CHAPTER III

CONCEPTUAL FRAMEWORK

The development and refinement of the term ‘Informal Credit Markets’ has been subjected to controversy. The discussion on the subject had emerged from the issue related to the conceptual definition given by Peattie (1987) of the informal sector in general. According to Peattie ‘informal sector’ is an exceedingly fuzzy concept widely used by different groups for different and even conflicting purposes, but none of them serves adequately as a tool of analysis or as a framework for developing policy; and the concept has little analytical or operational value’. Chandavarkar (1988) took the issue with Peattie of the concept of the ‘informal sector’ and showed that, if appropriately disaggregated, it has analytic and operational value as a portmanteau concept for a variety of policies – employment, development, finance and welfare.

Policy makers and researchers found it difficult to give a logically clear-cut and comprehensive definition of informal credit markets. This is mainly due to the sheer diversity of informal credit arrangements and the heterogeneity of informal lenders. Different conceptualisations have emerged in different contexts, due to the difference in the approaches adopted by different researchers.

Less developed countries are characterised by dualistic financial setup. It refers to the coexistence of different interest rates between the organised and unorganised money markets. (Myint, 1971). The formal credit markets are regulated and unorganised money markets are unregulated. This concept was developed in relation to the topic or title of ‘financial dualism’. But this definition lacked a defining
criterion in order to demarcate formal credit markets from informal credit markets. Chandavarkar (1986) was of the view that it was misleading to talk of financial dualism as an aggregation of two financial enclaves; the two sectors form rather a continuum with many sub-markets within each organised and unorganised credit market and many linkages between the two. Nevertheless it is feasible to map out the informal sector by applying alternative hypotheses of institutional and behavioural characteristics like that of the ILO (1972) or the ownership pattern of the constituent units (Chandavarkar, 1987).

Defining the informality of the informal credit markets is beset with theoretical and conceptual problems. For some researchers it is the informality in terms of ease and convenience for the borrowers that constitute the essence of informal credit markets, while others viewed informal credit markets in terms of informality for lenders, translated as escape from regulations and control. Still others have viewed informal credit markets as nothing different from formal credit markets with the exception that latter had regulated prices while informal credit markets were characterised by flexible, competitive and market clearing prices. Srivastava (1990) viewed that all these characterisations had various shortcomings.

It was agreed at the Design Workshop held in Manila, the Philippines (1986) in connection with the country studies under the auspices of the Asian Development Bank (ADB) that the formal and informal credit markets form a continuum, and where in this continuum the line of demarcation fell would be a country specific decision. This is because the same institution may be formal in one country and is found to be informal in another. Kim (1985) opined that it would not be desirable to place too much emphasis on the conceptual definition of informal credit markets. An
operationally useful definition on informal credit markets will be inevitably a country specific decision. He argued that absence of regulation was the most important criterion. Gupta (1997) also expressed his views in line with the above. Ghate (1992) opined that exact location of the dividing line in the formal – informal continuum, demarcating the two sectors was a matter of choice and convention and highlighted a country-specific decision as a criterion to define informality. Various names or terms have been used as synonyms for informal credit markets, by different researchers in their studies. This includes ‘Informal Financial Sector’, ‘Unorganised Money Markets’, ‘Indigenous Banking Sector’, “Traditional Financial Sector’, ‘Unorganised Financial Sector’, ‘Parallel Money Markets’, ‘Unregulated Banking System’, ‘Non-Institutional Credit’, etc. (hari@soc.titech.as.jp). The various names are the result of their different approaches followed by researchers to study informal credit markets.

The difficulties of operationalising the concept of ‘informality’ have been aptly captured in the observation of Lubell (1991). He made it clear that “an informal sector is like a Giraffe; it is hard to describe but you know one when you see one”. It has been in relation to the study of informal sector and not based on informal credit markets. But the statement is a useful guide to make some refinements in the existing conceptual frameworks and to form a working definition for the study. In order to arrive at such a conceptual definition various approaches need to be examined. The review of literature with regard to the conceptual definition / frameworks of past studies presented here includes both urban and rural studies. The one, which is developed for the study, will be completely of urban nature. The definitions adopted in different studies are analysed below.
3.1 ABSENCE OF REGULATION AS A CRITERION

Absence of regulation is used as defining criterion in two different aspects viz., Non-regulation by Central banks and Non-regulation by the Government. In the former case those sectors which are coming under the central bank control or monetary authority is termed as informal credit markets. So informal credit markets function outside the purview of regulations imposed on the formal sector in respect of capital reserve and liquidity requirements, ceilings on lending and deposit rates, mandatory credit targets, and audit and reporting requirements etc. In most of the countries the central bank imposes control on formal sector in these areas. Thus the freedom of action for informal credit markets enables them to cover fully the cost of lending by charging a higher rate of interest as well as any risk of default that may remain despite their close informational links with borrowers.

Lamberte (1987) used non-regulation by the banking authority as the defining criterion to find out informal credit markets. He considered non-banking financial institutions (in the Philippines) such as pawn shops, lending investors and non-stock savings and loan associations, money shops—which were regulated by central bank—term as formal sector. The financing firms coming under the purview of the Bureau of Cooperative Development were considered informal credit markets. It was stated that NBFI's (Non Banking Financial Intermediaries) in the Philippines were subjected to regulation relating to minimum capital and reserve requirements and their borrowing and loan portfolio were monitored by the central bank.

Rahman (1992) in his study on Bangladesh found that lack of recognition by the Central Bank of Bangladesh was the parameter applied to find out informal credit markets. To him there was no adequate statistical information available with regard to
their operations and volume of business, since their activities were not recorded in the official records. Ray (1998) held the same view regarding the definition of informal credit markets. He included Rosca, landlords, millers, traders, and other agents in the informal credit market list. And these agents used financial dealings as an important subsidiary activity.

Cole and Park (1983) held the same opinion about the informal credit markets. According to them non-existence of regulation was the distinctive characteristic of informal credit markets. They used the term ‘unregulated financial markets’ in the place of financial markets and the term itself signified lack of regulation as a criterion to define informal credit markets. Srinivas (1991) made it clear that a credit operation had to satisfy at least three of the criterion to become informal credit markets, of which the most important was non-regulation by the central bank. The other criteria were unsubsidised by the government and flexible repayment schedules or little or no collateral or flexibility of interest rates. Nwana (1994) defined informal credit markets as the one remaining outside the supervision, review and control of monetary authority. He classified the informal credit markets into traders, moneylenders, Rosca, neighbours and relatives who deal in moneylending.

With regard to non-regulation by the government as the criterion, Mauri (1987) asserted that formal credit markets was defined as the whole miscellany of non-institutional savings and credit arrangements and traditional institutions which were without legal standing and outside any legal control. Christenson (1993) opined that the term ‘informal credit markets’ was currently used more loosely to describe the activity of informal financial agents-defined as those individuals and institutions
which operated in financial markets outside the Government regulation and control. Peter et.al. (1989) also held the same view.

Bouman (1989) in his study covered both licensed and unlicensed moneylenders and these were considered as informal credit markets agents and licensed moneylenders/ pawnbrokers were officially registered and subjected to Government control and bound by maximum interest rates. To him these pawnbrokers were monitored and regulated much less than commercial banks. Hence they were considered as informal credit markets. The definition used by Lamberte (1987) in his study seemed to be a best definition comparing with the others. Other than non-regulation by central bank as a criterion, he also considered those firms which were registered with Government authority and not coming under central bank control and those firms not coming under either Government or banking authority as informal credit markets.

Though non-regulation by central bank is a useful criterion to define informal credit markets, there comes different firms which are regulated by central bank differ in terms of informality of operations. This is because registration of some firms is not mandatory but they are considered as non-banking financial companies. This was not explained in the definitions given above. On the other hand non-regulation by government can not be accepted as a criterion to define informal credit markets since commercial markets and other institutions coming under the regulation of central bank may have to be considered as informal credit markets. This would go wrong and that is why this criterion is not selected. What is actually needed is a compromise between the two. This is explained in the forthcoming section.
3.2 INFORMALITY OF OPERATION AS A CRITERION

Ghate (1986) asserted that informality and flexibility of operation gave the informal credit market an advantage over the formal sector. It gives the informal sector lower transaction cost advantage. The flexibility of ICM is due to the non-regulated character of these firms unlike formal sector. Ease of entry and exit, small-scale operations, multiple interest rates are the other features of ICMs. The informal credit market is a heterogeneous group. Lending and borrowing among friends and relatives, pawnshops, village moneylenders, wholesalers, traders, financing trade in food grains, textiles and raw materials, itinerant peddlers, small neighbourhood chit funds, saving organisations, etc. were included in the informal credit market category because of their informality of operations.

World Bank study (1989) suggested that the main constituent in the informal credit markets comprised of neighbours, friends and relatives, landowners, pawn brokers, professional moneylenders, merchants, shopkeepers and moneykeepers. Among them neighbours, friends and relatives are the most important source of informal credit. Teranishi (1994) endorsed the view that informal credit market took various forms: (a) Loans from relatives and acquaintances (b) Loans from moneylenders including pawn shops (c) Borrowing from merchants and landlords (d) Borrowing from moneylender companies. The activities of all these categories are informal in nature.

AIDIS (1982) also classified informal credit market, taking informality and flexibility of operations as the defining criterion. Wai (1957) asserted that informal credit market consists of three groups. Cooperatives, indigenous bankers, and other institutions serving traders and medium size landlords comprised the first group. The
second group included “respectable” moneylenders, traders and landlords serving small farmers at high but reasonable rate of interest. The third group composed of “shady marginal lenders” or loan sharks serving high-risk borrowers at exorbitant rate of interest.

The informality and flexibility of operations alone will be insufficient to use as a criterion to define informal credit market since firms coming under this head may be different from one another with regard to informality of their operations. Flexibility of operation implied escape from regulation. And it is not correctly given that from which regulation or legal purview that they are independent. As mentioned above there are two types of regulations viz., regulation by the government body and by the central bank. Hence the need to have a conceptual framework which considers all these viewpoints and it should specify from which regulation, the ICMs are independent.

3.3 CONCEPTUAL FRAMEWORK – INDIAN CONTEXT

Studies conducted on informal credit markets in India had used different approaches to define informal credit markets. Karkal (1967) and Radhakrishnan (1979) arrived at a working definition which comprised of entire gamut of financial agencies in corporate and non-corporate forms, involved in borrowing and lending activities with the public without directly or indirectly coming under the control of either the government or the Reserve Bank of India. According to Madhur (1985) this appears to be a reasonable good definition, but could pose certain problems as financial agencies subject to government control or RBI control, have not remained
the same over time. He asserted that many of the so-called direct and indirect control, which appeared on paper, are hardly exercised or implemented in practice.

Nayar (1973) concentrated on working of one form of urban informal credit markets—chit funds and provided some data on the sources and use of chit funds, interest rate structure etc. In the year 1982 Nayar studied about another informal intermediary called ‘financial corporation’ and provided information/data on the broad sources and uses of funds and interest rates. Timberg and Aiyar (1980) considered informal credit markets as those not regulated or monitored by the banking authority. They defined informal credit markets as those having traditional form of their functioning. To them there were three important functional categories: a) Full service indigenous bankers who accepted deposits and made loans b) Commercial financiers who lend primarily their own resources c) Brokers who connected potential lenders and borrowers. All of these sometimes existed in particular markets but one or the other was usually dominant. They conceded that since their study was one of the first of urban informal financial sector, any theory in connection with definition must be tentative (Timberg and Aiyar, 1984).

Madhur and Nayar (1987) used a more advanced conceptual framework. According to them the Indian financial sector was highly institutionalised and was thus much broader in coverage than its counterparts in other countries. It covered organisations both in corporate and non-corporate forms. One of the key features of their framework was that they included corporate segment in the definition of informal credit markets, because opting out the corporate sector from the framework may leave out chit funds from the definition of informal sector. The corporate sector
was included in the framework on the assumption that they were not regulated by RBI and exempted from quite a few clauses of the Companies Act, 1956.

Rajeshkekar (1988) found that those firms registered under Moneylenders Act, excluded from the purview of banking laws because their scale of operation was very small. They were regulated by governmental laws and regulations and not yet by monetary laws, and hence coming under informal credit market definition. These financial firms were supposed to function with less amount of capital but the total capital was invariably big amounts.

Srivastava (1992) stated that informal credit markets referred to the absence of state provided institutional infrastructure to support the organisation of economic activity. Such infrastructure included property rights, contract enforcement mechanisms and allied judicio-administrative apparatus of the state. The informal financial sector operated outside the penumbra of the state machinery. ICM is identified with what the RBI identified as non-institutional credit. Banks and registered NBFI were defined as part of the formal financial sector while the rest of the financial agents are classified as informal credit markets.

3.4 WORKING DEFINITION AND ITS JUSTIFICATION

It is clear from the above that there exists formal and informal financial sector in Indian financial system. It is decisive to use a criterion to make a distinction between formal and informal credit markets in India. Banking operations in the country is controlled and regulated by the RBI. Formal financial sector (controlled and regulated) includes commercial banks (nationalised and scheduled), Postoffice Savings Banks, Provident Funds, Insurance Companies, Development Financial
Institutions, Cooperative Banks etc. The Non-Banking Financial Companies includes Hire Purchase Companies, Equipment Leasing Companies, Loan Companies, Investment Companies, Nidhis, Housing Finance Companies, Chit Funds etc.

Madhur and Nayar (1987) considered NBFCs as formal credit markets because, nonetheless RBI extended its control on such financial agencies, and there was a problem of what constituted ‘direct control’. According to them many of the so-called controls, which appeared on paper, might hardly be exercised or implemented in practice.

Of late lot of changes took place in the field of regulations of non-banking financial companies. This was introduced due to the alarming growth of non-banking activities and to make the Monetary and Credit Policy effective. The scheme of regulation of the deposit acceptance activities of the NBFIs was conceived in the sixties not only as a supplement to the Monetary and Credit and Policy but also to provide an indirect protection to the depositors. Accordingly the RBI was vested with certain powers to effectively supervise, control and regulate the deposit acceptance activities of these institutions. The directions were restricted to liability side and that too, solely to deposit acceptance activities. It did not extend to the asset side of the balancesheet of NBFIs. Several experts and working groups, which examined the functioning of NBFIs, were unanimous about the inadequacy of the legislative framework and recommended for introduction of suitable legislation not only for ensuring sound and healthy functioning of NBFIs but also to safeguard the interests of depositors. Thus prior to Reserve Bank of India (Amendment) Act, 1997, the provisions of Chapter III B of the RBI Act, 1934 was the legislative framework.
used to control NBFIs (NBFCs) and this was aimed only to control the deposit mobilising activities of NBFIs.

Over the years, NBFIs become an important segment in the financial system of the country. Besides there were interpenetration of the markets both by banks and non-banks resulting in erosion of the distinction between these two kinds of institutions. These developments also rendered the existing regulatory framework inadequate to regulate the activities of NBFIs. In the light of these developments the RBI appointed in 1992 a Working Group on financial companies to make an in-depth study of the role of NBFIs and to suggest regulatory and control measures to ensure healthy growth of these companies.

Subsequently, an Ordinance effecting comprehensive changes in the Provisions of Chapters III B and V of the RBI Act was promulgated by the government of India on ninth January 1997 and it was replaced by an Act in March 1997. A new three tier supervisory framework was put in place by the RBI for monitoring the NBFIs. The nature and extend of supervision of NBFIs, prepared in the backdrop of the provisions of the RBI (Amendment) Act, 1997, and the recommendations of the Khanna Committee (1995) would be based on three criteria, viz., (i) The acceptance of public deposits (ii) The size of NBFCs (iii) The type of activity performed. To this end a comprehensive supervisory model on CAMELS (Capital adequacy, Asset quality, Management, Earnings, Liquidity and Systems) was designed. The CAMELS approach re-orientates the on-site-inspection process towards examining intensively the assets of NBFCs, besides their liabilities. (RBI News Letter. Vol. 23 Nov. 15, 1997 No. 21). In the light of these stringent regulatory
framework Non-banking Financial Companies are considered as Formal sector in the conceptual framework.

The Amendment Act inter alia, provides for entry point norm of a minimum Net Owned Fund (NOF) of Rs.25 lakhs, compulsory registration with the RBI, maintenance of certain percentage of liquid assets in the form of unencumbered approved securities. But there were number of firms which are not satisfying the criterion of maintaining or having NOF of Rs.25 lakhs is also coming under the regulation of RBI (they have to achieve this Rs.25 lakhs within three years).

The Mutual Benefit Companies (Nidhis) and miscellaneous non-banking companies were excluded from certain core stipulations of the NOF and other requirements. Nidhi companies are notified under section 620 A of the Companies Act, 1956 and they are under the jurisdiction of the RBI, Government of India (GOI). The Department of Company Affairs, GOI has issued guidelines for the operation of these companies and deployment of their funds. (Report on Trend and Progress of Banking in India, RBI, 1997-98). In the light of these regulations the Mutual Benefit Companies (Nidhis) are considered formal sector in the conceptual framework. Another feature of nidhis is that their operations are restricted to members only.

Chit fund companies are regulated by RBI under miscellaneous non-banking companies (Reserve Bank) directions, 1997 with respect to deposit acceptance. These companies are exempted from the requirement of compulsory registration with RBI. The exemption granted under section 45 IA, 45 IB, and 45 IC of the RBI Act, 1934 are available only to chit fund companies as defined under section 2 (b) of the Central Chit Funds Act, 1982. These companies are exempted from compulsory registration
because they are primarily engaged in conventional chit fund activities and the concerned Registrar of Chit fund would be monitoring their activities.

The Kerala state has not implemented the Central Chit Funds Act, 1982. The Kerala state has its own Chit Fund Act implemented in the year, 1975. According to the Act any chitty conducted by a foreman shall not exceed Rs.25,000. Any number of Rs.25,000 chitty can be conducted by the foreman but the maximum limit is fixed as 50 per cent of the net asset of the foreman. In addition to this, inter alia, the foreman should deposit an amount equal to the chitty amount or invest in government securities and transfer the amount so deposited or the government securities in favour of Registrar of chit funds. All these restrictions forced the chit fund companies which are privately run, to go to the state, Jammu and Kashmir where no chit act has been implemented. And they put a registered branch office there in Jammu and Kashmir (registered as per the Commercial Establishment Act.) and run/start chitties from that branch. As a result the number of chit funds registered with the Registrar of chit funds, Government of Kerala is very less. Even though they have registration with Registrar of Chit Funds, Government of Kerala, it was found that almost all of them had illegal chit fund business and they run chitties according to their whims and fancies. All these firms are considered as informal credit intermediaries.

Government owned companies, scheduled banks, cooperative banks, new banks set up according to the Banking Regulation Act, 1970 are exempted from maximum limit of chitty amount (Rs.25,000) and some other regulations, but registration procedure is the same as that of private corporate and unincorporated bodies. (Part II Sec. (3) (i) of the Kerala Chitty Act, 1975). This sector cannot be considered as informal since their activities are thoroughly evaluated and regulated by
either government or RBI. Government owned companies under Government of Kerala (for. e.g. Kerala State Financial Enterprises (KSFE)) is also controlled by stringent regulations and their activities are thoroughly monitored by the concerned authorities. These institutions are also considered as formal sector units.

Informal credit market in the present study comprises of mainly three major groups: i) Registered Moneylenders - registered under Kerala Moneylenders Act, 1958. These firms are regulated by Kerala Government and not by the RBI. ii) Chit funds firms-in this category there are two kinds of firms. Chit funds registered according to Kerala Chitty Act, 1975 and chit funds registered in outside the state not according to Chitty Act, but according to Commercial Establishment Act. It was found that chitty funds firms registered under Kerala Chit fund Act, 1975 also had obtained registration from outside the state. So chitties run according to Kerala chit fund Act, 1975 is considered formal, since they are thoroughly monitored by government authority (Registrar of chit funds) and all other activities of these firms are considered informal. iii) Third category is the totally unregistered category. This includes individuals (part-time and full-time), running business on cooperative basis and other loosely designed moneylenders. This category may include business people, employees, etc. The unregistered category does moneylending of varied kinds, run chit funds and acts as agents.

3.5 CONCLUSION

Non-regulation by the RBI is the main defining criterion underlying the working definition. But the institutions, which come under RBI regulation, are further divided into different groups, depending upon the intensity of control by the RBI. In
Kerala there are many institutions which run chitty activities. This category also includes Government owned companies, cooperative societies, Banking institutions registered according to Banking Regulation Act, 1970. These institutions are exempted from the purview of informal credit market definition since their activities are controlled and monitored directly by concerned authorities. No informal operations seem to occur since these institutions are directly accountable to the Government. Chitties run according to Kerala Chitty Act, 1975 are considered formal since the Office of the Registrar of Chit Funds closely monitors their activities. And it was also found that the number of private chit funds, which run chitties according to Kerala chit fund Act, were less in number due to the stringent procedures imposed by the Office. And these private chit funds run chitties registered in outside the state of Kerala totally unregulated by any legal authorities. Hence their activities are termed as informal. And all the firms which were registered according to Kerala Moneylender Act, 1958 were also termed as informal. Besides, unregistered moneylenders and chit funds are also considered as informal credit market.