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Source: *Economic Development and Cultural Change*, Vol. 33, No. 1 (Oct., 1984), pp. 43-59
Published by: The University of Chicago Press
Stable URL: http://www.jstor.org/stable/1153602

Informal Credit Markets in India*

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Informal financial markets, those which are not regulated or monitored by the banking authorities, account for much of business credit in developing countries.[1] These unregulated, informal credit markets (ICM) are important both in their own right, as part of each country's financial system, and because of their reciprocal relations with growing enterprises and the regulated financial sector. In order to study the operations of some of these markets in detail, in urban commercial settings, we conducted an extended survey of some of the informal credit markets of India.[2] Based, in some cases, on centuries of operation, these markets proved to be important in the functioning of the contemporary economy. "Indigenous-style bankers," belonging to particular ethnic communities and castes, formerly provided the full range of banking services to their clients.[3] With the rise of modern, Western-style banking the indigenous bankers either have transformed themselves to serve sectors, such as wholesale trade, not well served by the modern sector or provide services which the modern bankers cannot provide. Though any estimate is very approximate, it seems that informal credit markets account for as much as 20% of commercial credit outstanding in the various markets surveyed.

We began by surveying the Gujeratis, some of whom still practice their traditional form of full-service banking in their homeland of Gujerat and adjoining Bombay, the Shikarpuris or Multanis (originally full-service bankers in Sind, who now provide commercial credit in various other centers), the Chettiars in South India, the Rastogis in Uttar Pradesh, and the Marwaris, especially in Eastern India.[4] But our surveys revealed that a wide range of ethnic groups were now involved in informal credit markets, and the more meaningful differentiations

0013-0079/85/3301-0048$01.00

were now functional rather than ethnic. There were three important functional categories: full-service indigenous bankers who took deposits and made loans; commercial financiers who lent primarily their own resources; and brokers who connected potential lenders and borrowers. All of these sometimes existed in particular markets, but one or the other was usually dominant. Outside Gujerat, indigenous bankers of the traditional sort were rare. In Gujerat and Bombay, such bankers provided deposit, remittance, and other banking services to a large number of firms, primarily in wholesale trade. New "finance companies" (unincorporated commercial deposit and lending institutions), which resembled the old-style indigenous banker in many ways, were flourishing. Commercial financiers were present everywhere, but especially in the older Shikarpuri markets in the port cities. Brokers were even more common and seemed the dominant financial intermediary in the wholesale and small industrial markets we surveyed. Brokers secured their funds both from commercial financiers like the Shikarpuris and from an increasingly diverse investing public.

Since this study is one of the first of urban informal financial markets, any theory must be tentative, but three salient characteristics of the intermediaries in this market seem to lead to lower transactions costs: (1) the intermediaries' intimate knowledge of their clients, which reduces their information costs compared to those of commercial banks; (2) the absence of government control on lending and borrowing rates governing the intermediaries, which enables them to adjust more fully to market forces than regulated intermediaries; and (3) the absence of charges on the informal intermediaries in the form of idle or low-interest reserves, which are imposed on regulated intermediaries. The second and third characteristics clearly result from the lack of regulation of the informal markets. As John Gurley says, "If there is anything different about commercial banks . . . it is because they are controlled; they are not controlled because they are different."[5] The lower transactions costs lead to a higher level of intermediation for the economy overall and an increase in savings and productive investment.

But the small scale of ICM agencies and markets also has negative results. They function in small, localized markets, do not necessarily distribute funds to the best potential users, and may possess a large degree of monopoly power. None of these negative characteristics seemed marked in the Indian cases we studied.

We should emphasize that our survey concerns only urban (not rural), commercial (not consumer), and legal (not "black money") credit markets. All of the other forms of credit market are important in India but were not the focus of our study. The intermediaries we studied appeared to be involved only peripherally, if at all, in these other markets.

Modus Operandi

The borrowers in the informal market are "known" parties—under continuous surveillance in the closely packed lanes of the urban wholesale markets. Each bale of cloth that goes in and out is observed by neighbors, the finance brokers and bankers among them; an expensive night on the town is reported and judged the next morning in market gossip. In contrast to the relatively anonymous world of Western businessmen, even in the larger metropolitan centers Indian businessmen live their lives in a narrow social ambit. Most of the intermediaries interviewed seemed incredulous at the suggestion that they would have to ask formal questions of borrowers in whose shops they visited every day and with whose business confrères they were in continuous contact. Still, one Shikarpuri financier in Bombay said he asked to see borrower income tax returns in about 10% of his transactions, and one in Madras indicated that he, too, occasionally asked for income and wealth tax forms. These requirements are common, and some Shikarpuris in Bombay and elsewhere will only lend to income tax assessees. But the Shikarpuris deal with a more varied clientele than the typical informal market lender—a fact reflected in their higher than average interest rates.

In fact, the people in the market not only have a 24-hour relationship, they typically have one that extends over generations. We asked one finance broker how he evaluated "new borrowers"—he answered that he never took them. All his clients were children and grandchildren of businessmen with whom he and his father and grandfather had done business.

Informal financial intermediaries, by and large, concern themselves with the overall credit standing of the borrowing party rather than the specific enterprise or project for which credit is taken. They thus do not do any close check of the specific use of their funds but are generally content with monitoring borrowers' overall activity. In bankers' jargon, they lend on the basis of "cash flow" rather than asset protection. And they consider the borrower's total financial situation. The brokers in the informal market watch closely the level of business activity not only in their borrower's main establishment but in any others he may have. They watch his personal expenditure. They talk with his competitors and especially his employees. They then judge what sort of margin he is operating on and how likely he is to pay them. Most especially, they watch his payments record to see if he may be faltering on any of his market obligations.

Criteria for Credit

It was difficult to get informal market lenders and brokers to specify their criteria for lending. They resisted using banker's language and most of the standard banking ratios. For them the key elements were the overall prosperity, wealth, and cash position of the borrower and an evaluation of his commercial integrity. Most important seemed to be a reputation for punctiliousness in meeting debts. One elderly cloth market finance broker stated the principle, "Payment! Payment! Payment!" Borrowers, potential and actual, felt that to qualify for a loan they had to have a reputation for meeting their obligations promptly.

One explicit criterion for lending which seemed common was some target relationship between total borrowing and net worth. Two Shikarpuris (one each in Bombay and Madras) and one Rastogi in Kanpur mentioned 25% of net worth as their normal limit. A third Shikarpuri in Bombay set 33%—though he clearly had a relatively adventurous financing posture. In Amritsar, there seemed to be an informal rule—one-third from banks, one-third from the informal market, and one-third from own resources—at least for large borrowers. On the other hand, an informant who audits the books of larger trading firms in Calcutta said most of them try to limit their own equity to 25% of the gross capital employed, though only a portion of the remainder would be borrowed on the informal market. The Gujerati firms in particular seemed reluctant to commit themselves to any net worth figure, perhaps because their concerns are more focused on the cash and stock position of their clients than on their net worth.

In general, urban informal intermediaries try to avoid coming under the restrictive state moneylending acts and thus do not usually lend in amounts of less than Rs 3,000, nor do they lend to agriculturists, who are normally protected under these acts. They usually provide working capital accommodation to prosperous enterprises in well-known markets. Their major risk is either of a wave which sweeps under all firms in their market or of the bad faith nonpayment of their dues, which they reduce by lending only to those with strong roots in the community. As one financier said, "I guess they could run away, but where would they go? They would have to do business with their friends and relatives and I would find them."

Many lenders also have informal limits on their maximum lending to any one party. Shikarpuris usually limit their exposure to one party to Rs 25,000, though by selling Rs 5–25,000 notes on a single borrower to many Shikarpuris the brokers can put together loans of many hundreds of thousands of rupees. Two of the larger non-Shikarpuri firms surveyed—one a Gujerati indigenous-style banker and the other an Amritsar broker—had several much larger debtors. Except for the Shikarpuris, most lenders and brokers were too specialized in one or another commodity or product market to limit their exposure in it.

Purposes of Lending—Where the Money Goes

The bulk of informal lending goes to finance trade and industry, mostly the former as shown in table 1. *Badla* financing of stock market specu-

TABLE 1

Destination of Informal Credit Market Funds in Percentage of Loans Outstanding

Source	Trade	Exports	Small-Scale Industry	Large-Scale Industry	Other
Shikarpuri financiers	32	20	16	7	25
Gujerati bankers	60	10	5	10	15
Chettiar financiers (in Tamil Nadu)	45	10	5	10	20
Rastogi bankers (in Uttar Pradesh)	55	12	...	...	23
Chettiar pawnbrokers (in Tamil Nadu)	22	...	5	...	73
Finance companies (in Trichy and Karur)	40	...	8	...	52

Source.—Data gathered by C. V. Aiyar, 1979.

Note.—In December 1976, according to the *Statistical Tables relating to Banks in India* (Bombay: Reserve Bank of India, 1976), fig. 7, 10.27% of commercial bank advances were to trade, 7%–8% to exporters, roughly 10% to small-scale industry, 44% to large-scale industry, and 19% to other commercial borrowers.

lation is a large and important exception which flows through specialized channels. Essentially, *badla* finance involves short-term lending at rates about 14% plus 1.2%–2.4% brokerage on the security of shares with no margin requirement.

Gujerati credit goes almost entirely to funding trade, especially wholesale trade in agriculture and in craftwork commodities. The Shikarpuris lend to a wide variety of small and occasionally large enterprises, as do "finance companies." Rastogis and Chettiars finance smaller traders and artisans.

The credit provided by brokers in wholesale markets for cloth and grain is obviously solely credit to wholesale traders. Obviously brokers who provide money to industrial firms in the form of deposits, call money, or promissory note lending serve industry. Special demands on the informal financial market come from exporters who need quick money and from builders and restaurant owners who have no physical security to give. Certain industries—tanneries in Madras, *zari* cloth manufacturers in Surat, silk weavers in Benares, and *biri* (indigenous-style tobacco) merchants in Gujerat—have needs which banks are unable to meet and informal credit markets can accommodate.

None of the groups of informal intermediaries is involved to any notable extent with agricultural financing or speculative activities. Films, a high-risk proposition, are normally financed by a separate set of lenders, mostly in "black" money on which income tax has not been paid. Informal money is, in fact, generally only available for working capital purposes, precisely because new ventures are seen as too risky.

Much of the routine wholesale and export trade, and even many industrial firms on a sporadic basis, turn to the informal market for flexibility and accommodation that cannot be obtained from the commercial banks, in financing working capital.

While it is clear that the bulk of informal finance is provided directly to trading enterprises and very little is provided directly to very small units (under $14,000 capitalization), the borrowers are not the ultimate beneficiaries of the credit. The working capital needs that are financed are typically for advances to trading partners and actual manufacturers, large and small, who demand cash payment. The advances also fund the 30–90 days of credit on which the smaller retail shops subsist. Thus the entire economy is indirectly dependent on informal market advances.

Advantages—and Why the Borrower Chooses

At times the advantage of the informal financial sector for the borrower is the rapidity with which it can provide money or the cheapness of the money provided, though neither of these is the norm. Generally, informal money is slower to arrange and more expensive for the borrower than money from the organized sector would be if it were available. In several markets, informal market rates are even quoted in terms of a 1%–3% premium on bank rates. The exceptions to this slowness and expensiveness are found primarily in the large metropolitan markets, where indigenous-style bankers and commercial financiers provide money far more quickly than the banks and brokers in markets like the cloth market or the intercorporate call money market provide financing more cheaply than do the banks.

The informal money market has some other advantages from the borrower's point of view. Informal lending generally is unsecured. Borrowers do not have to tie up their stocks as collateral. Restaurant owners, exporters, and construction contractors often borrow on the informal market because their business does not generate acceptable collateral. Even where collateral is available, the restrictions on the use of collateral and the procedures for checking it often prove onerous. Indian bank credit to small-scale industry is almost always secured—and the procedures for checking and conserving the collateral often appreciably increase the real cost of the loan. On the other hand, there are forms of secured credit in the informal market. Firms that buy up Bombay textile mills' accounts receivable extend secured credit.

Informal finance generally is provided without having to fill out forms or spend much time in the intermediary's office—and is not tied into all sorts of formal requirements like compliance with municipal land use regulations, of which small-scale units are often in tolerated violation. In these respects, the cost to the borrower is not higher than face interest cost, unlike most formal bank lending. Small businessmen complain that they are foreclosed from loans for lack of official clearances and the burden of the connected paperwork. In fact, in many informal credit markets the broker visits the client's place of business and does all the preparatory work for the loan as part of his service. That is, the broker does what the borrower has to do when dealing with a commercial bank.

On the other hand, there are some negative aspects to informal sector borrowing. Much informal credit is "call" money and in any case may have to be paid on some precise due date, whereas "bank" credit is more flexible and it is easier to delay payment. Informal credit is also less reputable than bank credit, and informal market transactions are more likely to be challenged by income tax authorities. Almost half the units we surveyed, even in markets in which informal finance is important, denied using it—often because they were either too rich or too poor to be accommodated. Some of them, however, may have simply been reluctant to admit involvement on prestige grounds.

Volume and Terms of Credit and Deposits

Rough estimates of the volume and rates charged for credit in various ICMs are found in tables 2 and 3.[6] In general, brokers and indigenous

TABLE 2

INDIGENOUS CREDIT SYSTEMS AND THE CREDIT THEY EXTEND

Type of Firm	Number of Firms	Credit Extended (Millions of Rs)	Rates (% per Annum)
Shikarpuri financiers:			
Members of local assns.	550	600	21–37
Nonmembers	650	650	21–120
Brokers	550	1,250	21–120
Shikarpuri submarkets:			
Bombay members	238	240	Max. 30
Bombay nonmembers	350	330	N.A.
Madras members	126	150	Max. 37
Madras nonmembers	200	160	N.A.
Madurai members	20	30	21–25
Madurai nonmembers	10	N.A.	N.A.
Trichy members	30	8	21–25
Trichy nonmembers	12	N.A.	N.A.
Tanjore	4	6	21–25
Salem	40	50	21–25
Calicut	20	10	27
Coimbatore members	20	30	21–25
Coimbatore nonmembers	35	40	N.A.
Bangalore members	N.A.	45	N.A.
Bangalore nonmembers	N.A.	55	N.A.
Hyderabad members	N.A.	30	N.A.
Hyderabad nonmembers	N.A.	45	N.A.
Vijayawada	N.A.	10	N.A.
Marwaris in Madras doing similar work	100	104	N.A.
Gujerati indigenous-style bankers:			
Pure bankers	2,000	7,460	18
Bankers and commission agents	N.A.	N.A.	18
Chettiars bankers:			
Chettiar bankers	2,500	3,800	18–30
Chettiar pawnbrokers	25,000	12,500	18–30+
Rastogi bankers	500	1,000	18–24 up to 36

SOURCE.—Data gathered by C. V. Aiyar, 1979.

NOTE.—All rates are approximate: the interest rates and number of firms figures more solid than the estimates of credit extended. Shikarpuris receive Rs 30–Rs 60 million in bank refinance and have Rs 75 million in deposits. Chettiars have perhaps Rs 2,500 million in deposits. Rastogis have approximately Rs 550 million in deposits.

bankers provide money at an annual equivalent of 18%–24% to larger established traders, with 18% the norm, and to smaller artisans and traders in a range sometimes as high as 24%–36% annual equivalent. Checks and bills are discounted at 18%–24%. Call money loans in urban areas are sometimes provided at rates as low as 12%. Black money, on which income tax has not been paid, is normally available at slightly cheaper rates—12%–15% annual equivalent in Bombay and 24% in Madras. In general, South India has higher informal rates, and a

TABLE 3

FINANCE COMPANIES AND BROKERS AND THEIR RATES

	Rates (%)
1. Intramarket and intermarket lending through brokers:	
Lending to cloth commission agents in Amritsar	9–18
Lending to cloth commission agents in Delhi	15
Lending to cloth commission agents in Kanpur	13–16
Yarn traders advances to powerlooms, Kanpur	18
Yarn traders advances to powerlooms, Amritsar	14–22
Bombay:	
Lending to Bombay rice and gram traders	15
Lending to Bombay dried fruit traders	18
Lending to Bombay jute traders	18
Lending to Bombay iron and steel traders	18
Lending to Bombay share traders *(badla)*	15–16
Calcutta:	
Lending to Calcutta cloth commission agents	16.2
Lending to Calcutta yarn traders	15
Lending to Calcutta grain traders	15.2
Lending to Calcutta oil seeds dealers	15–18
Lending to Calcutta gunny dealers	18
Deposits with small pharmaceuticals firms	14.5–15
2. Finance companies:	
There are 60 in Trichy, 40 in Kothamangalam, and 100 in Karur. Twenty firms in Trichy had assets of Rs 440 million. They pay 7%–15% on deposits and charge 21%–24%.	

SOURCE.—Data gathered by C. V. Aiyar and Thomas A. Timberg, 1978–79.

wider variety of recently started informal institutions (*nidhis,* finance companies, and *chit* funds), possibly reflecting a greater capital shortage there. Shikarpuri bankers' rates also seem higher than those of other lenders, though more so in Bombay and Madras, where they are adjusting to a decline in bank finance, than in the smaller towns.

Table 4 sets forth data on commercial lending in India for the purpose of comparison. Normal bank lending rates in June 1978 were 13%–16% per annum. Total bank credit at that date was Rs 160 billion; outstanding credit to wholesale trade, excluding three large public sector corporations, was Rs 10 billion. Most informal market clients might well pay the higher rates, if they could get any credit. The modal informal rate is thus only 2%–8% higher than the bank rate and probably less if we take into account the actual transactions costs to the borrower. The All-India Debt and Investment Survey, 1971–72, reported that 75% of households (accounting for 85% of borrowing) in rural areas borrowed at rates under 25%.[7] The comparable bank rate is 9%–11%, charged on agricultural loans. The gap is roughly comparable to that in urban areas.

Many of these interest rates are fixed in competitive markets. In some cases there is some price leadership or institutional fixation, and

TABLE 4

COMPARATIVE DATA ON COMMERCIAL BANKS

A. ADVANCES TO SMALL-SCALE INDUSTRY BY STATE BY COMMERCIAL BANKS (in Billions of Rs)

State	1976	1977
All India	14.2	17.02
Maharashtra (including Bombay)	2.9	3.3
Gujerat	1.3	1.5
Uttar Pradesh	1.07	1.4
Tamil Nadu	1.5	1.8

B. OUTSTANDING CREDIT OF SCHEDULED COMMERCIAL BANKS (As of the Last Friday of December 1977; Amounts in Millions of Rs)

District	Total Credit	Of Which for Trade
Bombay	21,297.7	5,360.8
Kaira (Gujerat)	485.7	34.9
Kanpur	1,071.3	123.2
Amritsar	662.3	79.2

SOURCES.—Information in part A was obtained from *Statistical Tables Relating to Banks in India, 1977* (Bombay: Reserve Bank of India, 1978), p. 56. Part B is from a communication from the Credit Planning Cell, Reserve Bank of India, Bombay, April 15, 1980.

in others the degree of association between lenders must lead to some coordination. The rates clearly move in some sympathy with bank lending rates, as is documented in some unpublished work by V. V. Bhatt and T. R. Venkatachalam.[8] The differences in interest rates from city to city are substantial and reflect the largely local and even sub-local nature of the markets surveyed. Even the Gujerati bankers who moved back and forth between Bombay and Gujerat report money a percentage point or so cheaper in Bombay. Some of this difference may reflect the greater availability of bank credit in Bombay or the greater liquidity of Bombay as a financial center. The difference clearly does not reflect arbitrage costs which are less than 0.2%, or 0.3% if one assumes a need to cover double the remittance costs. The differences between Madras and Bombay Shikarpuris are equally hard to explain because the firms are related, though money is not freely transferred from place to place. Perhaps the perceived risk level is higher in Madras, or the lower Bombay figure may reflect the inelasticity of demand in the Madras market within the ranges the Shikarpuris charge (i.e., they could not place more of their Bombay funds in Madras at lower rates, since the demand for their funds is interest inelastic).

As to the persisting difference between the intermarket credit rates offered by brokers and Gujerati indigenous bankers, and those charged by Shikarpuris and finance companies, we must assume that the

Shikarpuris and finance companies deal with people who do not have access to sufficient lower-priced finance from either informal sources or the banks, and that seems largely the case.

Normal brokerage is less than 0.5% of the loan principal (on an annual basis), but Shikarpuri brokers charge, as we noted, 2%. In no case that we know of does the broker guarantee the loan, but his continuance in business is obviously based on his track record in finding good borrowers who repay on schedule.

Along with lending rates, tables 2 and 3 include some estimates of the size of the informal markets we surveyed. Short of an economic census, it is impossible to determine what percentage of total capital employed in trade and industry is accounted for by informal lending and what relation informal capital employed has to that provided by the commercial banks who are the other prime urban credit source. Urban cooperatives are relatively small and weak; development finance is available elsewhere but usually not for working capital purposes (from state finance corporations, industrial development corporations, and small-scale industry corporations).

Some of the urban markets surveyed generated some indicative estimates. As much as 50% of the working capital employed in the wholesale cloth trade in Calcutta and 20% of that in the grain trade may have come from the informal market. The percentages in Kanpur and Amritsar in the cloth wholesale market were probably lower. These are markets in which little if any bank finance is available. Small industrial units in the Amritsar powerloom industry get 5%–10% of their capital in peak season from the informal market. The Gujerat *biri* tobacco trade receives 15%–30% of its working capital as advances from Gujerati indigenous-style bankers.

The Banking Commission of 1981 reported that indigenous-style bankers provided one-twelfth to one-half of all credit to various different categories of industrial units.[9] The amount ranged from an average of Rs 300, or 20%, of borrowings for units of under Rs 25,000 capitalization and increased to Rs 35,000, or 7% of capitalization for those with over Rs 750,000 capitalization.

Table 2 also deals with the volume of deposits with indigenous-style bankers and the rates paid on them. Rastogis and Chettiars, but especially Gujerati bankers, had significant public deposits, while "finance companies" were entirely dependent on such deposits.

Instruments

The instruments for borrowing in the informal market vary. One of the most common is the demand note, often "informally" endorsed for a term and rate on the back. As a demand bill the instrument avoids the stamp tax on term bills such as those traditionally used by Shikarpuri commercial financiers. The Shikarpuris clearly feel that even with the added cost the stamp gives their notes greater authority, and in any case only stamped notes can be discounted with the banks. As bank discount has declined, they have largely abandoned this term note. In the smaller centers in the south where bank finance is unavailable, the bulk of Shikarpuri advances are done on demand notes. Shikarpuris have, in any case, been moving away from 90-day promissory notes toward installment credit, which now accounts for about half their advances in the south. The installment notes, especially in the south, are commonly supported by postdated checks, one for each installment payment.

Thirty to forty percent of Gujerati banker finance is done by direct cash advance and 60%–70% through the issue of checklike bills. The Chettiars obtain both promissory notes and securities from their clients, or hire purchase agreements when appropriate. Intermarket lending is most usually done on promissory notes. Finance companies often lend on a term bill. Deposits are often given on the strength of a simple receipt, which now is needed for income tax purposes; traditional deposit receipts simply bore a name and date. Much lending is done by discounting demand notes, trucking bills, and especially postdated checks.

Transactions Costs I: The Costs of Administration

Transactions costs in those markets where brokers are the only intermediary may be as little as 1.2% on annual average outstandings, though they may go as high as 1.2% of turnover, or 4.8% of average outstandings. Shikarpuri brokers charge 2% per annum on each transaction, usually a 3-month loan. Indigenous bankers and commercial financiers typically have higher costs. All of these costs are summarized in tables 5 and 7.

There are several reasons for informal intermediaries' relatively low costs. The employees, if any, in informal credit agencies are typically less well paid and educated, the establishment less elaborate, and the paperwork less complex than in commercial banks. Operations are smaller and typically under the personal supervision of the owner, so numerous cross-checks against fraud are not needed. Not surprisingly, costs are usually somewhat lower than those reported by the Indian commercial banks, as shown in table 6.

The intermediaries in the informal market have a limited span of lenders and borrowers. The largest brokers surveyed in Kanpur and Amritsar dealt with 15–30 firms each, on both the lending and borrowing side. The Shikarpuri brokers in Bombay deal with a clientele that changes but may be no larger at any given time. Shikarpuri market borrowers are usually expected to deal with only one broker, but lenders may deal with many and thus they constitute the market. Gujerati indigenous-style bankers rarely have more than 200 clients in a single branch.

TABLE 5

Data on Different Informal Credit Market Agencies

	Expense Ratios		Spreads between Borrowers and Lenders			
Type of Agency	% Wages and Salaries to Total Expenses	% Rental to Total Expenses	Cost of Lendable Funds in % Per Annum (as % of Working Funds)	Charge to Borrower in % per Annum	Margin	Deposit Cost in % per Annum
Shikarpuris	25	20	20/20.5	31.5	11.5	15
Gujeratis (Bombay)	45	20	11	20	9	8
Chettiars	55	15	14	24.5	10.5	9
Rastogis	35	25	14	20.5	6.5	9
Finance companies	...	...	15	26.5	11.5	10

Source.—Data gathered by C. V. Aiyar, 1979.

TABLE 6

TRANSACTIONS COSTS OF COMMERCIAL BANKS AS PERCENTAGE OF OUTSTANDING LOANS AND ADVANCES (1975)

Bank	Administration	Default Loss	Total
Syndicate bank	2.24	.52	2.76
Other small enterprise (nonindustrial, small business loans)	2.75	1.00	3.75
Large metropolitan bank	1.70	.70	2.40

SOURCE.—V. V. Bhatt and Alan R. Roe, "Capital Market Imperfections and Economic Development," World Bank Staff Working Paper no. 338 (Washington, D. C.: World Bank, July 1979), p. 42.

By contrast, commercial banks deal with larger and more rapidly changing clienteles, who are far more varied in terms of the markets in which they deal. While this gives them a flexibility in adjusting to market fluctuations, they lose in the detailed knowledge of their clients, and thus they have increased information costs.

Transactions Costs II: Bad Debts and Reserves

Besides administrative costs, a major transaction cost is typically represented by bad debts (see tables 6 and 7). Bad debt figures, as reported, are particularly questionable because of the obvious opportunities they present to "whiten" money that has been kept off the account books. The 5%–10% of profits reported as bad debt may thus be an underestimate, since it is understood that income tax authorities will rarely allow more.

Informal intermediaries avoid legal proceedings. They find them too costly and the resulting judgments hard to collect. For some, the fact that bad debts can be used to "whiten" money on which income tax has not been paid is also a reason not to pursue them. In any case, bad debts are usually compromised or rescheduled.

Whatever the precise figures, it is clear that bad debts are few and

TABLE 7

TRANSACTIONS COSTS AS PERCENTAGE OF WORKING FUNDS OF INFORMAL CREDIT SYSTEMS

Type	Administration	Default Loss	Total
Shikarpuri	4.5	1.0	5.5
Gujerati (Bombay)	2.5	.5	3.0
Chettiars	3.1	1.5	4.6
Rastogi	3.5	1.5	5.0

SOURCE.—Data gathered by C. V. Aiyar, 1979.

relatively easy to accommodate. In fact, they are roughly comparable to or slightly higher than those reported for small-scale enterprise lending by the commercial banks. But it is generally understood that the commercial banks seriously understate their losses on these small-scale enterprise loans.

One cost advantage of the informal agencies is their exemption from the large idle reserve requirements imposed on the organized sector—over 30% of total deposits. The larger proportion of their own capital that they use, however, achieves a somewhat similar anti-inflationary effect.

Summary

Legal, informal financial market intermediaries finance much trade in certain commodities and 10%–30% of the capital needs of small-scale producers like powerloom owners and pharmaceutical manufacturers. Despite the rapidly increasing bank credit for small-scale industrial units, most of these units find it necessary to go into the informal market, at least during their busy season. The rates in the informal financial markets are generally 2%–4% higher than the bank lending rates, but there is great variety in rates and forms of lending. Very small enterprises when served by these markets directly may pay nominal rates as much as 10% higher than normal bank rates, but usually this sort of unit is financed through trade credit refinanced through the informal market and increasingly by discount facilities. In southern Gujerat, a parallel system of indigenous-style bankers successfully serves much of the urban economy. Elsewhere informal markets are dominated by commercial financiers like the Shikarpuris or by brokers.

This informal market provides funds for purposes like wholesale trade, which the banks do not finance sufficiently, more rapidly than the banks can for those who require speed like exporters, and without security for those including restaurant owners and building contractors for whom security is difficult to produce.

The operating margins—the transaction costs and bad debt experience of these markets—are by and large superior to the banks' and their normal lending rates are 2%–4% higher. They benefit from lower information search, overhead, and reserve maintenance costs.

The Shikarpuri financiers of Bombay and South India might be presumed to be an exception since their margins and rates are higher than the banks by a considerable margin, but some of this is due to the limited funds in their market due to the banks' cutting off funds since 1970 and the resulting pressures of demand. One also might consider that their borrowers represent relatively high risks, and perhaps increasingly so as the banks accommodate their safer clients.

The result of the existence of these markets is that more credit is provided to activities such as wholesale trade and smaller-scale industry than otherwise, and their activities can be correspondingly expanded. The resulting pattern of economic activity will be a closer approximation to the pattern dictated by the market than would otherwise be the case.

Notes

*This paper emerges from a broader study sponsored by the IBRD (World Bank), the results of which are available in a monograph by Thomas A. Timberg and C. V. Aiyar, *Informal Credit Markets in India,* Domestic Finance Studies 62 (Washington, D.C.: IBRD, 1980). Some of the theoretical schema used here is contained in V. V. Bhatt and Alan R. Roe, "Capital Market Imperfections and Economic Development," World Bank Staff Working Paper no. 338 (Washington, D.C.: World Bank, July 1979), pp. 78–82. We wish to thank the numerous commentators on that study and monograph, including R. Krishnan, T. N. Srinivasan, U Tun Wai, V. V. Bhatt, S. Yusuf, Promodh Malhotra, B. S. Minhas, Avishay Braverman, Michael Lipton, Dale Adams, and Raymond Goldsmith. Needless to say, the resulting product is our own and in no sense reflects the position of the commentators or of the World Bank. These data were collected in 1978–79, and much has changed since then. In particular, a whole set of regulatory initiatives have been proposed which limit the scope of the markets surveyed.

1. Earlier treatments include J. A. Bottomley, "The Cost of Administering Private Loans in Underdeveloped Rural Areas," *Oxford Economic Papers,* N.S. 15 (July 1963): 154–63; U Tun Wai, "Interest Rates Outside the Money Markets of Underdeveloped Countries," *IMF Staff Papers* 6 (November 1957): 80–142; J. A. Bottomley, "Interest Rate Determination in Underdeveloped Rural Areas," *American Journal of Agricultural Economics* 57 (2d quarter 1975): 279–91, "Monopoly Profit as a Determinant of Interest Rates in Underdeveloped Rural Areas," *Oxford Economic Papers* 16 (November 1964): 431–37, and "The Premium for Risk as a Determinant of Interest Rates in Underdeveloped Rural Areas," *Journal of Economics* 77 (November 1963): 637–47. U Tun Wai updates his work in "A Revisit to Interest Rates Outside the Organized Money Markets of Underdeveloped Countries," *Banca Nazionale de Lavoro Review* 122 (September 1977): 291–312. Some specific studies include Yung Chul Park, *The Unorganized Financial Sector in Korea, 1945–75,* Studies in Domestic Finance 28 (Washington, D.C.: World Bank, Public Finance Division, 1976); Richard E. Benedick, "The Money Market in Iran," *Pakistan Development Review* 2 (1962): 406–21.

2. The data for this article come from a series of selected interviews with lenders, borrowers, intermediaries, and trade associations involved with informal credit markets. Over the course of the study almost 1,000 people were interviewed (not always singly) by three investigators, and these interviews represent the data base for the article. More complete details on the survey are available in Aiyar and Timberg, *Informal Credit Markets in India.*

3. These Indian markets have been extensively studied both in monographic literature and by various government commissions of inquiry. Most recently, see, e.g., the *Report of the Banking Commission* (Bombay: Government of India, 1972), 413–68. The standard work is still L. C. Jain, *Indigenous Banking in India* (London: Macmillan Co., 1929). They are treated in passing in Raymond W. Goldsmith, *The Financial Development of India, 1860–1977* (New Haven, Conn.: Yale University Press, 1983).

4. See n. 3 above and Thomas A. Timberg, *The Marwaris* (New Delhi:

Vikas, 1978); and Raman Mahadevan, "Immigrant Entrepreneurs in Colonial Burma—an Exploratory Study of the Role of Nattukottai Chettiars of Tamil Nadu, 1880–1930," *Indian Economic and Social History Review* 15 (1978): 329–58; "Pattern of Enterprise of Immigrant Entrepreneurs: A Study of Chettiars in Malaya, 1880–1930," *Economic and Political Weekly* 15 (1978): 146–52; and "The Development of Modern Entrepreneurship in the Chettiar Community of Tamil Nadu, 1900–1930" (paper presented at the Indian History Conference, n.d.).

5. John G. Gurley, "Financial Institutions in the Savings Investment Process, I," in *Readings in Financial Institutions,* ed. Leon T. Ketchum and Marshall D. Kendall (Boston: Houghton Mifflin, 1966), p. 14.

6. Normally interest is paid when the note is paid off, or on current account for credits from Gujerati bankers. In that case it is collected when the account is brought into balance. Shikarpuris and some other lenders take their interest in advance, and we have taken that into account in reporting their rates on a basis comparable to others. In each case, there may be some incidental fees—brokerage, charity, *shigriti* (speed money), and stamp taxes—but we consolidate these in our reported rates.

7. *Indebtedness of Rural Households and Availability of Institutional Finance* (Bombay: Reserve Bank of India, 1977), p. 146.

8. See also S. Ghatak, *Rural Money Markets in India* (Delhi: Macmillan Co., 1976), pp. 98–101.

9. *Report of the Banking Commission 1972,* pp. 144–46; and *Economic and Political Weekly* 15 (March 8, 1980): 490.