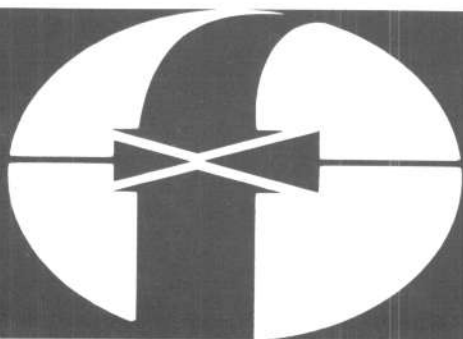


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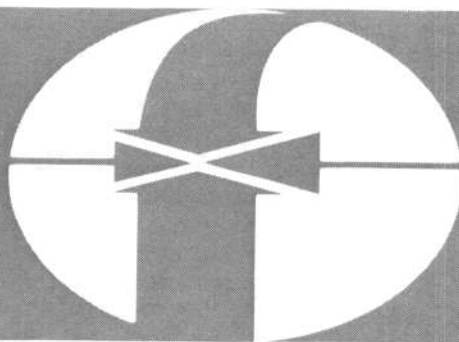
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FINANCE CORPORATIONS: AN INFORMAL FINANCIAL INTERMEDIARY IN INDIA

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1. Introduction

In India the bulk of the financial intermediaries is to be found in what is called the organised sector. This comprises the commercial banks, the co-operative banks and the development banks. However, there is also a sizeable unorganised sector which includes a variety of small financial institutions such as: (a) indigenous bankers like *multanis*, *shroffs* and *chettis*; (b) *chit funds* and *nidhis*; and (c) individuals like the professional or non-professional money lenders.

There is yet another category among indigenous bankers which has not been studied adequately so far by researchers on the Indian money market. The report of the Study Group on Non-Banking Financial Intermediaries set up by the Banking Commission, 1971, has identified such financial institutions operating in the informal credit market in India and named them as « Bangalore type finance corporations » which in effect function as « unregulated banks ». The Study Group stated, however, that they could not go deep into the matter because they « were handicapped by the paucity of adequate statistical data and the non-availability of details of working of these corporations »¹. They, therefore, contented themselves with a few observations on these institutions.

This paper, therefore, attempts a comprehensive study of finance corporations and similar indigenous financial institutions. They are known, by different names in different places in India but essentially the term covers individuals, groups of individuals or institutions which accept deposits from the public mainly for the purpose of lending. An individual money lender who lends his own money or a partnership firm which lends only the partners' own money is excluded from the purview of such a nomenclature. Again, if an individual or partnership accepts deposits from the public and utilises them only for the purpose of own business, they also are excluded from the purview of this study. Loan or investment companies, hire purchase companies, chit funds and nidhis are also excluded.

« Finance Corporation » is only one of the many names associated with this kind of a financial intermediary. Other popular names are: bankers, financiers, financing company trust, fund, capital centre, financial enterprises, investments, investment corpora-

¹ Report of the Study Group on Non-Banking Financial Intermediaries, Banking Commission, Government of India, 1971. para 8.1.

tions, credit corporation, benefit corporation, commercial corporation, finance and chit fund, finance syndicate, commercial syndicate, etc. Notwithstanding such a variety, a few names are more common than others. For instance, out of the 30 firms identified in Bangalore, 22 called themselves « finance corporations ». It seems they adopt this name because the word « corporation » sounds dignified and impressive and is expected to create a good image on the mind of the public. While the term finance corporation is generally used in Andhra Pradesh and Karnataka, in Tamil Nadu, the words, « finance » or « financiers » are used for the same nature of business. The title « finance corporation » also is frequently used. It is in Kerala that the term « bankers » is widely used by such financial intermediaries. About 50 per cent of the firms identified preferred the title « bankers ». The two most popular titles after this were « trust » and « fund ».

The objectives of the study are: (i) to identify the institutions that come within the purview of the study; (ii) to examine their operations in rural and urban areas; (iii) to identify the factors leading to their growth; (iv) to examine their utility; and (v) to examine the existing legal framework of regulation and suggest changes, if any.

Methodology

Non-availability of data on finance corporations compelled us to collect them through personal investigation. As a first step, 150 addresses were collected from newspaper advertisements. From these as well as from a few Associations of Finance Corporations, 300 more addresses were gathered making a total of 450 addresses at our disposal. It was found that all these firms were located in the southern States of Kerala, Tamil Nadu, Karnataka and Andhra Pradesh. Thus our study was confined to South India which, we estimate, accounts for about 90 per cent of the total number of finance corporations in the country. Among these four States, Tamil Nadu has the largest number of such firms and the volume of business done by them also exceeds that done in other States. Kerala was the next in importance. Karnataka and Andhra Pradesh lagged far behind.

Three types of fairly detailed questionnaires were prepared for eliciting information from these firms; one for proprietary concerns, one for partnership firms and one for private or public limited companies. A separate questionnaire each for depositors of the corporations and for borrowers from these was also drawn up. The 450 firms identified were scattered in as many as 20 districts in these four States. Care was taken to cover all the areas where there was a sizeable concentration of such corporations.

Altogether 116 (25.8 per cent) of the 450 firms identified were interviewed. The number of firms studied amounted to about 4 per cent of the total number estimated in the study region. We were also able to collect the addresses of 100 depositors and borrowers through personal contracts. In addition, we had an opportunity to obtain the addresses of depositors and borrowers of two defunct firms in Karala and Tamil Nadu. We were able to secure altogether responses from 51 depositors and 25 borrowers. The investigation and data collection were held between March and December 1980.

2. General Features and Working

The finance corporation is an intermediary set up for making profit from the business of lending money raised by way of deposits or borrowing. It may be a proprietary concern, a partnership firm or in rare cases a private limited or public limited company. The most common form appears to be partnership firm registered under the Indian Partnership Act, 1932. Out of the total units identified, 95 per cent were partnerships and the balance were proprietary concerns.

The proprietary concern is the simplest form of organisation of a finance corporation. An individual, alone or in association with one or more members of his family, starts the business of lending and borrowing after taking a licence under the Money Lender's (M.L.) Act, wherever applicable. Initially, he starts lending his own money but very soon he invites his relatives and friends to deposit their savings with him for which he offers attractive rates of interest. This as well as the knowledge which they have of the man's character in business gives them the confidence to deposit money. This money is lent out for periods ranging from one or two days to 3 to 4 months. As the business grows and confidence increases, deposits come from those outside the circle of relatives. When funds increase, he diversifies his lending business by discounting cheques, negotiating trade bills and lending to other finance corporations. By now, the individual proprietor has become a full-fledged finance corporation.

The partnership firm requires registration under the Indian Partnership Act, which is a relatively simple process. After the establishment of a partnership, one partner is selected as the managing partner for administrative convenience. Sometimes, there will be joint managing partners as well. The partners who may or may not be related to each other, meet frequently to take decisions on important matters and all major decisions especially regarding the sanction of loans are taken collectively. The managing

partner is allowed to draw an honorarium for his services. The initial fund for the operation of the corporation is contributed by the partners as subscription capital not necessarily in equal shares. Besides subscription to the initial capital, the partners also deposit their funds with the corporation just like the other depositors or lend money to the corporation. In both cases, they get interest at a rate often slightly higher than that given to the public. While the corporations accept deposits from anybody, moneys are lent only to persons recommended by or known to at least one of the partners.

Although in three of the four southern States, finance corporations are also licensed under the State Money Lender's Act, money lenders and finance corporations differ in several respects. While finance corporations lend money received as deposits and borrowings, money lenders invariably lend their own funds. While money lenders lend mostly for personal use, finance corporations lend both for economic activity and personal use. Finance corporations lend for very short periods while money lenders lend for comparatively long periods. The corporations maintain regular and systematic accounts and subject them to audit whereas money lenders do not go beyond the record of transactions required under the Money Lenders' Act. The corporations usually lend sizeable amounts to a small number of people while the money lenders preferred to spread their risk over a large number of people.

The finance corporations are closer to commercial banks in many respects. They accept deposits for varying terms and issue pass-books and cash certificates. They extend secured and unsecured loans, instalment credit for consumer durables and credit on hire-purchase basis for automobiles. They allow periodical withdrawals from savings and current account deposits by means of a withdrawal form and allow premature closures of term deposits. Like banks, they pay interest on term deposits and the interest payments may be either monthly or quarterly or half yearly or yearly and give loan to the extent of 80 per cent to 90 per cent of the fixed deposit amount at 2 per cent above the rate allowed for deposits. They discount trade bills on the basis of lorry receipts and railway receipts. They discount cheques of private parties and those issued by Government departments and autonomous corporations. They keep records of day to day transactions roughly on the pattern followed in banks.

The, however, differ from banks in that they do not issue cheque-books, have a flexible approach in regard to payment of interest on deposits, pay interest on current deposits, and also pay commission for canvassing deposits.

The business practices of finance corporations generally do not vary much from centre

to centre. They follow roughly the same pattern in respect of conditions, period of loan, purposes for which credit is given, mode of repayment, etc.

In Ernakulum, Idikki and Palghat districts of Kerala State, many corporations directly connected with agriculturists were found. (Nineteen of the 78 corporations identified in these districts were taken up for special study). They all started their operations by lending own and borrowed funds to the agricultural community against the security of gold, land and buildings and in rare cases, against demand promissory notes. The purposes of these loans were seasonal requirements of commercial crop producers and personal consumption of small farmers, marginal farmers and landless labourers. They charged interest at rates, significantly lower than those of individual money lenders and almost at par with those of commercial banks, in respect of loans against the security of gold. With the nationalisation of the major commercial banks and the changed political situation in Kerala, these corporations have switched over to other borrowers and those agriculturists who could offer gold jewellery as security. The new borrowers were contractors, civil as well as forest, transport operators, traders of commercial crops, timber merchants and plantation labourers.

Whereas the large majority of finance corporations (about 90 per cent) at Bangalore conducted chit funds² on a minor scale to supplement their main income from finance business and also to offer additional services to the depositors and borrowers, the majority of chit fund firms (about 85 per cent) at Madras resorted to the finance business mainly to create funds to be pumped into the chit fund whenever necessary. In the other centres, chit funds by finance corporations and finance business by chit fund firms, i.e., the mixing up of the two businesses, were only sporadic.

3. Raising of Funds

All partnerships keep their capital subscribed below Rs. one lakh as otherwise, they would come within the regulatory purview of the Reserve Bank of India under the Banking Laws (Miscellaneous Provisions) Act, 1963 according to which a non-banking institution which is brought under the provisions of the Act includes a partnership firm if its capital exceeds one lakh of rupees. This, however, has not come in the way of corporations raising large amount of deposits as they do not maintain any fixed relation

² A rotating savings and credit system; also known as « ROSCA ».

between internal and external funds. Funds are raised from the public by the finance corporations mainly through direct canvassing by proprietors, partners and employees and in the larger cities through newspaper advertisements. Some corporations also circulate among prospective depositors attractive folders and other publicity material describing the various deposit schemes available with them. The emphasis invariably is on the rate of interest offered under different schemes. In addition to interest, sometimes small gifts are also given as an added incentive.

Although current, savings, recurring and short notice deposits are accepted by the corporations, the bulk (97 per cent) of the deposits consists of term deposits and cash certificates for long periods. Cash certificates account for about 5 per cent of the total deposits. The term deposits range from 1 to 5 years, the preference being for shorter periods. Thus, 50 per cent of the deposits are for a year only and only 5 per cent of the deposits are for more than three years. The most common cash certificate is the one which doubles the sum invested in 5 to 6 years. In a few cases, the doubling is done in four years. There are, of course, inter-State and inter-district variations in the terms offered due to the differences in supply and demand conditions in these areas. Similarly, to a certain extent, there is inter-firm disparity as well in the same centre due mainly to the different financial standing and reputation of different corporations.

Cumulative Deposits

Besides cash certificates, some corporations accept cumulative deposits under the interest reinvestment plan. One corporation advertised its cumulative deposits scheme as follows. « Your Rs. 1000 grows to Rs. 1600 in 3 years or Rs. 2400 in 5 years ». This means a simple interest rate of 20 per cent per annum for a 3 year deposit and 28 per cent per annum for a 5 year deposit. It also means, as some corporations put it, a return of 60 per cent and 140 per cent, respectively for the 3 year and 5 year periods. And the return of 28 per cent per annum (or 140 per cent for 5 years) is the highest that is offered so far by any corporation in the study region.

Receipts Evidencing Deposits

All the corporations give beautifully printed and appropriately worded receipts in evidence of the amounts received as deposits or the amounts borrowed by partners/promoters for use in the corporation. Those who accept savings, current and recurring deposits issue pass books to the account holders and the pass book details are similar

to those contained in bank pass books. Withdrawals from savings and current deposit accounts are done by means of withdrawal forms.

In Salem and some other centres a promissory note signed by all the partners is given as an evidence of a deposit instead of a fixed deposit receipt to depositors. Although in theory, the depositor has the option of withdrawing the money at any time, in practice, there is an informal understanding that the deposit would not be withdrawn before an agreed period of time. Even if this cannot be adhered to, there is an understanding that adequate notice will be given. The practice of borrowing seems to be a precautionary step taken by a few who feel that the future of finance corporations is uncertain and that government may forbid them to accept deposits. It is felt that government cannot legitimately in such a circumstance prohibit borrowing.

The rates of interest offered by the corporations in each centre including agricultural centres are given in Table 1. For the sake of comparison, interest rates of commercial banks for different periods are also given. It will be seen that the minimum interest offered for a year is 12 per cent with the exception of one centre, Madanapalle. In more important centres like Madras, Karur and Salem, it is over 14 per cent. Surprisingly for three years, it is only 15 per cent in places like Bangalore and centres in Andhra Pradesh while in Tamil Nadu and Kerala, it is closer to 18 per cent. The rate rises further for a five year period. It is obvious that commercial banks cannot match the interest paid by finance corporations. But this disparity between centres does not lead to a movement of deposits from a low interest centre to a high interest centre because the basis of deposit is knowledge of and confidence in the partners of the corporations. Although corporations with long years of service offer less to depositors and others even these rates are significantly higher than the rates offered by commercial banks. The corporation's position is governed solely by the supply of and demand for funds.

Since cost of servicing increases with the decline in the period for which money is deposited, there is a preference for term deposits and cash certificates. On the other hand, the depositors prefer to deposit their money for periods ranging from one to three years rather than from three to five years.

Monthly Interest

One point to note here is the implication of monthly payment of interest on term deposits. This system of interest payment is preferred by the depositors. Accordingly, the corporations pay interest every month and when interest is paid monthly, a simple interest becomes, in effect, a compound interest on monthly compounding basis.

Table 1
AVERAGE INTEREST RATES ON DEPOSITS PAID BY THE FINANCE CORPORATIONS
(Effective on March-end, 1980)
(Simple Interest per cent per annum)

Centre	Savings		Term Deposits for							Cash Certificates for	
	Depo sits	Less than one year	1 year	2 years	3 years	4 years	5 years	10 years	3 years	5 years	
Bangalore	7.70	8.60	11.80	13.25	15.25	—	18.00	—	18.00	—	
Madanapalle	6.00	7.00	11.00	11.67	15.00	—	—	—	—	—	
Kurnool	—	8.00	12.33	13.50	15.00	—	—	—	—	—	
Hindupur	—	12.00	14.50	16.50	18.00	—	—	—	—	—	
Madras	8.00	11.00	14.25	15.50	17.68	17.83	21.33	—	20.93	20.82	
Coimbatore	6.00	9.00	13.75	15.33	18.00	19.00	20.00	—	—	—	
Salem	11.25	11.00	14.75	—	—	—	—	—	—	20.00	
Karur	7.36	8.57	14.56	16.00	—	—	—	—	—	—	
Ernakulum	7.00	8.25	13.50	15.40	17.60	18.00	20.00	—	—	—	
Kottayam	5.61	8.86	12.00	13.29	16.00	17.60	—	—	—	—	
Calicut	7.25	9.25	12.80	14.50	18.00	—	—	—	—	—	
Trichur	7.00	9.50	12.60	14.75	18.00	—	—	—	—	—	
Idikki	—	12.00	15.00	16.00	18.00	—	—	—	—	—	
Kozhanchery	6.83	8.83	13.00	14.50	18.00	—	—	—	—	—	
Palghat	7.00	9.00	13.00	14.50	18.00	—	—	—	—	—	
Agricultural Centres	7.62	9.83	13.11	14.81	17.53	18.00	—	—	—	—	
Chit fund companies	8.00	8.50	12.00	13.20	15.12	—	—	—	—	—	
* Weighted Average for all Centres	7.19	9.16	13.03	14.44	16.81	17.70	18.91	—	19.17	20.32	
Interest Rate on Deposits of Commercial Banks	5.00	5.50	—	7.00	—	—	8.50	10.00	7.72	10.46	
** Effective Rates (S.I.p.a.) on Term Deposits of Corporations when Monthly Interest is paid	—	—	13.90	16.60	2.66	25.50	31.00	—	—	—	
Effective Rates (S.I.p.a.) on Term Deposits of Commercial Banks when Monthly Interest is paid	—	—	7.19	7.45	7.70	10.00	10.54	16.96	—	—	

Business of corporations extend to other areas as well.

Note: The interest rates on deposits of commercial banks are fixed by the Reserve Bank of India. The commercial banks with deposits above Rs. 25 crores are included in the Table. However, commercial banks with deposits below Rs. 25 crores and cooperative banks can pay 0.25 per cent and 0.50 per cent, respectively more.

There is considerable difference between the two types of interest, especially for a long investment period, as could be seen from columns 4 and 5 of Table 2.

Table 2
EFFECTIVE RATE OF INTEREST ON MONTHLY INTEREST PAID DEPOSITS
(Amount in Rs.)

Deposit amount	Period of deposit in months	Rate of Simple interest per annum	Deposit + Interest on maturity (simple interest basis)	Deposit + Interest on maturity (on compound interest basis) (*)	Effective Rate of Interest on Deposits (Simple Interest per cent per annum)
(1)	(2)	(3)	(4)	(5)	(6)
10,000	12	12	11,200	11,200	12.00
10,000	24	15	13,000	13,225	16.13
10,000	36	17	15,100	16,016	30.05
10,000	36	18	15,400	16,430	21.43
10,000	48	18	17,200	19,387	23.47
10,000	60	18	19,000	22,877	25.75
10,000	72	21	22,600	31,380	35.64

* Using the formula $S = (1 + i)^n$ where « S » is the amount, at the end of term, resulting from the growth, at compound interest of an initial amount of 1. The formula assumes an interest rate of « i » per period and a term of « n » periods. The World Bank Publications, *Compounding and Discounting Tables*, edited by J. Price Gittinger is consulted.

The average rate for all periods of deposits comes to 14.92 per cent simple interest per annum but as the corporations pay monthly interest on most of the term deposits for one year and above, the average rate works out to 17.53 per cent per annum. Taking into account the service charges and managerial expenses, the average cost of funds works out to 20.62 per cent. Apart from the high rates of interest on all types of deposits, the corporations also offer a number of other facilities and incentives to depositors such as gifts for large amounts of deposits and long periods, liberal loan facilities from term deposits, simple procedures, easy acceptance of deposits in the names of the minors, etc.

The depositors who responded to the questionnaire all agreed that the main reason why they deposited their funds with these corporations was the high rate of interest offered. The second factor which persuaded them was the payment of monthly interest at their door without any effort on their part to collect it. The depositors were aware that

funds could be badly managed and often misused, and in the absence of security against much of the loans, poor liquidity position and absence of regulation, they were facing a serious risk of default. But the high rate of interest offered seemed to overcome their misgivings with regard to these aspects of the operations of finance corporations.

4. Lending Business

Finance corporations come into existence because credit is not available from existing agencies to certain persons or categories of persons either because of the nature of their business or because of the nature of security which they can offer. The corporations take advantage of this situation and raise money at high rates of interest and lend at still higher rates.

The general pattern of lending is to sanction a loan either on the security of a demand promissory note or tangible assets such as land, buildings, insurance policy, gold jewellery and silver wares. In the case of unsecured loans or clean loan, the loan period is no more than 90 days and the interest is collected in advance. However, the borrowers are under obligation to repay the loan on any day lenders demand. There is no such stipulation in the case of a loan secured by assets. Similarly, no advance interest is collected on such loans.

There are a number of variations with regard to types of loans. There is daily repayment where a part of the loan is regularly extinguished everyday, the interest having been collected in advance. Thus if the loan is for Rs. 1000 for a period of 100 days and the rate of interest is 7 per cent for 100 days, the borrower will receive Rs. 930 and will repay Rs. 10 a day for 100 days.

A few points that could be noted from the above method which is practised by many Corporations are:

- (i) The interest rate of 7 per cent for 100 days on Rs. 930 (as per the simple interest formula) is equal to 27.47 per cent. This rate is valid when the entire loan amount of Rs. 1000 is repaid in a lump at the end of 100 days.
- (ii) The repayment of loan in instalments reduces the effective period of loan or increases the effective interest rate. When a loan is repaid in equal instalments calculated by dividing the loan amount with the number of instalments, the period for calculation of interest is reduced by half or the rate of interest gets doubled. Under such a

situation, the rate of interest in the example cited comes to Rs. 54.94 per cent per annum.

(iii) With a given deposit amount, the corporation effects more loan transactions by raising funds out of loan repayments.

Such type of loans for 100 to 120 days with daily recovery in equal amounts are very common among the numerous corporations at Ernakulam, Kozhichery, Trichur, Piravom, Muvattupuzha, Coimbatore and among a few corporations at Kurnool. The borrowers are mainly merchants with regular sales income, private transport operators (both buses and lorries) cinema theatre owners, and hotel and lodge owners.

Export Credit

At least one corporation in Madras concentrates on export finance based on a letter of credit (L.C.). The corporation's clients are people who have not been able to secure finance from banks. They find dealing with the corporation more convenient than dealing with banks. The corporation finances the exporter to the extent of 75 per cent of the L.C. after ascertaining from the exporter bank that the L.C. is irrevocable. The corporation is authorised to receive the proceeds of the L.C. from the bank. The borrower gets the proceeds, after the loan amount, interest and/or any other commissions chargeable by the corporation have been adjusted. The corporation safeguards its interests by offering a complete package of services to the exporter from raw material purchase to shipment of goods. The commission on export credit varies from two to three per cent per month or 24 per cent to 36 per cent per annum. If the interest is collected in advance, this works out a little higher.

Bills Discounting

An important item of financing by the corporations in many towns of Kerala, more specifically Kottayam, is internal or domestic trade bills. The corporations purchase or discount the documentary bill consisting of a lorry receipt or railway receipt and an invoice on the consignee for goods despatched. The corporations then collect the proceeds of the bill from the consignee. Where the buyers and sellers settle the accounts through present dated or post-dated cheques, the corporations discount them provided they are presented by known and credit-worthy local purchasers and customers. For both these services, they charge a commission of 40 paise to 50 paise per Rs. 100 irrespective of the period of realisation. Normally, these are realised within two weeks.

Since the average period of waiting works out to something like 7 days, the rate of discount works out to 19 per cent to 24 per cent per annum. Total bill finance amounted to about one-fifth of the total advances of many corporations during 1979 at Kottayam. Such business, is carried on also in other spices and timber trading centres.

Gold Loan

Disbursement of loans against the security of gold ornaments is the main business of many a corporation in Kerala and at least one corporation at Coimbatore. Since this is a first-class security, no period is stipulated by the corporations for a gold loan. Interest is paid along with the principal at the time of repayment of the loan. The normal rate everywhere is Rs. 2 per Rs. 100 per month or 24 per cent simple interest per annum. The majority of the corporations at Kottayam charged only 18 per cent to 21 per cent simple interest per annum on such loans in 1979.

These terms were more favourable than what a commercial bank in the private sector would provide for a loan against the security of gold jewellery. Such a bank would charge simple interest of 18 per cent per annum, compound interest on quarterly basis, charge penal interest of 2 per cent per annum on interest defaults at every quarter after six months, charge rent and insurance charges at 1.75 per cent per annum on principal and limit the duration of the loan for two years. This would, in effect, mean a rate of interest of 21.17 per cent per annum for a one-year loan and 23.27 per cent per annum for a two-year loan. Further, the loan amount would only be a small proportion (40 per cent to 45 per cent) of the market value of the pledged article. Also, a borrower could not always be certain that he would get a loan against such security because it depended upon the current policy of the bank.

In at least two centres in the study region, namely, Bangalore and Karur, corporations provide credit to a significant extent to the decentralised (unorganised) textile sector. Those at Bangalore finance the handloom silk industry while those at Karur finance cotton handloom textiles. The rate of interest charged on loans is 6 to 7 paise for Rs. 100 per day, that is, 21.6 per cent to 25.2 per cent per annum. The loan is usually repaid within one month. And in no case is it allowed to exceed 90 days. The fact that interest is charged only for the actual days of loan used is a great convenience. If the loan is not necessary at a stretch for a number of days, a borrower can borrow for the day(s) he requires, paying interest only to the actual days of loan use. For those borrowers who use borrowed funds in day-to-day production/sales, such interest calculations which are not available in formal financial institutions are more favourable.

Security for Loan

The security for secured loans included gold jewellery, silver and sometimes brasures, life insurance policies, motor vehicles, cash crops like spices, raw-rubber, edible oils and immovables like land building. The unsecured loan was mainly on the basis of a demand promissory note (DPN) signed individually by the borrower and in certain cases individually and jointly by two guarantors also. The movable securities other than motor vehicles are held by the corporations under lock and key with proper records of weight, number of items, identification numbers, etc. When the loan is repaid, the pledged article is released forthwith. In respect of loans against motor vehicles including used vehicles, the registration book, undated sale deed mentioning that the vehicle is sold for so much amount to one of the partners by name and an undated request by the vehicle owner to the regional transport authority to transfer the vehicle to the name of the purchaser are given to the corporation. When the loan is cleared, all these documents are redeemed to the borrower. Regarding loans against immovable properties, their title deeds are mortgaged to the corporation through necessary registration with the registering authority in the area.

Hundi Loan

The corporations also lend against *hundis*³ which are then discounted if need be with other corporations and sometimes with commercial banks.

The Hundi loan works as follows: An individual or firm « A » executes a *Hundi* (see specimen below) in favour of corporation « X » stating that after a specified number of days he will pay the sum to « X » or order. In the acknowledgement (or consideration receipt) he mentions the amount of interest paid by him in advance for the whole period, and undertakes to bear the loss in interest in case the *Hundi* is dishonoured. The *Hundi* or *Hundies* of prominent individuals and firms are discounted by certain commercial banks and almost all the corporations. For example, corporation « X » can get the *Hundi* executed by « A » discounted at a bank or another corporation « Y » if « X » is short of cash. Alternatively « X » can borrow from these institutions on the security of the *Hundi*. However, if the discounted *Hundi* is dishonoured, the responsibility of payment falls on the endorser, namely, « X ». Normally *Hundis* are seldom dishonoured.

³ *Hundi* is a written order usually unconditional made by one person on another for payment on demand, or after a specified time, of a certain sum of money to a person named therein.

Loans to forest or public Wonda Department (PWD) contractors are given by corporations in Kerala on the basis of a power of attorney signed by the borrower. The power of attorney is registered with the Sub-Registrar of the area. One copy of the power of attorney is kept with the authorities who pass the bills of work completed. On completion of the contract work, the payment is sent to the holder of the power of attorney, namely, the corporation. The power of attorney is executed in addition to the usual demand promissory note. Normally, the corporations lend 75 per cent of the estimated amount of contract as a loan. The contractor himself has to invest 25 per cent of his own money in that work before taking the loan from the corporation.

In respect of all unsecured loans, some corporations insist in having with them a blank cheque of a commercial bank signed by the borrower.

Direction of Credit Flow

The direction of credit flows from the corporations is indicated in Table 3. The largest proportion of total loans in all centres (about 35 per cent) flowed to trade. This was followed by personal consumption (12.33 per cent), agriculture (10.41 per cent) and building construction (8.73 per cent). Industrial loans were of importance only in four centres. Similarly, the financing of the cinema, business (mainly theatre construction) and contract work were to be found in a few centres only.

The share of credit which went to trade, agriculture, transport, industry, export and small business was 63.34 per cent. While the share of building construction, cinema, theatre and contract work was 15.67 per cent. The balance of 20.99 per cent was accounted for by personal consumption and miscellaneous.

Some borrowers at larger centres like Bangalore, Madras, Ernakulum, Calicut and Trichur use borrowings from corporations to provide margin money needed to raise loans from commercial banks. The banks give loans for certain purposes, occupations, professions, etc., if only the borrower invests some amount from his own sources. For instance, if a transport operator wants a loan to buy a new truck, he will have to manage a part of the price, say 25 per cent, from his own sources as banks will not extend loan for the full value of the trucks. The difference between the price of the truck and the loan amount, called the borrower's capital of margin money is raised by the borrower from a corporation. This way, the corporations become instrumental in holding the weaker sections and in expanding the loan portfolio of commercial banks. Besides, by mixing a high cost corporation loan and a low cost bank loan, the borrower is able to bring down his average rate of interest.

Table 3
CENTRE-WISE DISTRIBUTION OF LOAN ACCORDING TO PURPOSE
(Percentage share under each head in total credit as on March-end, 1980)

Places	No. of corporations studied	Trade/Business	Agriculture including plantations	Building Construction and renovation	Transport	Industry (mainly decentralised)	Small Business	Cinema Theatre and allied Business (Excl. film Production)	Contract Work	Personal Consumption	Others (Unspecified)	Total of Percentages
Bangalore	10	48.27	1.02	34.86	3.24	4.90	1.26	2.15	—	4.30	—	100.00
Madanapalle	4	70.50	20.50	—	—	—	3.65	2.65	—	5.35	—	100.00
Kurnool	3	66.45	—	—	5.16	—	28.39	—	—	—	—	100.00
Hindupur	2	69.52	—	—	—	—	30.48	—	—	—	—	100.00
Madras	8	34.70	3.73	7.90	—	5.51	—	8.78	—	0.46	38.92*	100.00
Coimbatore	8	25.78	32.99	—	—	1.33	1.99	—	—	37.91	—	100.00
Salem	9	59.87	—	4.17	—	25.88	6.54	—	—	3.54	—	100.00
Karur	10	26.30	3.63	—	—	57.80	7.85	—	—	4.42	—	100.00
Emakulam	6	29.52	10.96	3.74	25.81	—	3.44	—	8.07	18.46	—	100.00
Kottayam	9	52.50	28.62	—	1.57	—	—	—	—	14.54	2.77	100.00
Calicut	5	49.24	3.28	—	5.71	—	10.29	—	10.67	10.95	9.86	100.00
Trichur	5	39.81	5.66	—	25.53	—	—	—	8.18	10.88	9.94	100.00
Idikki	2	39.23	28.21	—	5.64	—	—	—	—	26.92	—	100.00
Kozhanchery	3	37.87	12.14	8.12	1.79	—	0.44	8.12	9.91	19.82	1.79	100.00
Palphat	2	29.23	14.87	—	—	—	25.64	—	30.26	—	—	100.00
Agricultural Centres	9	15.37	35.91	1.39	15.41	—	3.16	—	8.89	19.52	0.35	100.00
Chit fund companies	9	8.08	—	25.05	—	—	0.96	8.83	—	27.07	30.01**	100.00
For all corporations												
Total (Amount Rs.)	114 +	1170.28	352.57	295.64	131.73	195.62	63.39	153.68	81.41	417.78	525.26	3387.36
Percentage share in												
Total Loan		34.55	10.41	8.73	3.89	5.77	1.87	4.54	2.40	12.33	15.51 ++	100.00

Note: 1) Trade includes textiles, stationery, grocery, spices, timber, grains, rubber, etc., and bills and cheques discounting. A part of the loan may also be used as margin money to get loans from banks.

2) Fifty per cent of the "gold loan" is treated as agricultural loan and the rest 50 per cent as personal loan.

3) Small business covers mandi merchants, vegetable vendors, petty traders, etc.

* Includes 26.29 per cent for export-import and 12.63 per cent for jewellery business.

© The loan operation extend to Emakulam, Trivandrum, etc.

** For chit business including loans to subscribers.

++ In which 6.85% accounted by export-import business.

+ Excludes two defunct corporations.

Specimen of 90-day Hundi

Place
 Rs. Date
 (90) Ninety days after this date without grace days I/We
 (address of borrower)
 promise to pay to M/s. (Name and address of Corporation)
 or order the sum of Rupees
 only for value received in cash/cheque on this day
 (date, month, year) payable at (Place of office of corporation)
 Address (of borrower/s) Signature of borrower/s

Note: This should be taken on the requisite Hundi paper of stamp and value as prescribed under the Indian Stamp Act depending on the amount and period.

Credit Flow to Speculative Trade

As the largest share of credit (about 35 per cent of total) of the corporation flows to trade, one may infer that a part of it may be used by the borrowers for buying and storing scarce commodities with the intention of selling at a time when their prices rise. Let us see what happens when a borrower uses the loan for withholding stock. The factors that he will have to consider are: (i) the cost of loan, (ii) the period that he can retain the loan with him and (iii) the return on the investment of loan. The return on investment is not influenced by the source of credit. But it is related to the other two factors. As the cost of credit is to be realised from the return on investment, a high cost of credit would mean a low profit. Similarly, when there is an embargo on credit period, the investment period will have to be adjusted to suit the credit period in which case the investment may not yield the expected profit, or even result in loss. Therefore, a high cost of credit with a short credit period is less suitable for hoarding stock for the purpose of « selling at an appropriate time » than a low cost credit with a fairly long and flexible credit period. If a trader has access to credit from both a corporation which extends credit at a fairly high rate of interest and for a short period and a bank which charges a significantly low interest for credit that may continue for a long period of a year or so, he is most likely to use the bank credit for hoarding purposes because it will enable him to make more profit. If he has access only to the corporation and if his sole purpose of borrowing is to indulge in speculative trade, his operations will be conditioned by the cost of credit and the duration of loan.

Lending rates are not publicised by the corporations although they vie with each other in advertising the rates of deposits. The need for secrecy arises from the existence of a ceiling on lending rates where Money Lender's Acts are in force as well as the desire not to tempt income-tax authorities. Secondly, since the nature of the security as well as the relationship that the borrower has with the corporations influences the lending rate, there is no fixed rate as such. In Karnataka, the Money Lender's Act prescribes a simple interest rate ceiling of 18 per cent per annum on secured loans and 21 per cent per annum on unsecured loans. But the ceiling is applicable only to loans up to Rs. 3000. The Kerala Money Lender's Act prescribes a ceiling of 12 per cent for loans up to Rs. 3000. The Tamil Nadu Money Lender's Act prescribes a ceiling of 12 per cent for loans up to Rs. 10,000. The result is that loans sanctioned by the finance corporations are usually above these stipulated maximum amounts and the rate of interest varies between 18 per cent and 36 per cent with the model being at 24 per cent.

Most corporations advanced all or more than what they received by way of deposits. This naturally meant that they had hardly any liquidity which could be used to meet contingencies. Did such a need arise, it is a common practice to borrow from other corporations. The managing partners of different corporations located in the same place are in touch with each other. When sudden demand arises in a particular corporation, the managing partner or one of the partners rings up the managing partner of another corporation who sends the necessary amount through his messenger within the shortest possible time. There would be no interest charge if the borrowing was for a day or two but if the period is longer definitely interest has to be paid. Where no such understanding exists between different corporations in the same area, funds were obtained through repledging of pledged articles particularly gold jewellery. Some of the corporations in the « High Ranges » in Kerala, stipulate that a notice of 7 days is necessary before a gold loan is extinguished in order to enable them to obtain the pledged article in case it has been hypothecated with somebody else. Usually, the lending corporation charges a lower rate of interest on loans against repledges.

In other cases, liquidity is secured by rediscounting at the commercial banks, trade bills purchased and or discounted by the corporations. They also borrow from banks against such assets they may have as shares of companies, insurance policies, Government and semi-Government securities, etc. In addition, in places like Madras, there exists a local call Money Syndicate of finance corporations and money lenders. This Syndicate is in a position to lend up to Rs. 40 lakhs at each time. The rate of

interest charged is 8 paise per Rs. 100 per day or 28.8 per cent per annum. If the period is longer, interest is charged on a quarterly compounding basis.

They also try to match their lending operations with deposit repayment schedules. A mismatch occurs only occasionally partly because the corporations reduce their risk by lending for periods not exceeding 100 days. Normally, withdrawals and fresh deposits or renewal of matured deposits will cancel each other. As the deposits are mainly for fixed periods, the repayment schedule can be known much in advance and hence there will be no difficulty in providing for such repayments. The emergency for hard cash arises when a depositor, particularly a large one, turns up unexpectedly for premature withdrawal of his term deposit. It is for meeting such a contingency that the corporations keep in reserve the near money sources mentioned in the preceding paragraphs. Besides, many corporations have the system of instalment loan. Instead of enhancing the lending capacity, these corporations may use the paid up instalment amounts to meet the payment obligations.

5. An Evaluation

The size of the informal credit market (ICM) in the four southern States is not known and, therefore, it is not possible to estimate the share of the finance corporations in the ICM. However, we can have an idea of the size of their operations in comparison with the formal credit market dominated by the commercial banks. As at the end of June 1979⁴, the outstanding deposits and credits of the scheduled commercial banks with 30202 branches in India were of the order of Rs. 28671 crores and Rs. 19116 crores, respectively⁵. Against these, the corresponding figures for finance corporations numbering 3071 as at the end of March 1980 were estimated at about Rs. 652 crores and Rs. 610 crores, respectively. Thus the operations of finance corporations were about 2 to 3 per cent of the operations of commercial banks. However, if we take into account the operations of commercial banks in the southern States alone, the corporations mobilised about 10 per cent of the deposits of commercial banks and lent about 12 per cent of their advances.

⁴ This is the latest year for which comparable data were available at the time of going to press.

⁵ *Banking Statistics*, Basic Statistical Returns, June 1980, Reserve Bank of India, Bombay.

Therefore, the question as to how finance corporations are able to function irrespective of their high rates of interest on loans and the total lack of security regarding the deposits which they collect becomes an important one. Commercial banks operate within the credit and other guidelines laid down by the Reserve Bank and Government and although their lending rates are lower and the funds at their disposal are larger, credit does not necessarily become available to all people. Therefore, those borrowers to whom the cost of credit up to a point is not the major consideration of those who wish to borrow for a purpose not favoured by commercial banks prefer finance corporations because of the flexibility regarding credit availability.

There are factors other than availability which induce people to borrow from the corporations. The alternative sources of funds are money lenders or banks; the former obviously cannot meet the credit requirements of borrowers from finance corporations because of lack of resources. The banks also are not attractive sources of funds partly because of their lending procedures and partly because the cost of funds turns out to be not that much lower on closer examination. Firstly, a borrower has to make several trips to a bank in order to secure a loan. These involve a substantial cost because of the cost of transport and other expenses as well as loss of working time. It is often alleged that there are in addition what might be euphemistically called access costs in securing bank loans. If these are added to the nominal rate of interest charged on bank loans, the difference between the two lending rates may not be as large as the gap between the nominal rates. The same is the case with gold loan rates.

For the businessmen who would never like to keep the money idle, the corporation loan is convenient because they can limit the quantum of borrowing to the actual requirements. In other words, they need not borrow tomorrow's requirements today as they can or they are certain that they can again borrow tomorrow the amount they require. This enables them to keep their interest burden light. On the contrary, many borrowers of banks borrow tomorrow's requirements today and keep the amount for a day as a precautionary measure because there is not only an element of uncertainty in getting the loan tomorrow but also the interest burden of the loan taken and kept idle for future use is light. The fact that interest is calculated on a daily basis on outstanding loans and that funds are available almost instantly at any time of the day are also added conveniences which make borrowing from the finance corporations more attractive. The depositors too find lending to finance corporations more attractive in spite of the lack of security because of the high rate of interest. In addition, they enjoy such conveniences as the withdrawal of even term deposits in an emergency without any great

Table 4

BREAK-UP OF ADMINISTRATIVE EXPENSES OF CORPORATIONS IN 1979-80

Centre	Number of Cor- porations including branches	Number of Employees	Salary and other Emolu- ments per month	Rent Elec- tricity and premi- ses mante- nance per	Other Expenses excluding adverti- sement an expenses per month
			(Rs.)	(Rs.)	(Rs.)
(1)	(2)	(3)	(4)	(5)	(6)
Bangalore	10	56	19850	5675	12300
Madanapalle	4	19	5600	760	1908
Kurnool	3	8	1711	690	450
Hindupur	2	7	1450	425	400
Madras	27	190	70600	22890	83300
Coimbatore	8	38	11985	2840	4720
Salem	9	31	7448	1490	4500
Karur	10	30	6650	2875	8350
Ernakulam	8	43	17350	3515	30750
Kottayam	9	41	14610	3380	15558
Calicut	5	19	5375	2120	3650
Trichur	5	20	6750	2000	4500
Idikki	2	7	2400	390	600
Kozhenchery	6	52	20000	3950	15150
Palghat	2	5	1250	530	550
Agricultural Centres	19	51	14220	4305	8420
Corporation by Chit					
Fund Companies	32	182	47611	13586	24537
All Centres	161	799	254860	71421	219643

Note: Data Based on information on establishment expenses collected from each of the Corporations.

Total Adminis- trative expenses per month	Total Adminis- trative expenses per annum	Number of Em- ployees per Office	Salary and other Emo- luments of an Employee per month	Rent and Electricity etc. per Office per month	Other expenses excluding advertisement expenses per Office per month
(Rs.)	(Rs.)	(3 ÷ 2)	(4 ÷ 3)	(5 ÷ 2)	(6 ÷ 2)
(7)	(8)	(9)	(10)	(11)	(12)
37825	453900	5.6	354.46	567.50	1230.00
8268	99216	4.75	294.74	190.00	477.00
2851	34212	2.67	213.88	230.00	150.00
2275	27300	3.50	207.14	212.50	200.00
176790	2121480	7.04	371.58	847.78	3085.19
19545	234540	4.75	315.40	355.00	590.00
13438	161256	3.44	240.26	165.56	500.00
17875	214500	3.00	221.67	287.50	835.00
51615	619380	5.38	403.49	439.38	3843.75
33548	402576	4.56	356.34	375.56	1728.67
11145	133740	3.80	282.90	424.00	730.00
13250	159000	4.00	337.50	400.00	900.00
3390	40680	3.50	342.86	195.00	300.00
39100	469200	8.67	384.62	658.33	2525.00
2330	27960	2.50	250.00	265.00	275.00
26945	323340	2.68	278.82	226.58	443.16
85734	1028808	5.69	261.60	424.56	766.78
545924	6551088	4.96	318.97	443.61	1364.24

Table 5

OPERATIONAL DETAILS OF CORPORATIONS IN DIFFERENT CENTRES DURING 1979-80
(amount in Rs. Lakhs)

Centre	No of Corpo- rations studied	Deposits (out- standing as on 31.3.80)	Average deposits of the year	Income from loans and invest- ments during the year	Interest paid to Deposits during the year
(1)	(2)	(3)	(4)	(5)	(6)
Bangalore	10	276.97	276.73	42.99	8.43
Madanapalle	4	26.42	24.63	5.85	3.40
Kurnool	3	14.85	14.96	3.12	1.91
Hindupur	2	9.00	10.25	1.75	1.27
Madras	8	1101.50	1005.93	240.80	179.90
Coimbatore	8	347.55	335.29	71.69	52.92
Salem	9	115.48	107.46	25.50	17.55
Karur	10	149.25	142.00	29.15	21.73
Ernakulam	6	263.25	254.50	51.00	36.30
Kottayam	9	187.28	184.08	32.33	23.54
Calicut	5	52.50	49.75	10.80	7.45
Trichur	5	79.25	75.00	16.45	12.35
Idikki	2	18.50	19.00	3.79	2.88
Kozhanchery ^a	3	365.29	348.28	78.38	57.59
Paigat	2	9.00	8.75	1.90	1.44
Agricultural Centres	19	152.25	147.35	26.50	19.71
Corporations by Chit Fund Companies ^{**}	9	362.12	369.84	52.04	44.22
Total for All Centres	114	3530.46	3373.78	694.04	519.15

Notes: Data based on statement of accounts and income and expenditure statements. The data analysed in Table 1 are based on published corporations might have under-reported the interest payments either to conform to the lending rate which is fixed low under M.L. Acts or to

^a Two corporation which invested the bulk of their deposits in their own building and therefore incurred heavy losses are responsible for the

^c Operations extend to other places also.

^{**} Chit fund companies lend at a comparatively low rate to subscriber and considerable deposits remain effectively idle for want of proper percentage of interest payments and loss.

All other expenses including those on fund raising during the year	Gross (subject tax) for year	Profit/interest to paid as the per cent of deposits (6 as % of 4)	Expenses as per cent of deposits (7 as % of 4)	Gross Profit as per cent of Deposits (8 as % of 4)	Interest payments as per cent of income (6 as % of 5)	Expenses as per cent of income (7 as % of 5)	Profit as per cent of income (8 as % of 5)
(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
—0.43	12.64	3.05	—	81.39	16.91	—	
1.23	1.22	13.80	4.99	4.95	58.12	21.03	20.85
0.58	0.63	12.77	3.88	4.21	61.22	18.59	20.19
0.35	0.13	12.39	3.41	1.27	72.57	20.00	7.43
53.30	7.60	17.88	5.30	0.76	74.71	22.13	3.16
13.93	4.84	15.78	4.15	1.44	73.82	19.43	6.75
3.39	4.56	16.33	3.15	4.24	68.82	13.20	17.88
4.24	3.18	15.30	2.99	2.24	74.55	14.55	10.91
9.93	4.77	14.26	3.90	1.87	71.18	19.47	9.35
5.47	3.32	12.79	2.97	1.80	72.81	16.92	10.27
1.85	1.50	14.97	3.72	3.02	68.98	17.13	13.89
3.07	1.03	16.47	4.09	1.37	75.08	18.66	6.26
0.54	0.37	15.16	2.84	1.95	75.99	14.25	9.76
15.07	5.72	16.54	4.33	1.64	73.48	19.23	7.30
0.33	0.13	16.46	3.77	1.49	75.79	17.37	6.84
4.31	2.48	13.38	2.93	1.68	74.38	16.26	9.36
11.96	—4.14	11.96	3.23	—1.12	84.97	22.98	—7.96
137.98	36.91	15.39	4.09	1.09	74.80	19.88	5.32

deposit rates and mode of interest payments. The two sources differ in respect of rate of interest on deposits. This may be because some show low expenditure in order to agree with the low income worked out for purposes of income-tax.

overall loss.

borrowers. At the same time, they have to pay market rate of interest for deposits. The low utilisation of borrowed money accounts for the high

difficulty and without any loss of interest (For premature withdrawals of term deposits, the corporations pay interest at the rate applicable for the period run while the banks pay at a rate 2 per cent less than the rate applicable for the period run); ability to borrow as much as 90 per cent on the security of fixed deposit receipts; and easy realisation of matured deposits of a deceased depositor by the heirs. Nevertheless, the scope of their activities is limited because only a limited number of people will accept the high rate of interest on deposits as fully neutralising the risk of default. Also the flexibility of their operations does not neutralise for most purposes acceptable for bank lending their high rates for lending.

Since deposit rates as well as lending rates are determined by competition, the only way to maximise profits is by keeping administrative and servicing expenditures to the minimum. Since expenditure connected with fund raising does not offer much scope for economy, the corporations effect cost reduction on the administrative side. Centre-wise break-up of administrative expenditure is given in Table 4. It will be seen that the average salary and other benefits of an employee of a corporation amount to Rs. 319 per month, which is about one-third the average monthly salary of a clerical assistant in a bank. Since supervision is tight, the employees' working time is utilised fully and thus the corporations are able to run their operations with the minimum number of people. Often the managing partners and proprietors also work with the staff to cope with the pressure of work. By keeping down the number of employees to the absolute minimum and paying them significantly lower salaries than those of bank employees, the corporations achieve a major cost advantage over the transaction costs of banks. Again, expenditure on stationery, etc., are kept to a minimum because of simple procedure of work and supervision. The details of operations of the corporations at different centres are shown in Table 5.

The efficiency of operation of finance corporations in comparison with banks may be seen from Table 6.

The following facts emerge from this Table:

- a) Administrative expenses form only 1.94 per cent of the deposits of the corporations, while they are 3.51 per cent of deposits for banks. But the corporations incurred about 2.15 per cent of deposits on fund raising. This raised their total transaction costs to 4.09 per cent of deposits.
- b) There is a difference of 9.06 percentage points in the ratios of operating expenses to deposits of the two agencies. As the difference in transaction costs (administrative and fund raising expenses) of the two are only very small (0.58 percentage points) the

Table 6
EARNINGS AND EXPENSES OF CORPORATIONS AND BANKS
(Accounts in Rs. Lakhs)

	Selected 114 Corporations with 161 offices	Commercial banks (136) with 31556 offices
1. Capital and reserves	116.25	43785.00
2. Average deposits for the year*	3373.78	312721.00
3. Earnings from loan operations	694.04	237494.00
4. Earnings from investment and other uses	—	121751.00
5. Total operating earnings (3 + 4)	694.04	359251.00
6. Interest paid to deposits and borrowings (financial cost)	519.15	215965.00
7. Administrative expenses	65.51	109955.00
8. Fund raising expenses*	72.47	&
9. Administrative and fund raising expenses (transaction cost)	137.98	109955.00
10. Total operating expenses (6 + 9)	657.13	325920.00
11. Profit before tax (5 — 10)	36.91	33331.00
<i>Selected Ratios</i>		
a) Earnings from loans as % of deposits (3 as % of 2)	20.57	7.59
b) Earnings from investments and uses as % of deposits (4 as % of 2)	—	3.89
c) Total earnings as % of deposits (5 as % of 2)	20.57	11.49
d) Interest payments as % of deposits (6 as % of 2)	15.39	6.91
e) Spread between interest earned and interest paid (c-d) in percentage points	5.18	4.58
f) Administrative expenses as % of deposits (7 as % of 2)	1.94	3.51
g) Fund raising expenses as % of deposits (8 as % of 2)	2.15	—
h) Administrative and fund raising expenses as % of deposits (9 as % of 2)	4.09	3.51
i) Operating expenses as % of deposits (10 as % of 2)	19.48	10.42
j) Interest paid to deposits and borrowings as % of earnings (6 as % of 5)	74.80	60.12
k) Operating expenses as % of operating income (10 as % of 5)	94.68	90.72
l) Profit as % of deposits (11 as % of 2)	1.09	1.07
m) Profit as % of earnings (11 as % of 5)	5.32	9.28
n) Capital and reserves as % of deposits	3.35	1.40
o) Profit before tax as % of capital and reserves	30.83	76.12

Notes: The data on corporations are for the financial year 1979-80 (ie, the year ending March 1980) and those on banks are for the calendar year 1979 (year ending December 1979). The bank data are from the Statistical Table Relating to Banks in India, 1979 published by the Reserve Bank of India in April, 1981.

* The average deposit is worked out from two year-end outstandings.

Earnings from investments and other uses are not separately available. However, the amount is small and is included in loan operations.

** The fund raising expenses of corporations include advertisement charges, commission and brokerage paid to employees and agents, car or other transport allowances paid to partners and others engaged in deposit mobilisation, refreshment costs, prices of gift articles such as pen set, diary, calendar, clock, jewellery, etc. and production cost of propaganda literature, folders etc. The figure is obtained by deducting the administrative expenses (Col. 8 of Table 5) from total expenses (Col. 7 of Table 6).

& The banks also incur advertisement and other fund raising expenses but the total of these is not separately available. Nevertheless, the share of these in total establishment expenses is very small as compared to administrative expenses and the item is included in administrative expenses.

wide gap is due to the difference in the ratios of interest payments of financial costs to deposits.

c) Despite a slightly higher transaction cost and a significantly higher financial cost, the corporations' profits as per cent of deposits are more.

Bad-debts

The data given on bad debts indicate that they are a minute percentage of total loans as compared to, say, loans given by banks. As the loan is paid not mainly on the strength of documents but on the personal assessment of the lender regarding the social standing and « real worth » of the borrower, backing out of repayment obligations or seeking evasive measures to circumvent loan contracts by the borrower is very much less than in a situation in which the loan is based entirely on documents and the lender's knowledge of the borrower is through documents. This is the difference between the corporation and the banks in the matter of recovery of loans. The corporations bind the borrowers with personal and legal obligations while the banks do them so with legal obligations only. Often the borrowers take the legal obligations lightly and will even be happy to be dragged on to a court of law by the lender because in that event he can prolong the repayment, may get the facility of easy instalment payments and may even prove that he deserves special consideration in respect of interest rates etc. When such an attitude is developed among the borrowers, especially when the lender happens to acquire a reputation of not enforcing loan contracts, « larger and larger proportion of borrowers will take liberties with their repayment obligations, and those who are apprehended will do their utmost to appear as poverty

stricken as possible or to offer excuses to « prove » that their case is special and deserving of lenient consideration » ⁶.

There is another reason why the borrowers attach a low priority to the repayment of a bank loan. The cost of bank loan is cheaper compared to the cost of loans from other sources. Therefore, it is advantageous to the borrower to repay the least cost loan last. To quote Pischke, « unrealistically low interest rates such as those charged by most farm credit agencies in developing countries encourage poor repayment. Little sense of urgency to repay is attached to money provided at a discount. Nominal interest rates exceeded by the rate of inflation actually reward borrowers who delay repayment » ⁷.

For the corporations there are several ways — personal contact, persuasion through friends, mediation through mutually helpful and influential parties and pressure by guarantors — of recovering the loan amount. If only all these efforts fail, they go to the courts as a last remedy. Further, whatever loss incurred by the corporations due to non-recovery of loan amounts or as a result of litigation is absorbed by them only, leaving the depositors or the public unaffected. But any loss of revenue sustained by the banks under the Government sector (comprising about 90 per cent of the banking system in India) is a drain on the public exchequer as an increase in revenue by the banks would otherwise have swollen it.

The corporations come off badly with regard to certain other aspects of their operations. Firstly, the depositors have very little security, should the corporations make bad loans, such bad investment is not unlikely if the funds are used by the managing partners in their own business or lent for speculative ventures like cinema, building complexes or hoarding, etc. Since they believe in making large loans, even a single failure may make them extremely vulnerable. There is no way of knowing how the corporations are being managed and the depositors have nothing more than their faith in the partners to go by.

Secondly, since there is no liquidity, any run due to a lack of confidence on the part of depositors can also lead to bankruptcy because they have no readily realisable assets.

⁶ J.D. Von Pischke, « Rural Credit Project Design, Implementation and Loan Collection Performance », *Savings and Development*, No. 2, 1980-IV. The contexts may be different but the findings are relevant in our analysis.

⁷ Ibid.

Nor do they have access normally to refinancing sources as banks have in the Reserve Bank. It is true that in some centres, they can borrow from other finance corporations by replying some of their assets but it is uncertain if others can come to their aid to any worthwhile extent as they themselves would be fully extended. Since the whole operation is based on confidence any jolt to it would really affect a finance corporation severely.

Thirdly, there is no way to know how sound their loans are. It is true personal knowledge of a client would afford a great deal of protection. Nevertheless, it is difficult to accept that they will always come out on top.

6. Regulation

Any examination of the current legal framework makes us come to the astounding conclusion that these corporations function without any regulatory control whatsoever. The objective of the Money Lenders Act is to prevent the lenders from charging usurious rates of interest for small loans. Therefore, the regulation under the Act amounts to no more than having a maximum rate of interest on small loans. The application of the act is restricted to loans not exceeding Rs. 3000 in Kerala and Karnataka while in Tamil Nadu the limit is Rs. 10,000. Any loan above these limits is free from the interest limit set under the Act. Thus the finance corporations succeed in keeping out of the purview of the act by making loans which are larger than the stipulated maximum. The Indian Partnership Act imposes no regulation whatsoever on the functioning of the corporations. Even though these corporations handle banking business they do not come under the Banking Companies Act 1949 or any of the regulatory measures of the central banking authority because of the exemption granted to firms with a capital of less than Rs. one lakh under the Banking Laws (Miscellaneous Provisions) Act 1963.

The case for regulation of finance corporations arises from two considerations. They collect deposits by offering high rates of interest and lend this money for various purposes at still higher rates of interest. The interest of the depositors would require (a) that a certain degree of liquidity is maintained by them in order to take care of unforeseen demands for withdrawal of funds and (b) that funds deposited with them are managed properly. The present situation is that the credit-deposit ratio is so high that liquidity is minimum. Secondly, there is hardly any control on the way these deposits are lent by corporations; the depositors have no protection whatsoever against mis-

management of their funds. Both these factors would necessitate a certain amount of regulation of the activities of these corporations.

On the other hand, it must be remembered that these corporations mainly cater to the requirements of persons who are inadequately served by the formal banking sector. They attract funds because they offer rates of interest which are determined by the scarcity of capital. People who go to them operate in areas where the returns are very high and where expeditious availability of funds is crucial to the profitability of these operations.

Secondly, regulations such as a mere inspection of accounts and calling of returns of operations cannot offer sufficient protection to the depositor. If regulation along the lines of banking companies is enforced upon them because they are in the business of lending other people's funds, finance corporations will cease to exist. It is to be noted that during their three or four decades old history, the corporations carried on the business without any outside control and there were only few failures. This shows that the system of self regulation and control followed by them has got some strenght in it. This does not mean that it leaves nothing to be desired. Over the years, the number of corporations has increased and their size has also grown considerably. Therefore, a reexamination of the self-regulatory system with a view to making it suitable to the changed circumstances is also appropriate.

7. Suggestions and Conclusion

It cannot be denied that the finance corporations do perform a useful service to the people with whom they deal. Savers do get much higher rates of interest although they run a much higher risk. Similarly, borrowers get funds with an unmatched flexibility for which they have to pay high rates of interest. The fact that their area of operation is the informal credit market does not deter the corporations from using some of the modern tools and techniques of banks operating in the formal credit market. This modern approach together with the commercial nature of operations enables them to attract both depositors and borrowers. Further, as commercial banks are not likely to meet the requirements of all borrowers, there is at any time some unsatisfied demand for credit. To the extent that these corporations meet this demand, the extent of unsatisfied demand left by the banking system gets reduced. Therefore, instead of banning them or converting them into banking companies, it is desirable that regulation which will offer

greater protection to the depositor and which will ensure a reasonable conduct of their banking operations is thought of.

Perhaps the following measures will serve the twin purposes. Our approach is two pronged. One is for strengthening the self-regulatory measures of the corporations and the other is for introducing some outside controlling measures to make up the deficiencies in self regulation.

Self-Discipline

The entire edifice of banking is built upon the confidence of the creditor in the debtor. This is particularly so in the case of informal financial intermediaries such as the corporations. Even a slight deterioration of this confidence will shake their foundations as there is no sure source to help them in the event of a crisis. Therefore, each corporation should be vigilant on this vital point. And for creating confidence and maintaining it steadily, the corporations should practise financial prudence and discipline. A creditor should never get the impression that the corporation is short of cash. A slight delay in payment to him may give room for a rumour which in turn may invite a run. Hence the corporations for their own safety should always keep some liquid funds with them, depending on the size of their business; it may vary from centre to centre according to the occupations and nature of business or professions of the clients and the composition of deposits. The liquid amount may be kept partly in cash and partly in bank accounts.

For a second line of defence, the corporations should deploy a part, say 10 per cent, of their liabilities in easily convertible and sound investments, preferably of a short-term nature. Diversification of advances portfolio should also be resorted to.

For the purpose of removing the hurdles in the way of the corporations and for introducing some common discipline among them, we suggest the following:

i) Debt Relief and M.L. Acts

All the States in the study region have Debt Relief Acts. The Acts are meant to provide relief from indebtedness to certain categories of small debtors who need not repay the debts up to a limit (for instance, Rs. 3000 in Kerala and Rs. 4800 in Tamil Nadu) incurred except from certain categories of creditors from the commencement of the Acts. The exempted creditors include the banks but do not include the finance corpora-

tions. Similarly, banks are outside the fold of the M.L. Acts while the finance corporations are within their fold. But both the banks and the corporations transact business with other people's money. The borrowed money of a corporation is to be returned to the owner with interest in the same way as the borrowed money of a bank. To say that the bank is exempted from the purview of these Acts and the corporation is covered by them is not only illogical but also discriminatory. Further, the application of the Acts to the corporations results in hardships to the small borrowers. We suggest that the finance corporations may also be exempted from the provisions of these Acts.

ii) *Licensing*

A system of licensing is essential as, otherwise, the number of corporations may grow up like mushrooms many of which may not have the expertise and resources to run the business. And when such an adventurist corporation fails, it brings discredit to the whole system. Even otherwise, the monetary authorities should know the number of financial institutions and the quantum of money flowed through them. The licensing system ensures that only the eligible category of people will enter this responsible and risky business involving the public. And the best authority to issue a licence is the Reserve Bank of India because finance corporations are really « mini banks » in the informal sector.

iii) *Organisation*

The present organisational pattern, namely, partner-ship firms and proprietary concerns has got some definite advantages over the company form of organisation, the most important among them being the personal interest and involvement of the partners and proprietors. Further, the company form of organisation does not necessarily provide a safeguard for the depositors' money. If the recent failures of chit fund companies are any indication⁸. When the promoters are liable only for the meagre capital they invest, they may go in for more risky operations. The non-company form of organisation ties the promoters to the creditors with social and moral obligations as well. These obligations are more important because the corporations generally limit their operations within their « command area », or « area of influence » where the

⁸ All the major chit fund failures during the last few years in India came after the introduction of company form of organisation in chit funds.

clients and the promoters know each other and, therefore, the backing out of obligations, even if it is legally possible, becomes difficult. However, incorporated bodies need not be altogether excluded from the field. The companies may also be formed under the Companies Act, 1956 to conduct the business.

iv) *Capital*

We have to differentiate the corporations into those owned by proprietary concerns, partnership firms and companies. Our study has revealed that there are many proprietary concerns which are engaged in financial intermediation in a big way. These proprietary concerns do not allocate any particular amount of capital for the business. Their owned fund consists of their entire assets and their liabilities include debt on all accounts. Usually, unlike the partnership firms and other forms of organisations, their liabilities are not much higher than their assets. Thus the prescription of a specified capital for the business has not much relevance in their case.

The situation is different in the case of partnership firms where the responsibility of meeting the obligations is shared by different people. The intention behind the exemption of partnership firms with capital less than Rs. one lakh from the purview of the Banking Laws Act 1963 was to allow the firms which were dealing on a small scale and accepting deposits of small amounts to continue the business. The Act did not specify the deposit amount that could be accepted by the firms. Thus, capital-wise, the firms remained small but deposit-wise they grew large. It is not that the partners are not interested in raising the capital, but the Act comes in the way. The suggestion made below in this regard is not confined to capital alone but extends to liabilities also.

It is suggested that the definition of « firm » in the Banking Laws (Miscellaneous Provisions) Act, 1963 may be changed to « firm means a firm as defined in the Indian Partnership Act, 1932 (9 of 1932) of which the capital subscribed by its partners exceeds five lakhs of rupees, or the liabilities incurred by its partners exceed one crore of rupees ». If there is only the fixation of capital and no fixation on the quantum of liabilities, the concept of size will remain vague, as capital is no bar in incurring any quantum of liabilities.

Capital Ratio

Another point to note on the provision for capital is that its relation to total liabilities should not be in the same proportion for any amount of liabilities. In other words, when

liabilities rise the percentage of capital to liabilities should also rise. This is because of the peculiarity in the distribution of assets of the corporations. The assets of most of the corporations consist only of loans. Again, in total loans, the secured part forms only a small percentage. As assets expand in tune with the rise in liabilities the proportion of secured loans in total loans gets reduced because there is a limit of such loans in any area and thus the share of unsecured loans in total loans goes up. Such a position is risky, for it is the default of unsecured loan that becomes detrimental to the corporation. Therefore, to arrest the temptation of lending too much on unsecured loans a check should be applied on the acceptance of liabilities.

Other Ratios

Any suggestion for a liquidity/liability or credit/liability ratio will upset the calculations and way of working of the corporations. These ratios cannot be the same for all corporations and for all time for the simple reason that their composition of deposits (with a very high percentage of term deposits), lending operations, nature of clientele, period of loan and mode of recovery vary to a great extent. Hence it is better to leave them for the corporations themselves who may use their own method according to their particular circumstances. Thus, apart from the capital/liability ratio, we do not suggest any restriction in their activities.

Deposit Rate

There does not seem to be any good reason for fixing the deposit rate of the corporations. If deposit rate is fixed without fixing the lending rate, the sole beneficiary will be the intermediary. When the deposit rate is fixed without a guarantee for the safety of deposits, no saver will bother to place his savings with such an agency. If the lending rate also is fixed, the distinction between the formal sector and the informal sector will disappear. The main argument in favour of the corporations is that they operate in a market outside the banking system to the convenience of certain borrowers and savers. The fixation of interest rates will destroy the *raison d'être* of such corporations.

These informal financial intermediaries prosper largely due to their realistic attitudes towards many of the problems facing the borrowers and savers. They serve both in urban and rural areas and their operations are flexible to adjust to the requirements and conditions of different clientele. By mostly confining the activities of borrowing and lending in a particular area, they mobilise local savings for local use. In sum, in any

country, where there is free play of market forces, these financial intermediaries have a place because they know how to tap the savings under competitive conditions, where to use the same to fetch the maximum return and how to minimise the transaction cost.

LES SOCIÉTÉS DE FINANCEMENT: UN INTERMÉDIAIRE FINANCIER INFORMEL EN INDE

RESUME

Les sociétés de financement sont des intermédiaires financiers informels devenus populaires en Inde depuis le début des années 1960. On les connaît aussi avec d'autres noms: banquiers, financiers, entreprises financières, sociétés d'investissement, etc., et le nom change d'après la région. Le terme « société de financement » indique une institution créée dans le but de tirer des profits de l'activité de prêter les fonds collectés à travers les dépôts ou l'emprunt. En ce qui concerne son organisation, ce type de société peut être la propriété d'un patron, ou d'une association de partenaires ou bien, plus rarement, une société à responsabilité limitée ou publique.

Au début, les fonds à prêter sont versés par le patron ou les partenaires qui simultanément sollicitent leurs parents, leurs amis et le public à placer des dépôts auprès de la société. Aux déposants ces sociétés paient des taux d'intérêt deux fois ou plus élevés que les banques commerciales et les autres institutions financières du secteur organisé, et d'autres services encore. Ces sociétés acceptent toute forme de dépôt — comptes courants, comptes d'épargne, à court et à long terme — et paient des intérêts périodiques sur les dépôts à terme. Le taux moyen des banques commerciales est de 7% environs, tandis que le taux moyen pour toutes les catégories et les périodes de dépôt avec les sociétés de financement atteint 17,5% par an. Cependant, elles ne donnent pas de livrets de chèques aux déposants, puisque la Reserve Bank of India leur empêche de le faire. Les prélèvements des comptes courants et d'épargne se font par des fiches de prélèvement.

Les montants que les sociétés collectent à travers les dépôts, l'emprunt, et d'après les conditions de la demande, même le fonds de dotation initial sont prêtés aux emprun-

teurs pour des raisons différentes et avec des différentes garanties. Il n'y a aucune limite à l'utilisation du prêt, mais de toute façon les sociétés préfèrent les emprunteurs qui doivent investir les fonds empruntés dans une activité économique. Elles autorisent des prêts garantis aussi bien que des prêts non-garantis. Les garanties peuvent être or et bijoux, argenterie, assurances sur la vie, voitures et véhicules à moteur, produits agricoles tels que les épices, le caoutchouc brut, les huiles alimentaires, des biens immeubles tels que les terrains et les bâtiments. Les prêts non garantis sont en général octroyés sur la base de billets à ordre à vue signés individuellement par l'emprunteur et parfois aussi par deux garants individuellement et solidairement. L'échéance des prêts non garantis varie généralement d'un ou deux jours à 90 jours. Pour les prêts garantis, surtout par des bijoux, il n'y a pas d'échéance fixe. Bien que les sociétés acceptent des dépôts de n'importe qui, les prêts non garantis sont octroyés seulement à des individus connus par le patron ou les partenaires. Le taux sur les prêts varie de 21% à 36% d'intérêt simple par an, avec une moyenne autour de 24% comparé au taux de 18% des banques commerciales. En définitive c'est la concurrence qui détermine le niveau des taux sur les dépôts aussi bien que sur les prêts.

La plupart des sociétés de financement prête tout ce qu'elles reçoivent à travers les dépôts, et même plus. Quand la demande de fonds augmente soudainement, elles empruntent des fonds d'autres sociétés, engagent ce qu'elles tiennent en gage, empruntent de l'argent des « call money syndicates » informels et finalement demandent le remboursement des prêts octroyés sur billets à l'ordre à vue. Puisque la plupart des prêts sont octroyés sur la base des rapports et des évaluations personnelles, le non remboursement du prêt est un événement très rare et donc les sociétés doivent faire face à très peu de défaillance. En général on ne saurait nier que les sociétés de financement fassent un bon service au public. Elles travaillent dans les villes aussi bien qu'à la campagne. Dans n'importe quel pays où on jouit du libre jeu des forces du marché, ces intermédiaires financiers ont leur place puisqu'ils savent mobiliser l'épargne en conditions concurrentielles, il savent comment l'utiliser avec le maximum de profit et minimiser le coût des transactions.

