IMPLICATIONS OF INFORMAL CREDIT FOR POLICY DEVELOPMENT IN INDIA FOR BUILDING INCLUSIVE FINANCIAL SECTORS

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This paper examines the characteristics of the informal credit market in India by giving a historical overview of that market. It also provides a microlevel analysis of the role of informal credit, with the help of a case study of a migrant professional moneylender in an Indian village.

India has a long history of professional moneylending. This paper is part of an ethnographic study which fills a research gap in the study of the informal credit market in India. This paper addresses two main issues. The first is the place of a Kabuliwallah, (professional moneylender in the village financial system) and the complementarities with other intermediaries in a village, as well as other dimensions of that business in a district. The second is the implications of the research for formal financial institutions in India.

Data from the account books of a Kabuliwallah show that he was complementing the financial services provided by the formal credit institutions operating in the same geographical area. It is a unique business approach, with flexible contractual terms and conditions.

The study concludes that, although the informal sector is acknowledged in policy, it is not clear as to how the formal sector should operate in the presence of the informal sector, where the activities of a professional moneylender is a good example. Keeping in view the findings presented, the paper concludes that the adoption of a decentralized process for the formulation of a financial intermediation strategy is required for building an inclusive formal financial sector.

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I. INTRODUCTION

The characteristics of rural financial markets differ from region to region in India owing to regional variations in the rate of economic development in the country. Therefore, there is a growing need to understand the informal financial markets of various regions within the country separately. The informal financial market is part of a country's informal economy; we know from previous research that the informal economy forms a significant part of the larger economy of a country (Kundu and Sharma, 2001).

The country also has a vast informal financial sector operating in the rural areas but very little is known about this sector, other than the wide variations that occur in business transactions across the country (Mahajan and Ramola, 1996). With loan sizes varying from \$150 to \$300 and with interest rates ranging from 3 to 10 per cent per month, with easy accessibility, low transaction costs to the borrower, flexible terms and provisions for multiple loan facilities, the functioning of the informal sector has strong implications for microcredit policies, particularly in rural areas of India.

Rural credit policies in India have been influenced by policies set out during the pre-independence period, as in most colonial countries. Colonial credit policies were directed mainly towards agricultural credit as the economy of the country was rural based. Those policies were a measure to expand institutional credit to rural areas. Accordingly, policies were directed towards imposing restrictions on traditional financial institutions so that formal financial institutions under the colonial rule could supply credit.

Today, the major sources of institutional finance in India are banks. In recent years, microcredit or microfinance (with the potential for providing savings, insurance and leasing financial services) as a group-lending programme – a relatively new feature in the Indian financial rural financial system – has been promoted though banks and non-governmental organizations (NGOs) by the National Bank for Agriculture and Rural Development (NABARD). What had been initiated as a pilot initiative in the 1990s has now grown into a large, national-level microfinance programme. The main reason for developing this programme was to improve upon the weakened delivery system, poor recovery, high operating costs, non-viability and high dependence on subsidies of banks and cooperatives. Moreover, the banks were facing high transactions cost when financing small borrowers, who required credit in small quantity (Nanda, 1995).

II. INFORMAL CREDIT IN PRE-COLONIAL INDIA

The rural and urban areas of India have a long history of moneylending and informal credit. Moneylending is referred to as an “art” in the Vedic era during the period 2000-1400 BC. In the *Rig Vedas,* there is reference to debt or *rina* and in the *Satapatha Brahmana*, a usurer is referred to as *kusidan*. In the Buddhist *Jatakas*, moneylenders are referred to as *seth* (Jain, 1929). It is evident from the ancient writings of Manu that transactions in the form of moneylending and banking existed in the second and the third centuries AD (Jain, 1929). Evidence from manuscripts, historical records and government archives gives the impression that usury was present as one of the various forms of economic activity in the past. One’s caste also played an important role in credit relations during the pre-colonial period. Furthermore, there were landlords in the villages and professional moneylenders, whose exclusive business was moneylending. These lenders relied on their own capital for their moneylending business.

There is also extensive evidence of usury in India during the sixteenth and seventeenth centuries AD. During the Mughal era, land revenue, was the main reason why peasants were in debt, as it accounted for about three fourths of their produce (Habib, 1964). As a result, usury flourished during this period; the usurer was referred to as *khameja*. Credit transactions in medieval India were based on personal relations, without a legal system; most of the credit was available for working-capital requirements and not for starting a new venture (Rothermund, 1993).

III. INFORMAL CREDIT IN COLONIAL INDIA (1850-1947)

During the nineteenth century moneylending in India was directed towards obtaining social power and commercial control (Subramanian, 1987; Schrader, 1993). Under the administration the former United Kingdom of Great Britain and Ireland, indigenously developed bankers provided credit to agriculturists and artisans, and they financed internal trade for the country, while European companies were confined to financing external trade (Jain, 1929). For large transactions, *hundis* (or promissory notes) were issued, which could be cashed within a specific time period. On the other hand, trader moneylenders supplied peasants with seeds and food grains on credit; occasionally, they gave cash credit for dowry and for other life cycle rituals.

The Deccan Riots of 1875 were one of the important events in the modern history of India. After the riots, the Deccan Riot Commission claimed that rural indebtedness was the main cause of the riots. The Commission reported that the riots were directed towards moneylenders who charged high interest rates to offset the risk of non-repayment as a result of irregular monsoons. These moneylenders were mostly migrants such as people belonging to groups known as Multani Shroffs, Marwaries and Chettiars; they combined trading with money-lending in different parts of the country. With the transition of the rural economy from subsistence to cash crop production in the early part of the eighteenth century, the role of the trader moneylender became even more important in the rural agrarian economy of India (Schrader, 1993).

IV. POLICES FOR FINANCIAL SECTOR REFORMS

During colonial rule, various policy changes took place to develop the credit delivery system. As a result, the Indian financial system was well developed by the year 1950. However, this system was functioning only in urban areas. Most of the facilities from the formal financial system were utilized by the urban commercial and industrial sectors.

According to the All India Rural Credit Survey Committee (1954), cooperatives and rural banks were politically influenced, lacked professional management, and suffered from viability problems associated with mounting overdue loans, as well as a lack of coordination with regard to short-term credit. The Khusrao Committee in 1986 observed similar problems and related these to the structure of production, selection of wrong borrowers, staff agitation and *bainami* loans. The various committees constituted by the Government recommended the following policies over the years:[1]

- Have regional rural banks adopt the practices of commercial banks;
- Confine the activities of the regional rural banks to the rural areas only;
- Make provision for setting up private sector banks;
- Redefine the scope of the "service area approach", by reordering the branch network with the inclusion of commercial banks within the service area;
- Concentrate the financial sector reforms on the removal of practices such as loan waivers, speedy recovery, careful targeting of loans, phasing out of subsidies and removing the ceiling on interest rates on loans and deposits.

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1 Summarized from the papers of Narayana (1993) and Misra and Puri (1994).

V. CONTEMPORARY TRENDS IN THE INFORMAL CREDIT SECTOR

Official surveys shown contemporary trends in the informal sector credit service. Official figures have shown a sharp decline in the share of rural debt owed to moneylenders, landlords, cultivators and traders, which accounted for 80 per cent of all debt in 1951. National surveys have reported the debt outstanding from informal credit sources in urban areas to be 30 per cent of the total. Such surveys have also reported a decline in the debt of rural households in the informal sector by 12 per cent within 10 years, i.e., from 83 per cent of the total in 1961 to 71 per cent in 1971, declining further to 39 per cent in 1981 (Germidis et al., 1991). The All India Debt and Investment Survey of 1980-1981 showed the expansion of institutional credit and reduction in the share of landlords, traders, friends and relatives and a consequent reduction in the share of moneylending to about 16 per cent in the rural credit markets (Gadgil, 1986; Binswanger and Khandker, 1995). However, a particular microlevel study conducted by Jones (1994) in the state of Rajasthan showed that, instead of a decline in the use of informal credit, there was in fact an increase in the use of informal credit in one village in terms of the number of loans as opposed to the trend projected by the above-mentioned official macrolevel surveys with respect to the volume of debt.

VI. A CASE STUDY OF A VILLAGE MIGRANT MONEYLENDER: IMPLICATIONS FOR POLICY

The microlevel analysis shows the role and market niche occupied by a migrant professional moneylender, known as a *kabuliwallah*, in a rural financial market of a village in Assam, where he operates in a multi-ethnic situation among local moneylenders, banks and co-operatives. These *kabuliwallahs* belong to the Pushtun ethnic group of migrants from Afghanistan who live in India. There are members in this group from two or three clans living in north-eastern India, who are in the business of moneylending.

The case study was developed by analysing the supply side of the debt market in terms of the volume of debt over a year and the distribution of the debt within various segments of the rural financial market. A large portion of the data has been taken from studies conducted during 1994 and 1995. The primary data have been analysed from the personal account books of a moneylender who documented each transaction with his clients. These data were seldom accessible to anyone. The data for this case were drawn from one village, Hirapur, in the state of Assam.

Village Economy

Hirapur is a village with many agribusiness activities. Paddy (rice) is the main. Apart from paddy, the farmers cultivate jute, oil seeds, pulses and vegetables. Most of the produce is exported to different parts of the state and to other states in the country. Owing to the presence of abundant fresh water, jute is extensively cultivated as a cash crop. The village also produces a large quantity of jute products, and local traders also sell cotton.

The majority of the farmers have sharecropping contracts with landlords within and outside the village. Under the *Sukani* system, the land is subdivided and the rent is paid in cash; under the *adhi* system, rent is paid in kind. In general, the *adhi* system is followed; it is also called the *adhi sukti* contract, in which the tenant contracts to deliver a fixed quantity of grain irrespective of the character of the harvest. However, the more common procedure is for the tenant and the landlord to divide the crop according to a particular ratio, which is fixed by the landlord.

The rural areas of Assam have a history of rural indebtedness. Apart from the standing crops, the inhabitants in the rural areas of this state have very little to offer as security or collateral for loans. The rates of interest that moneylenders charged during the colonial period ranged from as high as 37.5 per cent to 75 per cent of the total crop. During that period, foreigners such as traders and Marwari mahajans were the main moneylenders. Officers of the former British administration reported that more than half the village population was in debt.[2] They also reported that whatever may be the composition of inhabitants in a village, a Marwari mahajan or a *kabuliwallah* was always present as a source of informal credit in most of the districts of Assam. Likewise, friends and relatives were also reported as sources of consumption credit, and wealthier businesspersons formed a source of trade credit in Assam.

Hirapur is similar to other villages in the river valley plains of Assam, with a conglomeration of settlements having a multi-ethnic population. The village centre falls within one developmental block. The state agricultural department has divided the entire village into two village-level extension worker service areas or *elekas*, calling them Hirapur-I and Hirapur-II. The two areas, however, comprise one *panchayat*.[3] Hirapur has 724 Assamese households, with a land holding of

[2] From Barooah, D.P. (1978). *Assam District Gazetteers* (Guwahati, Government of Assam Press).

[3] A *gaon panchayat* is a village community organization, which is also recognized by the Government as a village governance unit that administers areas within a specific geographical area.

1,971.9 hectares, 720 Maymensingia Muslim households with an operational land holding of 646 hectares, 512 Kachari households with 496 hectares and 203 Bengali households with 68.26 hectares of land, as recorded in 1994/95.

Village Financial System

The village financial system is composed of the formal and the informal financial sectors. The following sections of this paper first examine the informal credit system in the village and then the role of the *kabuliwallah*. The sections discuss the various types of financial services given by him and the nature of his business with respect to the livelihoods in that village. Further, the role of the formal financial system is shown and compared with the role of the *kabuliwallah*.

Informal Financial System

The informal financial system caters to both informal credit as well as informal savings. There are trader moneylenders, casual moneylenders with a regular profession and professional moneylenders such as the *kabuliwallahs*. The moneylenders belong to both the indigenous and migrant communities. The composition of moneylenders in the village of Hirapur resembles the typical informal credit market in India.

Table 1. Village moneylenders: primary occupation, ethnic group, size of business and average loan size

Primary occupation	*Sex*	*Ethnic group*	*Business size (in Indian rupees) (total loans outstanding)*	*Average loan size of total loans outstanding*	*Average number of loans (per month)*
			(thousands of rupees)	*(Rupees)*	
Farmer/ businessman	Male	Maymensingia	2 500	10 000	6
Grocery owner	Male	Bangali	800	3 000	8
Farmer/ businessmen	Male	Maymensingia	900	3 000	5-7
Teacher	Female	Maymensingia	65	400-1 200	10
Teacher	Male	Kachari	50	1 000-2 000	4 -5
Grocery owner	Male	Maymensingia	500	4 000	8

As can be seen from table 1, village moneylenders in Hirapur belong to almost all the ethnic groups present in the village. Credit relations among local ethnic groups are confined within their communities. For example, the "lady teacher" is the only female moneylender in the village and her clients are mainly *kamlas* (daily wage labourers) and women belonging to the Maymensingia community, to which she also belongs. Similarly, there are three teachers from the Kachari tribal community, they provide credit exclusively to members from their community. The Kacharis prefer to borrow from these teachers because they rely on moneylenders from their own community (table 1 shows data only with respect to one of these teachers). As may be seen the average size of the loans provided by the Kachari moneylender was relatively smaller than that of the other village moneylenders. There is however a possibility that the other teachers practising moneylending within the Kachari community could be supplying larger loans. Table 1 also shows that there are moneylenders in the village, such as grocers, farmers and traders, who were providing loans ranging in value from $8 to $84 (Rs. 400 to Rs. 4,000) (US$ 1 = about 46.3 rupees).

Presence of Group Savings and Credit Associations

Two group savings and credit associations are located in Hirapur. The teachers of the village established *Sakhyah Hasutya Pujaya* in 1980; their main objective was to improve the financial security of the member teachers. Initially, the *pujaya* had 20 members and each member contributed Rs. 100 per month to the kitty. The association was dissolved and the fund was liquidated after five years to avoid payment of taxes when the fund exceeded Rs. 200,000. In 1990, it was once again started with contributions of Rs. 200 per month. The members were allowed to borrow as much as 80 per cent of their deposit. Loans were disbursed only after six months had elapsed, when a certain amount of savings were mobilized. The size of the loans provided reached as high as Rs. 3,150.

The second association in the village, called the Hirapur Higher Secondary *Nidhi,* operated with the aim of giving members access to credit for medical expenses, home consumption, and wedding and life cycle ceremonies. A maximum of Rs. 20,000 could be taken out as a loan for the above purposes. Membership was however confined to schoolteachers only, although a number of these teachers were also part-time traders with small businesses.

***Kabuliwallah* Credit**

A migrant moneylender, Mr. A. Khan provides a good case study. His credit provision shows the complementarities with the formal sector and the niche occupied in the rural financial market. The following sections throw light on the rural business of Mr. Khan. They unveil the role he plays (the business of moneylending is often shrouded in secrecy) in the financial system of Hirapur village in terms of the type of credit supplied, the size of loans, the timing of the loans, the screening of borrowers and the type of ethnic groups he serves by analysing the data from his personal account books.

The account books of the *kabuliwallah*, Mr. Khan, revealed that he was supplying credit to people from various ethnic groups and for various purposes in Hirapur, as well as to a number of people in the district town. Three types of loans were supplied by him: one-day loans, for which money was borrowed for a day and returned the same day or the day after, and interest was charged at the rate of 3 to 5 per cent on a daily basis; the second type of loan included that taken for a specific length of time, and the interest rates on such loans were between 5 and 10 per cent per month; and the third type included large loans disbursed for a period of six months, and the interest charged was at the rate of 3 to 10 per cent per month depending on the type of borrower. The structure of financing was examined, taking into account the volume of debt and size with respect to various loan purposes. The moneylenders provided credit services with innovative and novel credit contracts.

One-day Loan System with Daily Interest Charge

Innovative credit contracts are an important feature of the moneylender's business in the village. An example is the provision of "One-day loans" for clients with different livelihoods. In addition to the regular village market in Hirapur, a weekly village market *haat* is held on Wednesdays depending on the decision of the village committee in charge of the *haat*. Since the quantum of goods sold is generally higher than normal on these days, certain businesses need to increase their stock of goods the day before the *haat*, and therefore require working capital. A number of businessmen borrow from the *kabuliwallah*, Mr. Khan, for this purpose. These businessmen are those who had to meet their working capital needs for their farm-processing units (mainly aricanut-processing factories) and those in regular trading businesses. The schoolteachers who are members of the Hirapur Higher Secondary *Nidhi* borrow from the *kabuliwallah* when they need working-capital credit for their part-time business.

As can be seen from table 2, Mr. Khan supplied 23 one-day loans in the course of a month in Hirapur so that borrowers could invest in their business during the *haat*. All these loans were taken the night before the *haat* and then returned in the evening of the *haat* or the day after. Moreover, apart from one teacher and a government official, the rest of the borrowers were full-time businessmen.

Table 2. Permanent borrowers of Mr. A. Khan's one-day loan for the Wednesday market

Borrowers' occupation	*Number of Loans*	*Amount (Indian rupees)*	*Amount (United States dollars)*	*Daily Interest rate (%)*	*Remarks*
Regular business	7	33 000	695	5	Frequently
Butcher	4	80 000	1 684	8	Regularly
Farmer businessmen	7	39 000	821	2	Frequently
Fruit vendor	3	3 000 10 000 5 000	63 211 105	2	Not frequently
Teacher	1	2 000	42	5	Regularly
Food Corporation of India officer	1	30 000	632	5	Regularly
Total	23	202 000	4 253		

The highest individual loan, Rs. 30,000, was given to an employee of the Food Corporation of India office in Hirapur at the rate of 5 per cent per day. That person needed working capital to invest in the sugar wholesale business. In terms of the category or type of borrowers, the highest amount for a loan, Rs. 80,000, was given to four butchers for the purchase of goats from the wholesale goat market. They were charged a higher interest rate of 8 per cent a day, while the moneylender also supplied such credit to seven small businessmen, seven farmers-cum-businessmen and three fruit vendors at an interest rate of 2 per cent per day.

It is revealing that, after advancing about Rs. 202,000 in loans, Mr. Khan made a profit of about Rs. 10,790 (or $227) a day as earnings from interest from one-day loans in view of the fact that all loans were repaid after a day. These loans were exclusively for working-capital requirements for a specific group of clients, and the loan sizes varied from Rs. 2,000 to Rs. 30,000. Furthermore, Mr. Khan explained that these borrowers were his permanent customers who had been doing the same business for many years and were borrowing more or less the same amount of money every month. However, collateral is not required for such loans.

Monthly Interest Rate Loans Without a Fixed Repayment Period

Mr. Khan also supplied credit to borrowers, charging monthly interest rates; such loans were normally against collateral either with *pernotes* or pawned jewels. He supplied the loans for various purposes. They were not extremely small loans which is contrary to the general perception that only very small loans are provided by rural moneylenders.

Such loans were provided to clients from various occupations and also to members belonging to specific ethnic groups. The timing of the loans varied according to the purpose of the loans. The interest charged by the *kabuliwallahs* on these loans also varied according to the type of client and the size of the loans, which in general banking terminology are called differential interest rate loans. This was also a general characteristic of the *kabuliwallah* credit service, cutting across rural and urban areas of north-eastern India.

In examining the volume and number of loans, one can see that Mr. Khan adds variety to his credit portfolio. Table 3 shows that credit was given for a wide range of loan purposes over the course of a year. The credit purposes have been classified into five broad categories: credit for household purposes, bribes, purchase of land, working capital and travel.

The highest number of loans (52.4 per cent) was provided to meet the working-capital requirements of rural businessmen, which comprised about 80 per cent of the total loan volume in 1995. On the other hand, 23.0 per cent of the loans were provided for household consumption purposes and formed only 6.3 per cent of the total loan volume. The other 9.5 per cent of loans were made for the purpose of paying bribes, which accounted for 8.6 per cent of the total loan volume; 7.1 per cent of the loans were for the purpose of purchasing land, which accounted for 2.9 per cent of the total loan volume. The same number of loans were also made for the purpose of medical treatment and travel. Therefore, clearly the focus was more on the provision of working-capital loans for small businesses in the village.

It was also seen that pawn loans occupied half of Mr. Khan's loan portfolio in terms of loan volume. Out of the total number of loans, eight pawn loans ranging in value from Rs. 24,000 to Rs. 100,000 were made to businessmen, with the total value being Rs. 269,000. This type of loan accounted for 50.2 per cent of the total loan volume.

Table 3. Classification of loan purpose, by number and volume

Loan purpose	Number of loans		Amount		
	(No.)	(%)	(Indian rupees)	(United States dollars)	(%)
Household purpose					
Marriage	1		3 000	60	
House repair	1		8 000	160	
Purchase of television	1		2 800	56	
Purchase of bullock	1		2 000	40	
Pay rent	1		4 000	80	
Purchase motorcycle	1		2 800	56	
Medical treatment	3		8 900	178	
School admission	1		2 000	40	
Subtotal	10	23.8	33 500	670	6.3
For bribe	4	9.5	46 000	920	8.6
Buy land	3	7.1	15 500	310	2.9
Working capital for business					
- Labour payment	1		35 000	56	
- Repair machine	1		2 800	700	
- Aricanut-processing	1		2 000	40	
Factory extension	1		16 000	320	
Working capital in aricanut processing	9		179 000	3 580	
Labour payment	1		100 000	2 000	
Jute processing	1		18 000	360	
Purchase stock	1		12 000	240	
Repair truck	1		28 000	560	
Cloth shop	3		23 000	460	
Fruit vendor	1		1 000	20	
Pharmacist (urgent need)	1		7 000	140	
Subtotal	22	52.4	423 800	8 796	79.3
Travel	3	7.2	16 000	320	2.9
Total	42		534 800	10 696	100

Selection and Screening of Borrowers

The selection and screening of borrowers by Mr. Khan is another important feature of his business. First, he abides by the norms of the society by not having any transaction with women, which is a cultural specificity aspect of his business. However, there was a stray case where one loan of Rs. 2,000 was made to a woman for the purpose of paying for her sons' admission to a private school. Second, he provided credit to borrowers belonging to specific occupational groups. Although loans were made to various types of borrower, by and large, a greater proportion of credit was supplied to a certain group of borrowers belonging to a specific occupational group. Like most informal lenders, the *kabuliwallahs* are also more concerned with the adverse selection process than moral hazard (Aryeetey, 1996).

Table 4. Classification of occupation of borrowers, by loan volume and number

Major occupation	*Number of loans*		*Volume of loans*			
	Year-1	*Year-2*	*Year-1*		*Year-2*	
	No.	*No.*	*Amount in Indian rupees*	*(%)*	*Amount in Indian rupees*	*(%)*
Businessmen	27	26	170 000	84.2	357 800	66.9
Government Job	7	14	31 800	15.8	157 000	29.4
Others (landlord)	–	2	–	–	20 000	3.7
Total	34	42	201 800	100	534 800	100

Third, he gave first preference to those people having a regular business and second preference to those holding government jobs. He generally prefers clients with a regular source of income. As can be seen in table 4, 79 per cent of the loans in year-1 and 62 per cent of the loans in year-2 were extended to businessmen in the village, whereas the rest of the loans in both those years were made to borrowers in government jobs. About 60 to 80 per cent of the total loan volume was disbursed to the business community in the village. In year-2 however, loans (4.7 per cent by volume) were also given to landlords in the village.

Furthermore, within the occupational groups, it appears that Mr. Khan prefers to lend money to a certain type of borrower in order to diversify his portfolio. Table 5 shows that 28.6 per cent of the total number of loans were made to schoolteachers, who comprised 9.6 per cent of the total loan volume. The teachers were the largest single type of borrower in the village. After teachers, a group of

Table 5. Classification of borrower types, by loan number and volume

Types of borrower	*Number of loans*		*Amount of loans*		
	(No.)	*(%)*	*(Indian rupees)*	*(United States dollars)*	*(%)*
Petrol station employee	1	2.4	12 000	253	2.2
Aricanut businessmen	10	23.8	197 000	4 147	36.8
Doctor	1	2.4	100 000	2 105	18.7
Teachers	12	28.6	51 200	1 078	9.6
Nurse	1	2.4	2 800	59	0.05
Landlord	1	2.4	18 000	379	3.4
Shopkeepers/grocers	8	19.0	44 800	943	8.4
Petrol station owner	1	2.4	35 000	736	6.5
Barbers	2	4.7	4 000	84	0.07
Watchmen	2	4.7	10 000	210	2.0
Rice mill owners	1	2.4	2 000	42	0.03
Truck owner	1	2.4	28 000	589	5.2
Farmer businessmen	1	2.4	30 000	631	5.6
Total	42	100	534 800	11 259	100

businessmen involved in processing aricanut were provided with 25 per cent of the total loans which formed 36.8 per cent of the total loan volume that year; it was the highest in terms of the volume of credit disbursed to any single group. This was followed by 19 per cent of the total loans extended to shopkeepers in the village, which corresponds to 8.4 per cent of the total loan volume. Table 5 shows that, apart from teachers, the aricanut businessmen and the shopkeepers in the village were important clients of the *Kabuliwallah*. Furthermore, along with these major groups of borrowers he also disbursed credit to 10 other types of borrower.

Credit Delivery and Ethnic Specificity

Mr. Khan's loan portfolio has been classified in terms of ethnic groups, which reveals that he serves the majority of ethnic communities in the village.

As can be seen from table 6, in the two succeeding years the trend in the supply of credit to various ethnic groups shows that most of the loans to the Maymensingia Muslim and Bengali communities. In the case of the Maymensingia Muslim community, it accounted for 47 per cent and 69 per cent of the total number of loans respectively for year-1 and year-2. The second highest number of loans went to the Bengali community, which accounted for 44.1 per cent and 19 per cent of the total number of loans in year-1 and year-2 respectively.

Table 6. Loans with monthly rate of interest, according to ethnic composition

Ethnic group	Number of loans				Loan volume			
	Year-1		Year-2		Year-1		Year-2	
	(No.)	(%)	(No.)	(%)	(Indian rupees)	(%)	(Indian rupees)	(%)
Maymensingia	16	47.1	29	69.0	70 000	34.7	324 800	60.7
Bihari	–	–	1	2.4	–	–	2 000	0.4
Malayali	2	5.9	3	7.1	19 000	9.4	40 000	7.5
Bengali	15	44.1	8	19.0	112 500	55.7	156 000	29.2
Marwari	–		1	2.4	–	–	12 000	2.2
Assamese	1	2.9	–	–	300	0.01	–	–
Total	34	100	42	100	201 800	100	534 800	100

However, in terms of loan volume the supply was slightly different. In year-1, 55.7 per cent of the total volume of credit was supplied to the Bengali community, whereas in year-2, 60.7 per cent of the total volume of credit was supplied to the Maymensingia Muslim community. It is however important to note that, although the Assamese community was a major group in the village, only 3 per cent of the total number of loans were made to one member of that community in year-1, that is, a share of 0.1 per cent of the total volume of credit. Likewise, one loan was made to a Marwari client in year-2, but in this case the loan formed 2.2 per cent of the total loan volume for that year.

The Assamese community refrained from borrowing money form professional moneylenders in Hirapur because they can easily borrow money from wealthy friends and family members without interest. Most of the small businessmen that borrow from the moneylenders belong to the Bengali community. The aricanut merchants who borrow money from the *kabuliwallah* belong to the Maymensingia Muslim community. Data on his business examined for five years also show that the majority of the borrowers in Hirapur were from these two communities.

Business Relations with Formal Financial Institutions

The books of Mr. Khan, as a professional moneylender, also revealed his business relations with formal financial institutions. Table 7 shows that he supplied three loans to members of the commercial bank worth a total of Rs. 50,000. Four loans were made during the *puja* (worship) season to four employees of the cooperative bank, with the loans ranging from Rs. 20,000 to Rs. 80,000. He also

Table 7. Mr. A. Khan's credit transactions with employees of financial institutions

Number of transactions	*Clients*	*Place of transaction*	*Amount (Indian rupees)*	*Amount (United States dollars)*	*Month*
3	Commercial bank employees	Hirapur	50 000	1 053	August
4	Cooperative bank employees	Nahat	80 000	1 684	August
			65 000	1 368	September
			35 000	737	September
			40 000	842	September
			20 000	421	September
1	Manager, State Bank of India		550 000	11 579	October
8			840 000	176 842	

deposited Rs. 550,000 in the State Bank of India in a particular year because the bank needed cash and the *kabuliwallah* was asked to deposit the amount for only one month. The Bank provided interest of 2 per cent for this service.

Credit Policy of the Kabuliwallah

Therefore, the business strategy, in terms of lending within a pre-determined budget, investment planning, responsive to clients' needs, provision of weekly and one-day working-capital loans, as well as the provision of credit to employees of formal institutions, has helped the *kabuliwallahs* to establish a profitable business in Hirapur.

Furthermore, the credit business of Mr. Khan and that of the commercial bank in the village complemented one another in the rural credit market of Hirapur. In this particular case, the *kabuliwallah* did not disburse any loans smaller than Rs. 2,000 to any of his clients as a policy specific to the credit market in which he was operating. He also had other lending policies, such as in the case of teachers for whom he had a ceiling or quota that varied from Rs. 10,000 to Rs. 20,000. For small traders, the amount did not exceed Rs. 50,000. Similarly, for very big clients, the maximum limit was Rs. 100,000. Apart from clients in Hirapur, he also had 32 clients from various other parts of the district who borrowed from him, with loans ranging from Rs. 5,000 to Rs. 30,000.

Informal savings in Hirapur village

Informal savings were also a feature of the rural financial market in Herapur. The bank provided savings facilities to community members in the village. Only the small businesses and those in government jobs availed themselves of these deposit facilities. Poor farmers did not utilize the facilities because they were (a) not aware of such saving facilities in the bank or (b) found it time-consuming to withdraw money from the bank. Instead they preferred to keep their money with money guards who are often wealthy businessmen or respectable persons in the village, who kept the money for safekeeping. Poor farmers could withdraw the money any time they wanted, especially during weekly market days for the purchase of goods.

This feature is quite similar to the “money keepers” in many West African countries, such as Ghana (Adams, 1992; Christensen, 1993); such people are known by several local names. In this case, the “money guards” did not charge any or pay any interest for providing safe-keeping services, but used the money to invest in their own business and made it available to farmers whenever they needed it. Apart from moneylenders, one chit fund company also operated in the village as an informal savings entity.

Formal Credit System

From the foregoing discussion, we have seen that Hirapur village has a distinct informal financial market, with various entities providing credit and savings facilities. In particular, this informal credit market has been functioning in the presence of a distinct formal credit market, with various banks and cooperatives providing financial services. Table 8 and the following sections will show features of the formal credit market and compare the role of the commercial bank and cooperative bank to that of the *kabuliwallah* in the credit market of Hirapur village.

The State Land Development Bank and the commercial bank are the only two banks located in Hirapur village centre. The commercial bank was established in 1971. The Apex Co-operative Agricultural and Rural Development Bank, a land development bank sponsored by NABARD and the state government, was established in 1994. There are other bank branches located in the Hirapur Block, which is the district administrative area.

Table 8 shows that there is a distinct formal credit system for rural development for the entire Hirapur Block, comprising a network of branches of formal financial institutions, each branch having provisions for targeted credit set by the District Rural Development Agency. We found that the commercial bank of

Hirapur village had 23 per cent of the total targeted schemes for rural development, of which 96 per cent of the schemes were accepted by the commercial bank in 1994/95. The following sections describe the credit provisions made by the commercial bank, with data having been obtained from bank ledgers.

Table 8. Hirapur block formal bank branches and district rural development credit schemes

Bank	*Number*					
	Branches	*Target*	*Proposed*	*Accepted*	*Pending*	*Rejected*
UBI	1	30	70	53	17	–
RRB	1	10	18	10	8	–
	2	20	25	20	5	
	3	15	20	20	10	
	4	15	7	10	7	
SBI	1	85	163	84	27	30
Cooperative bank	1	30	21	7	14	–
Hirapur Punjab National Bank	1	75	142	72	–	70
Central Bank of India	1	50	38	35	3	–
Total	15	330	504	311	91	100

Table 9. Commercial bank in Hirapur: loan volume and number

Type of loan	*Loan volume (with subsidy)*	*Percentage of loan volume*		*Number of loans*	
	(Indian rupees)	*(United States dollars)*	*(%)*	*(No.)*	*(%)*
Term loans					
– IRDP loans	59 857	1 260	4.6	14	38.9
– Non-IRDP loans	503 828	10 606	39.1	14	38.9
Prime minister's Rojgar Yojana	114 000	2 400	8.8	4	11.1
Consumer loans	536 200	11 288	41.6	3	8.3
Staff loans	75 000	1 579	5.8	1	2.8
Total	1 288 885	27 134	100	36	100

Table 9 shows the classification of the bank loans under six categories: IRDP loans, non-IRDP loans, employment loans, consumer loans and staff loans. The bank disbursed 41.6 per cent of its total loan volume as consumer loans and 39.1 per cent as non-IRDP loans, but these corresponded to 8.3 per cent and 38.9 per cent respectively of the total number of loans. Although 38.9 per cent of the total numbers of loans were IRDP loans, they corresponded to a small part (4.6 per cent) of the total loan volume. Therefore, the IRDP loans were small in size. There were also four employment loans and one staff loan, which formed a share of 8.8 per cent and 5.8 per cent respectively of the total loan volume.

Table 10. Bank: purpose of loan, by volume (with subsidy) and number

Loan type & purpose	*Loan volume*		*Number of loans*	
	(Indian rupees)	*(%)*	*(No.)*	*(%)*
Term loan				
IRDP				
– Dairy	24 906	1.9	7	19.4
– Bullocks	13 884	1.1	3	8.3
– Bullock cart	11 068	0.9	2	5.6
– Poultry	10 000	0.7	2	5.6
Non-IRDP loans				
– Housing	150 000	11.6	1	2.8
– Grocery	68 828	5.3	7	19.4
– Furniture shop	31 000	2.4	2	5.6
– Stationary shop	10 000	0.7	1	2.8
– Colour television	10 000	0.7	1	2.8
– Purchasing of truck	224 000	17.4	1	2.8
– Bookstall	10 000	0.7	1	2.8
Consumer loans	536 200	41.6	3	8.3
PMRY loans				
– Stationary shop	38 000	2.8	1	2.8
– Furniture	48 000	3.7	2	5.5
– Grocery	28 000	2.7	1	2.8
Staff loan				
– House Building	75 000	5.8	1	2.8
Total	1 288 886	100	36	100

A detailed classification of loan purpose under different types of credit provision in terms of loan volume and number is shown in table 10. Among the IRDP loans, the highest number of loans (19.4 per cent) were disbursed for purchasing dairy cattle, which accounted for 1.9 per cent of the total loan volume. The volume of credit was relatively low when compared with just 8.3 per cent of the total number of loans for purchasing bullocks, which formed 1 per cent of the total loan volume. In addition, small amounts of loans were disbursed for purchasing bullock carts and poultry.

In the non-IRDP category, loans were disbursed for the construction of houses and establishing groceries, furniture shops and stationary shops, and purchasing television, a truck and establishing a bookstall. The highest number of loans (19.4 per cent) in this category were disbursed for the establishment of groceryshops, which accounted for 5.3 per cent of the total loan volume. On the other hand, the highest amounts in terms of loan size were disbursed for purchasing a truck and for the construction of a house; these accounted for 17.4 per cent and 11.6 per cent respectively of the total loan volume. In the above table, the purpose for the three consumer loans was not mentioned specifically in the account books; these loans comprised a very high proportion (41.6 per cent) of the total loan volume.

There were four employment loans under the Prime Minister's Rozgar Yojana Scheme (for educated but unemployed youth) for the purpose of establishing a stationary shop, furniture shop and a grocery store; they formed 11 per cent of the total number of loans and 8.8 per cent of the total loan volume. There was one staff loan disbursed for the purpose of house construction, which was about 6 per cent of the total loan volume.

Thus, 36 loans were disbursed that year, which had a total value of Rs. 1,288,886, and all these loans were for the purpose of starting a new business or for the purchase of fixed-capital assets. There was however no loan purpose seen in the account books that could be ascribed to loans exclusively for meeting working-capital requirements.

Role of the Cooperative Bank, Commercial Bank and the *Kabuliwallah* in the Village Credit Market

In the previous sections the characteristics of the informal credit market, including the detailed role of the *kabuliwallah* and the banks in terms of the various structural characteristics of their business, have been examined by specifically looking at the following: types of borrower, types of financial product, purpose of loans and types of policy.

Table 11. Loan size according to number and volume

Range of loan size (Indian rupees)	Percentage of number and volume of loans, according to loan size					
	Cooperative bank		Commercial bank		Mr. A. Khan	
	No. (%)	Volume (%)	No. (%)	Volume (%)	No. (%)	Volume (%)
Up to 5 000	–	–	41.7	5.0	42.9	8.9
5 001-10 000	–	–	25.0	7.0	16.7	10.2
10 001-15 000	4.8	1.5	8.3	3.2	14.3	13.8
15 001-20 000	–	–	2.8	1.2	4.8	6.3
20 001-25 000	19.0	9.8	–	–	7.1	13.1
25 001-30 000	–	–	2.8	2.2	7.1	16.2
30 001-35 000	9.5	5.9	–	–	4.8	12.5
35 001-40 000	28.6	24.9	5.5	6.0	–	–
40 001-45 000	–	–	–	–	–	–
45 001-50 000	–	–	–	–	–	–
50 001-100 000	33.3	45.1	2.8	5.8	2.3	18.7
100 001-200 000	4.8	12.8	2.8	11.6	–	–
200 001-400 000	–	–	8.3	58.0	–	–
>400 001	–	–	–	–	–	–
	100	100	100	100	100	100

Table 11 shows that 41.7 per cent of the loans provided by the commercial banks and 42.9 per cent of the loans provided by Mr. Khan were about Rs. 5,000 in size; the cooperative bank did not provide loans in this range. Although a similar number of loans were disbursed by the bank and Mr. Khan for loans ranging up to Rs. 5,000, the provisions made by the bank were for start-up capital for new businesses, whereas the *kabuliwallah* was disbursing loan for working-capital requirements and for consumption purposes, as explained previously. This was also the case in terms of the purpose of the loans within the range of Rs. 5,001 to Rs. 20,000. It is worth mentioning at this point that the self-help group present in the village had given access to their books of account, and it was found that it had 19.9 per cent of the loans within the range of Rs. 1,000 to Rs. 5,000, and the rest of the loans were below Rs. 1,000.

The chi-square test results show that there is significant difference between the number of loans disbursed by the *kabuliwallah* and the banks ($P<0.001$) within the different ranges of loan sizes. The difference is attributed to the fewer than expected number of loans disbursed by the cooperative bank, which were up to Rs. 5,000 in size, and the fewer than expected number of loans that were bigger than Rs. 25,001 in size, which were disbursed by Mr. Khan.

Comparison of Loan Size and Interest Rates in the village Credit Market

The average size of monthly interest loans provided by the *kabuliwallah* was about Rs. 13,400, with the interest rate being 8 to 10 per cent per month. On the other hand, the Group Savings and Credit Associations in the village were providing an average loan size of Rs. 3,150 at one interest rate of 2 per cent a month. Microcredit self-help groups operating in Hirapur and neighbouring villages were providing similar loans at similar interest rates as those of the Credit and Savings Associations of Hirapur. Therefore, both the Savings and Credit Associations and the self-help group were providing very small loans as compared with the Banks and the *kabuliwallah*.

However, the specific features of the *kabuliwallah* in credit provision are the following: the various sizes of loans, duration of credit and the interest rates which depended on the amount of credit and the type of borrower. Furthermore, in this particular district town where Hirapur village is situated, *kabuliwallahs* were providing loans varying in size from Rs. 100 for 10 weeks extended to tea-estate workers to between Rs. 5,000 and Rs. 100,000 extended to small businessmen in the villages and urban centres. Although the loan sizes provided by the commercial banks operating in the same area were similar to those of the *kabuliwallah*, the credit provisions differred with respect to loan purpose. The banks provide loans or start-up capital, whereas the *kabuliwallahs* provide working capital to meet recurring costs in a business as well as loans for consumption purpose. In addition, as seen in the case study, within the same range of loan size, the credit provision differs in terms of the volume of loans vis-à-vis banks and the *kabuliwallah*.

VII. CONCLUSION

Historically, moneylending has been an important part of the Indian economy. During the medieval period, moneylenders financed the administration of various rulers. Since Vedic times until today, they have been an important part of the rural and urban economy of India. Moreover, moneylending in the rural areas of India has influenced the underlying premise of formal rural credit policies in the past. In fact, the first post-independence rural credit policy initiative in 1950-1951 took rural indebtness with moneylenders to be an important indicator for developing policies.

The alienation of the formal sector from mainstream requirements of the rural financial market in terms of the various financial products that they deliver has enabled the informal sector, particularly the various types of moneylenders and the *kabuliwallah* in Assam and other parts of north-eastern India, to operate in niche markets in a sustainable manner, with their own portfolio and products. Despite the restrictions on the scale of operation, the informal sector has been complementing the credit services of the formal sector in the province of Assam and perhaps in other parts of the country. Policymakers in the formal financial sector need to have a deeper understanding of the various dimensions of the informal financial sector, as shown by the role of the *kabuliwallahs* compared with the local banks.

In another revealing study on informal credit markets in Africa, Aryeetey (1996) contends that the demand for loans from moneylenders with higher rates of interest usually comes from borrowers with no other option. This view cannot be generalized, as can be seen from this study; the poor people borrow from moneylenders even when they have different options. They either had no access to the services of formal financial institutions or they lacked information. It should be pointed out that the view that moneylenders charge high rates of interest and make credit unattractive for borrowers seeking working-capital loans or loans for fixed investment should not be generalized. There are country- and region-specific variations, that is, specific to particular rural credit markets such as in Africa. Again, as has been seen in the case of Mr. Khan's business in Hirapur village, this particular moneylender was providing working-capital loans for small businesses in the village. There is also evidence that *kabuliwallahs* such as Mr. Khan have been supplying similar working-capital loans to small entrepreneurs in the urban areas of north-eastern India, and pawn brokers belonging to the Jain religion have been providing consumption loans in the villages of Rajasthan (Jones and Rafique, 1997). In all these cases, high interest rates were not the deciding factor for borrowers; rather, accessibility, flexibility, confidentiality and customer-tailored loan contracts were more important to the borrowers.

Another aspect of the rural financial market is that moneylenders do not always provide credit to the poorest of the poor in the rural areas, as exemplified in this case. The poorest of the poor do not come within the purview of this type of moneylender. Here, unlike the bank, the moneylender is not functioning to off-set the risk of non-repayment, but he is concerned about the inherent delinquency in the regular monthly repayment of the interest on his loan as a result of the low capacity of poorer borrowers to generate a higher return on investment with the loan money. In fact, they complement commercial credit services provided by banks and cooperatives. This is also similar to a provision the Kisan Credit Cards Scheme, which extends short-term credit to farmers for their cultivation needs, in the rural areas of north-eastern India. A recent interaction with community members in a tribal village in the state of Assam revealed that such credit cards were provided to fairly better-off farmers; the poor or the “ultra” poor did not have access to such credit card facilities.

Since the poorest of the poor are left out by all the components of the village financial system, they either get loans from their friends and relatives, or they are pushed to such a level of deprivation that they are compelled to send their children out to beg or come out themselves to beg during the lean months when there are not enough menial jobs available in the villages or in the surrounding areas.

Government intervention in the credit market so far has not been able to reduce the market power of the informal sector. This situation has only contributed to changes in the type of borrowers in the informal market (Hoff et al., 1993). The various strategies to remove moneylenders from the market have forced the informal lenders to do business in the areas of the market with the highest levels of risk.

Integrating the different segments of the market has been done through group formation and linkages with banks. Instead of just linkages, which would at best improve information exchange between the two sectors, a further step could be on-lending or retailing microcredit funds through the informal lenders for greater integration of the different segments of the financial markets (Aryeetey, 1996). Other than microcredit (e.g., short-term working-capital loans), microfinance products could be retailed through these informal lenders, such as microinsurance and leasing contracts (infrastructure and equipment).

Policy proposals for the informal financial sector have been made in response to the existing financial dualism in the rural financial markets of developing countries. Therefore, banks serving the rural areas could take two main policy positions: they could either compete with the professional moneylenders to eliminate completely their existence, or they could decide not to compete in the market by being separate entities in the financial system. At the same time, linkages with the moneylenders could be established to use them as commission agents, or for on-lending funds (retail funds), and to encourage people to save in banks (Ghate, 1992b; Crow, 1994; Bolnick, 1992). Whichever option the formal sector chooses, initially it will have to "mimic" the efficiency features of the informal sector. An in-depth understanding of the functioning of the informal sector will be necessary. Next could be the substitution of the direct mechanisms used by moneylenders, such as the introduction of new rules for screening, providing incentives to repay and enforcing credit contracts.

It may be pointed out here that the main focus at the initial stages of a financial intermediation strategy at the provincial level needs to be the local adaptability of regional policy. This aspect should be monitored by the formal sector over a period of time in order to determine how well the different financial products, particularly credit, adapt to local market segments. Therefore, national policy guidelines need to be tailored to local issues, which should be framed after a detailed understanding of the rural financial markets has been obtained.

An *inclusive* financial sector is a term that needs to be defined in the context of this case study so that the implications from the study will be in context with regard to the process of "building an inclusive financial sector". This term may be defined as the ability of the financial institutions to be able to develop low-cost financial products and services after developing an understanding of the financial market in which they operate. After a proper understanding of the market segments has been reached, an effort should be made to prepare strategies to create links with the informal sector to share information about clients and possibly retail microfinancial products and services, with the informal sector being obligated to pay recovery and services charges included in a negotiable contract. Financial operations that provide a wide range of financial services in a cost-effective manner, with integration of the various segments of the market, will go a long way towards sustaining the successful achievements made so far in the frontiers of rural finance. This will occur without compromising on the financial viability of the programme. Thus, a policy for the decentralization of a financial intermediation strategy in the rural areas needs to be developed by the formal financial institutions along with policies for organizational restructuring and formation of capital in order to provide financial services in a cost-effective manner alongside the informal sector in rural areas.

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