fixed so the informal lender can be avoided by the rural poor.

iii) To make rural banking profitable, the transaction cost to be minimised and ensure the entry of private banks in rural sector to enhance the competition in rural financial market (A. A. Reddy-2010, also opined the same).

iv) Framing of better regulation and supervision for restructuring rural banks. Enforcements of supervision need to be maintained strictly. Tough measures need to be taken for dealing with inefficient Regional Rural Banks and rural Cooperative Banks for ensuring entry of other financial institutions.

The reasons of reluctances of both the public sector banks and the private sector banks to expend their rural lending activities and opening of rural branches had been analysed by Sahasranaman and George (2013). They pointed their finger on the transaction cost and the total cost associated with the channel of providing the credit to the rural people. According to them, the channel of delivery of credit, matters. They examined five channels of delivery, viz. i) Public Sector Bank lending through rural branches, ii) Public Sector Bank lending through Self Help Groups, iii) Public Sector Bank lending through Microfinance, iv) Private Sector Bank lending through rural branches, and, v) Public Sector Bank lending through Microfinance institutions. They showed that the same amount of loan transmitted through different channels would have their different implication. The total channel cost including cost of debt, capital cost and loan losses is lowest at 13.75% when the transmission was done through AA rated microfinance finance institution and 41.53% when it is transmitted by a public sector bank directly through its own branches. This is one of the main reasons of the reluctance of private and public sector banks from expanding their rural branch operations and preferring of paying penalties of not meeting their priority sector obligations.

Using the secondary data, Chavan (2014) analyzed the coverage of small borrowers by the banking systems of India. She studied the distribution of bank credit, household debt and analyzed the change of position of small borrowers for getting bank credit by passing of times, i.e., from 1990s to 2000s. She found that during second half of 2000s the share of

small borrowers and other borrowers increased in respect of credit allocation in all the regions of the country and the major gainers were the small rural women borrowers. The rural men small borrowers too were able to get more share of credit during 2000s than before. There was also an increase in the proportion of bank credit extended to rural labour households during the second half of 2000s. According to Chavan, all these should be seen in the light of change in banking policy as there was a thrust on the policy of financial inclusion since 2005. She also indicated some points regarding allocation of bank credit to small borrowers that should be given due attention:

i) Marginalisation of small borrowers in the urban areas of the country.
ii) Marginalisation of urban women small borrowers who lost the share of credit in respect of urban men and rural women small borrowers.
iii) There was a persistence fall in the share of total bank credit of backward social groups.
iv) The relative share of small and marginal cultivators did not reach desired level; only the fall of share of credit was stopped.
v) Though the share of bank credit to weaker sections was revived, but still, some banks were below their set target level.

She found that the financial inclusion had a positive impact on various aspect but still it did not provide the positive result for all, specifically, for under privileged section of the society. She suggested the followings:

i) The effort of banks to reach the set target of lending to weaker section i.e., backward social groups, small marginal cultivators should have been continued.
ii) Financial inclusion policy should have been continued for strengthening banking activity in rural region of the country and also in urban area where the poor people reside, particularly urban poor women who engage themselves as unorganised labour.

2.08. Conclusion: After discussing the issues relating to non-institutional and institutional credit on various sub-topic, like its definition, institutional and non institutional credit in India, difference between formal and informal credit and their interaction etc., and the recent trends of providing credit by using virtual system, it can be concluded that a little work has been done on the actual need of small borrowers'

and the role that is played by the credit market in the district of Darjeeling. The work 'Small Borrowers' Need and The Credit Market: A Study of Formal and Informal Borrowing in the District of Darjeeling, West Bengal' has been initiated to find out the issues relating to borrowing from the formal and informal credit market. But, before going to the issues related to small borrowers residing in the District of Darjeeling, it is necessary to understand the position of small borrowers in Indian credit market, as a whole, including formal and informal credit markets which have been discussed in Chapter No. III and Chapter No. IV respectively.