CHAPTER FIVE

CHARACTERISTICS AND ANALYSIS OF INFORMAL LOANS

Informal and formal finance sources invariably co-exist although their respective market share varies. When formal finance is well distributed and adapted to local needs, informal finance tends to diminish in importance. However, because of certain characteristics of formal finance and the constraints on it there are always a number of credit needs that this sector is unable to meet and these needs are catered to by informal finance.

Informal finance offers many advantages. Informal or indigenous financial agents know their clients better than formal banks do which reduces their information costs, and administrative and staff overheads. Further, interest rates are not regulated so they can readily adjust to market forces. Moreover they are not subject to state controls and regulations like the formal lenders which lowers cost. However, an informal borrowing system has several drawbacks. Perhaps the most important is the limited amount of credit available for distribution. Secondly, borrowing through informal systems often means doing business with a lender who maintains a virtual monopoly on credit resources. In this case, borrowers may be exploited and be caught in a vicious cycle of indebtedness.

The notorious practices of informal lenders like charging very high rates of interest, accounting malpractices and grabbing of security, etc. are very well known.

Interestingly enough, however, there is evidence to showthat borrowers often continue to rely on money lenders for high interest loans even when they are provided with the alternative of low-cost government sponsored loans. Elavia and Zafar Alam (1994) found that informal credit contributed a significant proportion (43 per cent) of total credit and it accounted for higher proportion (57 per cent) of borrowers compared to formal credit in the state of Gujarat[5]. There are very few studies on informal finance. More research is necessary to highlight the brighter side of informal finance, viz., meeting the survival needs of the poor and for developing a suitable model adaptable to the local circumstances because it supplements formal credit and thus promotes development.

The broad objective of this chapter is to examine the characteristics of credit provided by informal financial sources to sample households. Informal credit is studied with reference to the following dimensions :

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5 *Elavia. and Zafar, Alam. 1994. Rural households and credit : some evidence from Gujarat. working paper, WHODSIC, MSU, Baroda.*

- Size of loan and activities financed
- Source
- Tenure
- Security
- Interest rate structure
- Repayment performance and
- Gender

5.1 Size of Loan and Activities Financed

The quantum of finance available from informal sources is limited compared to that of formal sources. Thus, it is beyond their capacity to provide large loans.

To the money lender all credit needs are alike and he grant loans for all purposes. Credit serves a useful purpose only when it is used for a productive purpose for generating a surplus after paying the interest on capital and providing for loan repayment. Diversion of credit to unproductive purposes is greater in the case of informal loans. In the table given below unproductive purposes include the expenditure incurred for housing, repayment of old debts, obtaining visa for job abroad, marriage, medical expenses and for a number of miscellaneous purposes including social obligations, religious ceremonies, food, clothing, education, etc.

Table 5.1 : **Distribution of Loans According to the Activities Financed**

(Amount in rupees)

Activities	No. of loan cases	Percent	Loan amount	Percent	Average
1	2	3	4	5	6
Agricultural operations	30	9.49	286900	16.85	9563.33
Animal husbandry	10	3.16	39000	2.29	3900.00
Self employment	11	3.48	379500	22.29	34500.00
Business	14	4.43	185550	10.89	13253.57
Housing	25	7.91	169600	9.96	6784.00
Repayment of old loan	8	2.53	44600	2.62	5575.00
Visa	6	1.90	69500	4.08	11583.33
Marriage	12	3.80	136000	7.99	11333.33
Medical expenses	26	8.23	47400	2.79	1823.07
Miscellaneous	174	55.06	344450	20.23	1979.59
Total	316	100.00	1702500	100.00	5387.66

(Figures in columns 3&5 are percentages to the totals columns 2&4 respectively.)

Table 5.1 shows that there were 316 informal loan cases in the sample who received loans amounting to Rs. 1702500. Around half of the loans were given for productive purposes. Self employment received the highest share (22 percent of total loans) followed by agricultural operations and business. Out of unproductive loans housing received the highest share of less than 10 percent, closely followed by marriage with less than 8 percent. Loans for miscellaneous purposes mostly given for consumption and survival needs accounted for one-fifth of the total. It needs to be noted that informal finance was largely provided for non-farm productive activities and consumption. Thus it played a complementary role to formal finance in meeting the credit needs of rural households.

The average amount of loan for the sample was only Rs. 5387. The biggest loan size was found in case of self-employment (Rs. 34500), and business came a low second (Rs. 13254) closely followed by visa (Rs. 11583). However, majority of loans were of small size.

5.2 Sourceswise Distribution

The main informal sources of credit in rural areas are money lenders, relatives, friends, neighbours and shopkeepers. It is a known fact that money lenders charge exorbitant rates of interest, indulge in unfair practices and frauds and deceive the illiterate and gullible borrowers. Instead of being a friend in need and supplier of productive credit he tries to keep his borrowers in debt perpetually and acquire their land and property by all means, fair and foul. The credit needs of the farmers include production and consumption. Hence, many times loans turn into a type of facile credit for wasteful items of consumption. Under the system of subsistence farming farmers themselves are not in a position to devise a meaningful allocation of credit and the money lenders do not offer any opportunity to them to think in this direction by giving loans whenever they ask. Our discussions with borrowers revealed the following details about various types of informal lenders. Even the money lenders do display certain characteristics of a good credit system - adaptation to changing needs, flexibility, straight forward dealings and ready availability. Living among his clients and knowing the credit worthiness of each one they are some of the very few creditors who often lend on personal security as distinguished from the security of real property. Thus what cooperatives merely postulate they actually possess, namely the knowledge of the character and repaying capacity of borrowers. Further, borrower's enthusiasm never got blurred as they were not required to fulfill a plethora of conditions attached to institutional lending. Relatives rarely turndown requests for small loans, because a loan to a family member is in one sense a loan to the entire family. Repayment is not insisted upon, until the borrower is in a position to return the loan and interest is not often explicitly charged. Relatives are usually nearby so that loans can easily be arranged and perhaps most important, immediately made available.

Borrowing from neighbour has several advantages. Reciprocity in borrowing is common among neighbours. There is a tendency for borrowers to become lenders and lenders to become borrowers. Again loans are easy to arrange in small amounts and can be made available to borrowers immediately often without security. Shopkeepers may extend credit to well- known, regular buyers for food and other household requirements by maintaining a record of the purchases and bills which remain unpaid for sometime. Interest is not explictly charged but collected rather implicitly through higher prices of goods.

The credit union is an informal organisation associated to the Catholic Church with a rotating saving scheme for all the villagers in Puduppady village. It operates in such a way that each member is provided a fixed amount of money for a given period. Table 5.2 presents the sourcewise distribution of the informal loans.

Table 5.2 : **Sourcewise Distribution of Informal Loans**

(Amount in rupees)

Sources	No. of loan cases	Percent	Loan amount	Percent	Average
1	2	3	4	5	6
Money lenders	71	22.47	871450	51.19	12273.94
Friends and neighbours	172	54.43	551400	32.39	3205.81
Relatives	32	10.13	122500	7.2	3828.12
Credit union	15	04.75	101500	5.96	6766.67
Shopkeepers	26	08.23	55650	3.27	2140.38
Total	316	100.00	1702500	100.00	5387.66

(Figures in columns 3&5 are percentages to the totals of columns 2&4 respectively.)

Table 5.2 shows that more than half of the total informal loans came from money lenders and friends and neighbours contributed another one-third. The other three sources contributed less than 16 per cent of the total.

Analysis of the loan size revealed that money lenders gave much bigger loans than the others. The credit union came second. All the other sources provided very small loans.

5.3 Tenurewise Classification

All informal loans can be classified into three categories depending on the period for which a loan is given i.e. short term, medium term and long-term. Various studies show that loans available from informal sources are usually short-term in nature, generally less than a year. Table 5.3 shows the tenurewise breakup of the informal loans, which coroberates the previous findings.

Table 5.3 : Tenurewise Classification of Informal Loans.

(Amount in rupees)

Sources	No. of loan cases	Percent	Loan amount	Percent	Average
1	2	3	4	5	6
Short term	313	99.05	1617500	95	5167.73
Medium term	2	0.63	73000	4.29	36500
Long term	1	0.32	12000	0.71	12000
Total	316	100.0	1702500	100.00	5387.66

(Figures in columns 3&5 are percentages to the totals of columns 2&4 respectively.

It is evident from table 5.3 that most of the loans were short-term. The average amount of short term loans was Rs. 5167. There were only two cases of medium-term loans of very large size and only one case of long-term loan of Rs. 12000

5.4 Securitywise Classification

It is a well known fact that loans from informal sources largely depend upon the personal relation between the lender and the borrower. Literature shows that collateral security is rarely given in case of informal loans. When security is given, it is mainly land and gold ornaments. Table 5.5 presents relevant data on loans according to security.

Table 5.4 : Securitywise Classification of Informal Loans

(Amount in rupees)

Category of Loan	No. of loan cases	Percent	Loan amount	Percent	Average
1	2	3	4	5	6
Secured	14	4.43	112250	6.59	8017.86
Unsecured	302	95.57	1590250	93.41	5265.73
Total	316	100.00	1702500	100.00	5387.66

(Figures columns 3&5 are percentages to the totals of columns 2&4 respectively)

It is evident from the table 5.4 that unlike formal loans, very few of the informal loan cases were secured. 93 per cent of the total informal loans were unsecured, and in case of the loan cases, the percentage was still higher. Further, the unsecured loans were smaller in size compared to secured the ones for obvious reasons. This is the key to the success of informal finance; the poor have nothing to offer as security and this blacks their access to formal credit.

5.5 Interest Rate Structure

It is evident from the literature on informal finance that the role of moneylenders and pawn brokers is considered highly controversial. Commonly, they are characterized as ruthless loan sharks who force the poor into perpetual debt. They tend to charge high rates of interest invariably much above formal market rates. While high interest reduces the profitability and income of a venture, it has to be recognized that paying higher than formal market rates may be acceptable for the end-users in certain circumstances because it meets a particular need. Thus, borrowers are usually prepared to pay higher than average interest rates when funds are required urgently for consumption or are to be used for a particular profitable venture. Out of all the financers relatives and friends tend to offer the cheapest loans. They are likely to lend free of charge or at a very low rate of interest. Table 5.4 classifies, loan cases according to the rate of interest.

Table 5.5 : Interest Rate Structure of Informal Loans

(In percentages)

Interest margins	Loan cases No.	Loan cases percent	Loan amount Amt.in Rs.	Loan amount Percent
1	2	3	4	5
No interest	219	69.30	709000	41.64
1-14	14	4.43	187800	11.03
15-49	5	1.58	114500	6.73
50-99	30	9.49	318950	18.73
100-149	39	12.34	338450	19.88
150-200	9	2.85	33800	1.99
Total	316	100.00	1702500	100.00

(Percentages in column 3 are percentages to the totals of column 2)

It can be observed from table 5.5 that nearly 70 percent of the total loan cases were given without charging any interest mainly by relatives and friends. On the other hand, only 15 percent of the loan cases carried exhorbitant interest rates, above 100 percent per annum.

5.6 Repayment Performance

Good repayment record indicates positive return on investment. Friends and relatives usually do not demand repayment until borrowers are in a position to repay. But dealings with money lenders are different. Physical intimidation and threats to borrowers or their guarantor on defaults are common. Fear to loose the land or security given also forces the borrower to repay the amount in time. Table 5.5 shows the repayment record of informal loans.

Table 5.6 : Repayment Performance of Informal Loans

(Amount in rupees)

Repayment	No. of loan cases	Percent	Loan amount	Percent
1	2	3	4	5
Fully Repaid	119	37.66	353300	21.1
Overdue	197	62.34	1349200	78.9
Total	316	100.00	1702500	100.00

(Figures in columns 3&5 are percentages to the totals of columns 2&4, respectively).

It can be observed that 79 percent of the informal loans were overdue. However, poor repayment may also be due to the large number of loans from friends, neighbours and relatives who do not demand an early repayment as the tenure of the loan is flexible. Thus, the exact amount of overdues is difficult to estimate.

5.7 Gender Analysis

Caught between the inadequacy of formal institutions as a source of credit and their increasing need for capital, women continue to depend largely on informal sources to bridge the gap. All poor women are part of the informal system of the economy which implies that their dealings are of small size, based on trust or dependence on known people and on verbal transactions rather than written communication. It also implies that women have little control over assets and means of production and that since the margin of returns over the investment of their effort is small they often resort to a wide variety of occupations and trades. Seasonality assumes a crucial significance in such a context, and timeliness of responses become a very important attribute of successful credit intervention. Credit is often used to creat forward and backward linkages to women's income producing activities.

Particularly in low income groups, women rely on money lenders, pawnbrokers, middlemen and a variety of indigenous saving associations to provide them with the credit they urgently need. A study by The Research Institute Rajagiri College of Social Sciences, Kerala found among the sample of women borrowrs that money lenders were the most widely used sources.[6] While this source can be effective, it is important to note that the informal system does not function independently of the gender bias. There is a lot of evidence that shows that women do not have direct access to

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6 *Credit facilities for women : availability accessability and utilisation in Kerala. 1990. The Research Institute. Rajagiri college of Social Science. Kalamassery. Cochin. Kerala.*

informal credit also. In many cases women have to approach the informal source through a male household member of her family.

As noted earlier in the last decade and a half, concerted efforts were made to bring women in the mainstream of economic activity. Hence, gender assumes importance in credit analysis. A study of genderwise distribution of credit is important for developing gender centered credit system in the future. Genderwise analysis of credit is undertaken using the following three indicators :

- Loan size
- Activities financed and
- Repayment performance

Loan size

While there are differences in the activities undertaken by men and women, the quantum of a loan available to them also varies. Various studies indicate that the type of credit women need is small and short-term. Mostly, women have little to offer as collateral; hence the amount available to them is also small. Often women lack the confidence to contract larger loans.

Table 5.7 : Genderwise Distribution of Sample Loans

(Amount in rupees)

Gender	No. of Loan cases	Percent	Loan amount	Percent	Average
1	2	3	4	5	6
Male	253	80.06	1268550	74.51	5014.03
Female	63	19.94	433950	25.49	6888.10
Total	316	100.00	1702500	100.00	5387.65

(Figures in columns 3&5 are percentages to the totals of columns 2&4 respectively)

It is evident from table 5.7 that the major part of the informal loans was taken by male borrowers, i.e. nearly 75 per cent. But an interesting phenomenon that can be noted here is that the average amount of the loans borrowed by the female borrowers was higher than that of their male counterparts. This shows a clear dependence on informal sources for bigger loans by women.

Out of the total sample borrowers, 73 per cent was men and 27 per cent women.

Activities financed

Women undertake a variety of occupations in rural areas. In many cases women's loan also may be used to finance economic activities for their husbands, or other household members. Their desperate living conditions may make them eager to take loans if they can obtain them, but their investment from loan is unlikely to lead to significant income expansion and this may force them to divert a loan to consumption.

Table 5.8 : Genderwise Comparision of Activity Financed

(Amountin rupees)

Gender	Agricultural operations		Animal husbandry		Self employment		Business		Housing		Repayment of old loan		Visa		Marriage		Medical expenses		Miscellaneous	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Male	27	245000	6	33300	9	278000	12	165550	14	77600	4	7100	3	22500	9	103000	22	32900	147	303600
	(90 00)	(85.40)	(60.00)	(85.38)	(81.82)	(73.25)	(85.71)	(89.22)	(56.00)	(45.75)	(50.00)	(15.91)	(50.00)	(32.37)	(75.00)	(75.74)	(84.62)	(69.4)	(84.48)	(88.14)
Female	3	41900	4	5700	2	101500	2	20000	11	92000	4	37500	3	47000	3	33000	4	14500	27	40850
	(10.00)	(14.60)	(40.00)	(14.62)	(18.18)	(26.75)	(14.29)	(10.78)	(44.00)	(52.2)	(50.00)	(84.09)	(50.00)	(67.63)	(25.00)	(24.26)	(15.38)	(30.5)	(15.52)	(11.86)
Total	30	286900	10	39000	11	379500	14	185550	25	169600	8	44600	6	69500	12	136000	26	47400	174	344450
	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)

(Figures in parenthesis denote percentage to the totals)

It can be observed from the table that for all productive purposes, women's share in credit was less than men's. Under unproductive purpose such as repayment of old debt women had much higher share of loans (84 percent) compared to men.For the purposes like housing and visa women's credit share is larger than men's, 54 and 68 percent, respectively.

Repayment performance

Domestic expenditure does not normally generate income to be used for loan repayment. On the other hand loans used for productive purposes generate sufficient income to repay. The rate of repayment depends upon the activities for which a loan is used. Table 5.9 provides a comparative picture of the repayment performance of the male and female borrowers.

Table 5.9 : Gender comparison of Repayment Performance

(Amount in rupees)

	Male		Female	
Repayment	No.	Amount	No.	Amount
1	2	3	4	5
Fully repaid	98	302350 (23.83)	21	50950 (11.74)
Overdue	155	966200 (76.17)	42	383000 (88.26)
Total	253	1268550 (100.00)	63	433950 (100.00)

(Figures in parenthesis denote percentages to the total)

It can be observed that around 76 per cent of men's loan and 88 percent of women's loan are overdue. Men's repayment performance is better than women's.

5.8 Conclusion

Our analysis revealed the following salient charateristics of the informal loans received by the sample borrowers. Our analysis of the loansize revealed that the sample households received credit amounting to Rs. 5388 per loan case. Loans for self-employment were 6 times bigger and those for business were double in size compared to the sample average. On the other hand loans for medical treatment had a smaller size (Rs. 1823) and loans for miscellaneous purposes were only marginally bigger than them.

Activitywise analysis of the credit to the sample borrowers indicated that out of the nine listed activities self-employment had the highest share of 22 percent. Agricultural loan came second with nearly 17 percent. Animal husbandry had the smallest share of 2 percent. Business and housing had 11 and 10 percent, respectively. Thus, non-farm productive loans accounted for one-third of the total loans and the farm loans were almost less than half of this in proportion indicating success in diverting credit to non-farm sector.

Sourcewise distribution of the credit revealed that the professional money lenders provided more than half of the loans. Whereas, nearly, one-third of the loans came from friends and neighbours. On the other hand relatives provided 7 percent of the loans.

Further, considering the loan amount nearly 70 percent of the loans were provided free of cost by relatives and friends. Another 4 percent of the loans were at nominal interest rates, comparable with the formal loan interest rates. Only one-fourth of the total loans carried very high rates of interest. Thus our enquiry into the interest rate structure brought out interesting and unexpected results. These findings explode the myth that informal loans always have a very high interest burden.

The tenurewise classification of the loans indicated predominance (95 per cent of total credit) of the short-term loans having maturity of one year or less. Two medium-term loans were of a much bigger size. Only one long-term loan was there of Rs. 12000/-

Most of the loans (93 percent) were unsecured. This indicates the high risk carried by the lenders for which they are justified in charging high interest rates.

Gender analysis revealed as expected men had a predominant share in the loan cases and credit; Women accounted for less than one-fifth of the loan cases and one-fourth of the total credit. Women received the major share of the loans for the repayment of the old loans (84 percent), visa (68 percent) and housing (54 percent).

Besides, their smaller share of the loans, even the loan size was much smaller compared to those of men. Unlike the findings of many other studies, our analysis shows that women had a higher proportion of overdues than men. This finding supports our impression that most of the loans taken by women were just fronts for loans used by men. When men were not eligible for loans, they were taken in women's name. Women use loans themselves only in some cases. Thus, further investigation is necessary to find out the loan cases where women have taken and used themselves the loan and compare the loan overview position with those cases where women are just fronts for men in borrowing. However, this is beyond the scope of this single handed study.

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