CHAPTER 2

LITERATURE REVIEW

Literature review is comprehensive survey of the published and unpublished work and forms the secondary sources of data for the research work. It is an inalienable part of the research process and makes valuable contribution and helps understand the field of research and growth in the discipline over the years. It brings clarity and focus to the research problem, helps improve methodology, contributes to knowledge base and contextualise findings, acquaints researcher with the methodologies that have been used by others to find answers to questions of similar investigations in the past, methodological differences and similarities to investigate similar problems and gaps. Literature review ensures that the researcher scrutinises wide range of literatures in the subject, which helps identify the gaps and improvement required. It also helps identifying how the findings of the researcher compares with the existing body of knowledge.

The chapter is organized in 6 sections, (i) Introduction, (ii) Financial Dualism, (iii) Theories, (iv) Inter-institutional Linkage and its Impact (v) Inter-institutional linkage and contracts, (vi) Inter-institutional Linkage in India.

2.2 Financial Dualism

The history of banking of the past 200 years suggests that there has been a dual system of financial institutions in the Indian sub-continent. One, there were banking firms set up during the late 18th and early 19th century, which were formal in nature and, two, there existed informal institutions such as indigenous bankers and moneylenders. Thus, the financial system of those days was characterized by coexistence of formal and IFIs. The studies on financial system in modern times would suggest that, formal and informal institutions existed side by side, commonly referred to as financial dualism.
FFIs include, Commercial Banks – Public Sector, Private Sector and Foreign Bank, Development Financial Institutions, Regional Rural Bank and Non-Bank Financial Institutions. In addition, private equity and venture capital firms could also be included in this group, as could be the social lenders and impact investors, whereas, IFIs are defined as the ones which operate at the community or village level. Within the two extremes of formal and informal institutions, there are SFIs, having some overlapping characteristics of both. “The FFIs are organized, institutional and are regulated and caters to the financial needs of modern economy; whereas, SFIs are partly regulated and largely unregulated and the IFIs are unorganized, non-institutional and non-regulated, dealing with the traditional and rural economy” (Pathak, 2007). SFIs could be divided into membership-based Self-Help Organizations (SHOs) and externally funded Non-Governmental Organizations (NGOs). SHOs are indigenous private institutions which finance activities of poor communities with funds mobilized from within the community itself (Wesselink, 1993).

Dualism in the financial eco system emanates from existence of dual mode of economic activity, i.e. primitive (agriculture, animal husbandry, fishing etc.) and modern (industrial or machine-driven activities), famously known as agricultural – industrial complex. Such economies have strong characteristics of both modes of production. The dualism in the economy reflects presence of dualism in society also. Julius Herman Boeke (1953) a dutch economist presented the theory of social dualism, which is “characterized by (i) Social Spirit, (ii) Organizational Form and (iii) Techniques dominating them. Their inter-relationship and inter-dependence are called the social system. A society is homogenous if there is only one social system, but if there are two or more systems, it is a plural society”. Such societies show characteristics of pre-capitalist and post capitalist mode of production. Such societies have advanced imported western system and endogenous pre-agricultural system, alongside one another.

Prof. Benjamin Higgins (Economic Development, 1959) observed that it would not be correct to say that social dualism is prevalent only in underdeveloped societies and is found in the developed societies as well. While discarding the social dualism theory, he develops a theory of
Technological Dualism. He believes that underdeveloped societies “are characterized by structural disequilibrium at the factor level, which is due to a single factor getting different returns for different uses”. Such disequilibrium leads to unemployment by creating imperfection of price system and structure of demand resulting in surplus labor in over populated backward countries. Looking at the Indian economy, Professor Higgins’ findings appear to be appropriate, which is reflected not only in the large unemployment / underemployment and dependence of large number of people on agriculture for sustenance. As at the end of fiscal 2011, while agriculture employed 48.9 percent of the work force, it contributed only 18.4 percent to the GDP, industry employed 12.6 percent but contributed 29.02 percent to the GDP, whereas, services sector employed 38.5 percent and contributes 53.66 percent to the GDP [Indian Labor Market Update, July 2016].

Hala Myint (1984) developed the theory of financial dualism, which states that “financial dualism is caused by division of money markets in unorganized (informal) and organized (formal)”. The organized money market consists of the central bank, the commercial banks, the cooperative societies, the foreign banks, and other financial institutions like agricultural finance corporation, industrial finance corporation, insurance companies, and development banks etc. The unorganized money market includes indigenous bankers, moneylenders, traders, merchants, landlords, friends and relatives, pawnbrokers etc. They are characterized by higher interest, flexible terms in comparison with the one prevalent in organized money market. They charge high interest on lending as, (i) lenders are dominant, while the borrowers are weak, (ii) paucity of savings in the traditional sector as the savings invested in illiquid or less liquid assets such as land or gold, (iii) natural calamities increase the risk in such lending. The high interest rate consists of financial cost (interest) and hidden charges by underpricing the agricultural produce of the farmers, not allowing them to sale their produce at competitive market rate to other purchasers, not allowing them to work on other’s farm land and produce those goods which lender desires them to produce.
Contrary to the above, organized markets have lower financial cost and availability of credit facilities in abundance and loans are extended to modern sectors. According to Myint, “the cheap and easy credit to the traditional sector is not provided because of (a) high overhead cost and salaries of the officials of the commercial banks in rural areas; (b) red-tape in dealing with small borrowers according to the rigid rules of creditworthiness; (c) lack of coordination between the head office and branches; and (d) supply of limited amounts of subsidized loans through cooperative credit societies to some favored parts of the rural sector”.

Soyibo (1996) opined that the informal sector indicates at the failure of the modern market economy to provide jobs and livelihood for large section of people. Such economies consist of the individual and groups left out of development. They struggle to survive; lack entrepreneurial initiatives and it keeps expanding daily as people lose jobs in industry and manufacturing. Growth of industry and modern sectors has been sluggish in many developing economies, though the governments are trying to cope-up with a dual economy to foster economic development. The banking system in large number of developing countries is inadequate to provide services to everyone in their pursuit of economic activities. As a result, economic development is hampered and bulk of the rural and urban people, particularly the poor and the lower middle class are unbanked, and therefore, they resort to getting their financial needs met from the informal sector.

Many studies suggest that a large part of credit in developing countries is controlled by informal sector – money lenders, despite the efforts to channelize credit either via banks or regulated by banks, as poor do not have enough assets to offer as collateral, which is a pre-requisite for bank credit. The Informal credit markets are characterized by – (1) loans on the basis of oral agreements rather than written contracts, with little or no collateral, making default a seemingly attractive option, (2) the credit market is usually segmented, marked by long term exclusive relationships and repeat lending, (3) interest rates are much higher on average than bank interest rates and also show significant dispersion, presenting apparent arbitrage opportunities, (4) there is frequent inter linkages with other
markets, such as land, labor and crop, (5) significant credit rationing, whereby borrowers are unable to borrow all they want or some applicants are unable to borrow at all.

Myint (1984) argues that the reasons for high interest at times is a real shortage of savings in the traditional sector as substantial amount of savings is hoarded in gold and jewelry. Even though risks and costs of lending money to many small borrowers are very high, yet there are other contributing factors arising from imperfections in such unorganized money market. The village shopkeepers, landlords, moneylenders and traders occupy strategic positions in the village economy and create monopoly powers over the peasants, which is because of personal and informal dealings with borrowers, flexibility in loan transactions, and blending of money-lending with other types of activities such as selling of goods. K. Basu (1984) states that “the high rates of interest which the peasants have to pay are not only formal interest charges but also in considerable part, concealed charges obtained through manipulating prices of the commodities which the peasants buy or sell. Concealed charges may take the form of very high prices for goods on credit terms at the local shop or the obligation to repay the landlord the loans advanced with a specified amount of the crop at harvest. On the other hand, in the organized money markets, the interest rates are low and credit facilities are abundant”. Therefore, there is a preference in the market to avail finance from the FFIs, despite, processes being relatively cumbersome.

2.3 Theories of dualism

There are numerous studies worlds over to assess financial inclusion and role of financial institutions. Similarly, there are many theories too that address the financial inclusions and have tried to assess the role of various layers of financial institutions, their history and growth over past decades. The key theories of financial markets are - Neoclassical and Neo Institutional, Political Economy, Economic Sociology and Economic Anthropology, Neo-liberal financial market perspective. These theories do not form a universal view on financial institutions and their views have wide variation depending upon the perspective adopted by the researchers. For
instance, neo-classical / neo institutional school focuses primarily on the institutional aspect, political economy school on political economy of the subject society, economic sociology and economic anthropology on the origin of subject society, money and its various aspects, while the neo-liberal perspective looks at the financial markets as the center point in their studies. Other differentiating factors between various schools of thought are summarized in following sections.

2.3.1 Neoclassical and Neo Institutional School

The prevalence of financial dualism or the segmented character of the financial sector is attributed to different factors, as viewed by various schools of thought. Neoclassical and Neo Institutional School emphasize the role of economic and technical factors. The major argument is that the dualism in the credit market could be due to many factors such as differences in transaction and information costs, and administrative efficiency (Hoff and Stiglitz, 1990; Conning, 1999).

It is understood that the informal or semi-formal sector is considered to have the information about their prospective clients, which formal institutions lack. Due to which, informal sector players do not have much concern for the collateral / security as compared to that with the formal financial institution, for whom collateral / security is best risk mitigation. The FFIs seek collateral / security to make good the lack of information about the rural client. Unawareness of information about the rural client is one of the reasons for bank officials restraining themselves deliver financial services to rural people. Due to which, IFIs, get a market for their lending, which keeps the rural economy in vicious circle of backwardness. These institutions keep the rural market Inter-locked, which ties down the labor, restricts land access or confiscate produce as per the neo classical / neo institutional school, as a useful channel for resolving information asymmetry in credit markets and the problem of collateral, facilitating access to finance in adverse scenario.

Stiglitz and Weiss (1981) have emphasized availability or lack of information and stated that “interest rates play a dual role of sorting
prospective borrowers, leading to adverse selection and influencing the actions of borrowers leading to incentive effects. Both these effects are imperfect information inherent in credit markets. Adverse selection is due to lenders preference for the borrowers, who is most likely to repay loans since the bank’s returns depend on the probability of repayment. To identify borrowers with high probability of repayment, banks use interest rates as a screening device. Despite the interest rate variations, there are borrowers, who are willing to pay high interest rates”. However, such borrowers pose higher risk of default. Thus, with increases in interest rate, the riskiness on such lending also increases, reducing the bank’s profitability.

Stiglitz and Weiss have further observed that “lenders cannot distinguish between borrowers of different degree of risk and that loan contracts are subject to limited liability”. They assume that borrowers repay when they have capacity to pay. In this sense, FFIs have a disadvantageous position vis-à-vis IFIs, which owing to being better informed about the market have option to choose less risky clients. Lenders generally make good of losses by increasing interest rates, some-times selectively and occasionally on the entire pool. Additionally, they exercise their security rights on the collateral and other assets charged to them. When applied to entire pool, there is a tendency of low risk borrowers dropping out of the applicant pool and therefore, higher interest rates increase the average riskiness of the applicant pool.

Moral hazard model illustrates the tradeoff between extraction of rents and provision of incentives to induce a good harvest. Higher interest rates cause the problem of debt overhang. A highly indebted farmer has very little stake in ensuring good harvest, since the large loan repayments leave him with a small portion of returns from the harvest. Therefore, financial institution is not likely to charge interest rates beyond a point. As in the adverse selection theory, the interest rate may not guarantee that all loan applicant would get the credit. Loan contracts in informal sector are rarely explicitly recorded and therefore are not enforceable by courts. Repayments are caused by fear of social sanctions, coercion or threat of violence or confiscation of assets and elimination of access to credit in future. Ohio school argues that “informal financial arrangements, especially
money lenders charge relatively high interest rates because they face high risk of default and lack of legal means of enforcement. Also, the cost of funds in low income countries is necessarily high due to general scarcity of liquidity and the opportunity cost of funds”. However, in India, the moneylenders have been in commanding position and have been able to make recoveries without much difficulty. The moneylenders here, had protection of the mighty landlords or were landlords themselves were moneylenders. They exercised brute force if found their clients delinquent.

In credit rationing, lenders limit the supply of credit to borrowers, even if they are agreeable to bear higher interest cost, challenging the principle of demand and supply determining price at optimum, called equilibrium in the market. Despite their differences in detail, the two theories of credit rationing described above are similar, as both are driven by the positive effects of higher repayment burdens on default risk. Poor due to lack of collateral have limited access to credit.

Similarly, it is largely accepted that the SFIs and IFIs generally charge higher rate of interest, which is attributed to many factors. First, it is considered as an outcome of lender’s monopoly. As sole lenders in some segments, it is possible for certain lenders to charge exorbitant rates. Second, it is considered as an outcome of higher risk perception in the informal sector, where FFIs are not engaged. Therefore, the interest rates deviate as per the riskiness of the debt. In various Asian countries, the rate of interest charged by money lenders has been very high from 60 percent to 200 percent per annum against 12 percent charged by FFIs. There are, however, contrasting evidences from Nigeria, where, informal sector is reported to be charging very low rate of interest. The rates can even be zero, when the lending-borrowing was within close acquaintances. However, interest rates remain hidden in other aspects of transaction like in inter-locking of assets. Thus, explicit interest rates may not always reflect the true cost of borrowing. Finally, higher interest rates are also explained in terms of supply side constraints like informal sectors’ lack of access to deposits and economy wide sources of funding on softer terms. These institutions must depend on FFIs for their resources, which render them costlier. Also, administrative cost is generally very high in respect of these
smaller credits, which is adds upto the interest charged from the end beneficiary.

Absence of strong legal system for enforcement in case of voluntary / strategic default in developing countries is also considered as an important reason for restricted operation of FFIs. In some developing countries, this therefore leads to cooperation among FFIs and IFIs. The SFIs, promise a good blend of availability of resources and information about the local conditions. Hence, they have influenced the financial market to a reasonable extent.

2.3.2 Political Economy School

The Political Economy School highlights the larger social structure within which financial transactions happen. It outlines how social hierarchy based on gender, caste, and ethnicity pervade the financial institutions and exclude many from accessing finance (Bhaduri, 1973; Harriss, 1982; Harriss-White, 1994; Harriss-White and Colatei, 2004). This theory attempts to establish the co-existence of formal and informal institutions and circumstances in which people are compelled to rely on an exploitative informal sector. It also highlights the capitalist interest in the financial market and how corporate and traditional village elites are powerful in the semi-formal and informal market which ensures that poor and marginalized are either exploited or excluded.

2.3.3 Economic sociology and economic anthropology

Studies in economic sociology and economic anthropology focus on the social meaning of money and debt. Some of these explanations go beyond self-centered material interests to the questions of moral and social factors. Compartmentalization of the use of money has been highlighted by Bloch and Parry (1989) and Zelizer (1994). Zelizer has explored the history of money in United States of America. While dealing with the subject, she has attempted to explore issues associated with money, such as gift, charity etcetera in 19th and 20th century America. How charitable societies were created and what compulsions they imposed on recipients of gift and
charity has been dealt in detail by her. David Graeber in his seminal work “Debt: The first 5000 Years” has also explored the origin of money and debt from social perspective. His studies are conducted on a wider canvass, covering nearly every continent, including some of the primitive societies of Africa and Asia. While, Zelizer has largely focused on America, Graeber’s Debt is a pan world study of money and debt. On the one hand, he explores the ancient practices related to money and debt in European Countries on the other hand, he has presented examples from oriental societies including China and India and far away Madagaskar and other African Nations. These perspectives suggest the significance of financial embeddedness and how status, honor, power and social identity dictate many times our choice of debt and lender (Zelizer, 1994; Graeber, 2011). It is a departure from the mainstream thinking wherein formal sector represents transparency, reliability, contracts and long-term association and the informal sector the opposite, i.e. short-term, insecure, and unreliable transactions enmeshed with social relations. It suggests that, based on certain factors, informal sector may be preferred over the formal sector, indicating that the two may not be fitting into a hierarchical system in terms of societal preference.

2.3.4 Liberalized financial market perspective

In developing countries policy makers are searching for alternative delivery mechanism. This new model emphasizes financial market liberalization “moving away from national bank-based systems to open capital markets, which is expected to raise savings and investment, increase the rate of growth and reduce macroeconomic instability”. On the other hand, the role of financial intermediation and inclusion of small entrepreneurs and marginal people have acquired a renewed importance in the financial life of developing economies due to the increased inequity caused by structural adjustment programs. Certain kinds of semi-formal and informal financial intermediaries find a legitimate place in this scheme. Collaboration with informal sector is considered useful and augmentation of formal sector beyond a level may not be desired. In India, many proposals by RBI have reoriented the financial system to more market-based solutions (Verghese, 2005). For instance, RBI introduced a regulation in 2006 allowing banks to provide service at the doorstep using third party services, called
Business Correspondents / Banking correspondents (BC), which could be a representative to provide services such as cash transactions where the banks and financial institutions does not have a branch. Expected benefits to customers include instant access to banking services at the doorsteps.

2.3.5 Beyond Dualism

Irrespective of these varied perspectives on the co-existence of formal and informal sector, access to formal sector finance particularly to the vulnerable sections remains a stated official objective of most developing countries. There is therefore, focus on cooperation among FFIs, SFIs and IFIs, especially in African, Asian and Latin American countries, which at times are spontaneous and on other times market driven or is instituted by deliberate state policy for financial inclusion.

Besley (1994) has stated that “since credit markets are characterized by imperfect information and high cost of contract enforcement, an efficient measure as exists in perfectly competitive market will not be an appropriate measure against which market failure could be defined”. As Stiglitz and Weiss (1981) and Besley (1994) have stated that “the problems of imperfect market lead to credit rationing, adverse selection and moral hazard”. Adverse selection arises because in the absence of perfect information about the borrower, an increase in the interest rates encourages borrower with most risky projects, and hence least likely to repay, to borrow, while those with least risky projects cease to borrow. Interest rates thus play the allocative role of equating demand and supply for loanable funds and will also affect the average quality of lender’s loan portfolio. Lenders will fix the interest rates at lower level and ration the access to credit. Imperfect information is therefore important in explaining the existence of credit rationing in rural credit markets. Moral hazard occurs basically because projects have identical mean return, but different degrees of risk and lenders are unable to discern the borrower’s action.

Besley (1994) also talks about “existence of collateral security and covariant risk”. For him, collateral security some-times is not available with the borrowers, but even where issue is not of the availability of collateral,
the ability of the lender to foreclose a loan has limited choices and options, which renders loan repayment difficult. Such difficulties help to explain the use of informal financial markets, which use social sanctions to ensure enforcement in rural areas. In most rural economies, borrowers are faced with risk arising from the uncertainties about their incomes. By diversifying their loan portfolio, lenders can avert such risks. However, credit markets in rural areas are segmented, with lenders loan portfolios being concentrated on borrowers facing common shocks to their income.

In absence of formal contract enforcement mechanism, both FFIs and IFIs rely on lending practices that emphasize loan screening rather than monitoring, which appears to suggest more concern with adverse selection than moral hazard. Differences emerge in the methods used by formal and informal institutions. While formal institutions rely more on character and history of the borrower, particularly on personal knowledge of the borrower, loan monitoring is rarely done by informal lenders due to lack of facilities. Transaction costs are lower in informal markets than the formal markets.

Aryeetey (1995) argue that “the informal sector derives its dynamism from developments in the formal sector as well as from its own internal characteristics. The informal and formal offer similar products that are not entirely homogenous implying that both sectors cater to the needs of easily identifiable group of individuals and businesses, but at the same time serve sections of the total demand for financial services. However, participants from either sector may cross to the other depending on factors like institutional barriers, availability of credit facilities and the ease of physical access”.

Linkage between formal and informal is complementary. Positive relations exist between them. Knowledge of interaction between the two will provide useful guide to understanding the efficacy of development policies for improving the performance of both the sectors. Without such information, it is possible that the policy targeted at improving the performance of the banking sector may lead to surprising and disappointing outcomes. The omission of the activities of the informal financial sector in the official statistics calls for introspection because the level of economic
development in most developing economies depend on the size of its informal sector.

Oresotu (1996) concluded that the macroeconomic policy environment and informal sector are closely linked and should not be seen in isolation. The link is provided by the activities of the informal financial agents that rely on the loans taken from the formal financial intermediaries to relent to borrowers in the informal financial markets. The informal financial agents render the financial services by financing production activities through the extension of loans to micro enterprises and peasant farmers, who ordinarily are not considered in the scheme by formal sector because of their inability to provide suitable collateral.

Chipeta & Mkanwire (1992) wrote that money lenders, indigenous bankers and cooperative saving societies deposit surplus funds with FFIs. Similarly, customers of FFIs also avail credit from IFIs. This is how inter-institutional linkage is established, which helps in credit control. Accordingly, monetary policies are prepared to ensure resources and credit for the informal financial sector.

2.4 Inter-institutional Linkage & its Impact

Based on the products and services that are offered by the banks, there are twin relationship between the FFIs, SFiS and IFIs. This relationship operates on the credit side and on the deposit side. IFIs such as Money lenders, indigenous bankers and cooperative saving society are known to be depositing surplus funds with FFIs. Similarly, customers of FFIs have lines of credit from IFIs. Both indirect and direct credit and deposit links exist. The indirect credit and deposit linkages are significant. The direct credit links are not so significant, but the direct deposit links with moneylenders are significant (Chipeta and Mkandawire 1992). In Indian context, linkage can be understood in terms of relationship between the Bank and the Client. Clients constitute SHGs, which are formed and financed by banks is an example of direct credit linkage, whereas, SHGs formed by NGOs and formal agencies but financed by banks is an example of indirect linkage.
With the fast-paced changes in the financial sector and wide variety of products on offer, the relationship between the FFIs and IFIs is also witnessing a change. However, under direct financial linkage, the purpose of the linkage is to help less formal institutions diversify its resources base, and manage liquidity. A typical example of this type of linkage is a bank or apex financial institution offering bulk loans to MFIs for on-lending to clients.

The linkage is expected to help financial inclusion in different ways. First, linkage programs are expected to capitalize on the complementarities of the FFIs, SFIs and IFIs. This is expected to enhance the scale and scope of operation greatly. Second, linkage programs can help regulate and control informal sector, which has varying ways to function, and thus different clients are dealt with differently, based on the lender-borrower relationship. State owned agencies in the formal sector can develop contractual arrangements which can ensure that the objectives of financial inclusion are actively pursued. Activities of the informal sector can no more remain hidden and there would be official mandates to make certain details known to the formal sector for accessing funds etc. Finally, as funds and other help from formal sector are extended to the informal sector, it would lead to the entry of new players increasing the competition in financial market, which puts downward pressure on interest rates making it affordable, accessible and easy for the needy.

An attempt was made to analyze the linkages between formal and informal lenders by Bell (1990), who presents his theoretical analysis to understand the impact of financial intermediation in the backdrop of Indian market where state agencies, cooperatives and banks were established to reduce the influence of money lenders way back in 1970s, which marks the beginning of social banking in India. He analyzes how the borrower is affected under four different scenarios, i.e. (i) money lenders operating monopolist; (ii) institutional lenders operating as monopolists, (iii) institutional / formal and non-institutional / informal co-exist as competitors and (iv) the money lenders as agents of formal lenders. Bell explains how, in the case of intermediation, the cost of funds to the money lender will decline. The impact of this on the money lender's clients will depend on whether he is a monopolist or a perfect competitor. If he is a perfect
competitor, the entire gain from the decline in the rate of interest accrues to the borrowers, whereas if he is a monopolist the gain is shared between lender and borrowers. This suggests that the presence of the money lender in the credit market does not necessarily have a negative impact on the borrower and there is scope for intermediation.

However, there are some interesting theoretical works which either qualify or dispute such positive outcomes expected from linkage programs. Hoff and Stiglitz (1996) argue that as more lenders enter the market, borrowers have a larger choice of lenders. This may induce the rate of default as other sources of fund would be easily available. The incentive for the borrower to default is to the extent of amount not paid, its opportunity cost and associated benefits. Thus, linkage may lead to rising costs and not falling costs as expected from competition. The rising costs would be a function of the number of active lenders in the market. This refutes the thesis that competition due to linkage will be beneficial for the borrowers. Take for instance the case of primary agricultural credit societies (PACS), a government sponsored programme, due to incentives accruing due to default, large number of PACS are unviable due to which credit expansion has severely affected the market creating gaps in availability to finances.

Bose (1996) extends Hoff and Stiglitz (1996) argument, which suggests that competition may not sustain itself as credit market is highly heterogeneous in lenders and borrowers. Some lenders have information about borrowers while others lack such information. If the former group of borrowers increases due to competition, it will degrade the mixed group of borrowers further and lending activities of the latter group will be severely constrained. This will lead to shrinkage in overall lending activities instead of an improvement in outreach.

Another dimension of the problem is that instead of competition, there can be strategic cooperation. Credit market is divided into ‘zones of influence’ due to sorting of borrowers as lenders have informational, monitoring and enforcement advantage on group of borrowers. Each lender would have a committed group of borrowers prohibiting free competition and entry barriers (Floro and Yotopoulos, 1991; Ray and Sengupta, 1989).
Under such circumstances, lenders operate under two opposing forces, an incentive to undercut a competitor and at the same time to be prepared to face a credit war as retaliation. Here, linkage programs provide funds which can be used for retaliation if need be. Hence, the potential for strong retaliation at the slightest overture for encroachment of one’s ‘zone of influence’ becomes high with linkage. Thus, lenders collude and honor each other’s domain and do not compete. Hence, the outcome can be far from a competitive outcome favorable to borrowers.

Pagura and Kirsten (2006) argue that instead of enhancing competition subsidized new entrants can force out the established players. Sometimes, exclusive contract requirements within a linkage also prohibit better institutional linkage with others bringing in rigidities in the credit market. There are few empirical studies concentrating on linkage and its impact on the financial markets. In the context of Nigeria, Ojo (1996) has stated that the linkage between the FFIs and IFIs are complimentary and not competitive. Verghese (2005) while summarizing “some studies, both on India and other developing countries stated that the assessment” of the linkage between FFIs, SFIs and IFIs and its impact on pricing indicates that greater the dependence of IFIs on the FFIs for financing, lower was the cost to the end beneficiary. The higher dependence of SFIs and IFIs on the FFIs has led to greater compliance and better responsible finance from the former. Pagura and Kirsten (2006) based on 12 studies from Africa, Asia and Latin America find that financial linkage, while promising, are difficult to establish and manage. The pre-requisite here is the existence of both strong formal and informal institutions.

2.5 Inter-institutional linkage and contracts

Contracts are basic tenants, which defines expectations and conduct of both / all parties to a contract. Indian Contract Act, 1872 defines a contract, as “an agreement enforceable by law”. Hence, those agreements that are not enforceable by law are not contracts. Contracts could be – a Letter of Sanction / Offer, Loan Agreement, Promissory Note, Bill, Hundi etc., which becomes a contract when the proposal is accepted. By implication, an agreement is an accepted proposal. In other words, an agreement
consists of an 'offer' and its 'acceptance'. From the above, it can be inferred that, any contract has two parties to it, i.e. **offerer** (lender / vendor) and **offeree** (borrower / vendee).

The lender enters into a contract with the objectives to (i) set out conditions on compliance of which, it will be obligated to disburse funds, (ii) enable it to monitor the borrower’s financial situation and, when necessary, to take remedial action if the borrower experiences financial difficulties, (iii) provide itself with a legally enforceable claim to its funds, or access to other remedies, if the borrower defaults. Whereas, a borrower’s objectives from the contract is, to (i) ensure funds will be available when needed, (ii) obtain funds at the most advantageous financial terms possible, (iii) provide for the repayment of the loan over a period that will not place an undue burden on it, and (iv) ensure that it can comply with all other terms of the loan agreement (such as financial covenants) in its ordinary course of business.

In Banking, a loan process begins with borrower approaching the lender seeking sanction of certain credit / loan facility to meet its credit requirements. The lender examines the proposal in terms of its own policies, requirements of the borrower, prospects of the borrowed money getting repaid in timely manner etc. Once, lender is satisfied on the above aspects, a term sheet, mandate letter, engagement letter, letter of intent, letter of offer or sanction letter is issued to the borrower indicating the intent / decision of sanction of facilities subject to certain financial / legal covenants.

All the contracts on Indian Geography (except for the regions excluded under relevant Acts / Laws of the Union) are governed by Indian Contract Act 1872 and violation thereof could be referred to the court of law. To understand contract, certain terms viz. offer, acceptance and agreement, consent, consideration and covenant etc. need definition. In the context of present study, the analysis of contracts is done at two levels in chapter 5. (i) Contract between FFIs and MFIs, and (ii) Contracts between MFIs and JLGs / end beneficiary. There are different views on the role of contract in repayment of loans. Formal contracts between FFIs and micro finance institutions are generally adhered to and there are not many reported instances of contract violations.
Looking back in history, it is observed that the shift in financing pattern commenced immediately after the independence of India, the visible impact of which was observed only after the microfinance started providing credit to hitherto financially excluded because of costs for formal banks was very high, and therefore were left to traditional moneylenders and indigenous bankers, who were perceived to be extractive and coercive in their practices. There are varying narratives on collateral by money lenders / indigenous bankers. While, some scholars have observed that money lenders and indigenous bankers did not seek collateral, there are instances which strongly favour that they indeed took collateral in various forms – cattle, piece of land, jewellery and even human capital to secure their money. If literature is true reflection of society, then who can dispute the prevalence on moneylending during the times of Munshi Premchandra, the famous Hindi novelist and story writer of early 20th century. Microfinance removed the traditional notion of collateral for safety of the money lend and did away with coercion for recovery. These institutions dispensed with expensive, often gratuitous, formal procedures and depended on peer monitoring and social capital.

Haldar & Stiglitz have observed that the flexibility of the informal contract is not available to formal financial contracts. The terms of a formal contract are fixed, difficult to change and expensive. Whereas, the flexibility of the informal system allows shocks to be absorbed more readily, which may be witnessed in the success of Group Liability model in the wake of the 1998 floods, when the loan repayments were redrawn without much ado. Such tinkering in the formal contracts are difficult and process in each case is time consuming and expensive. In-built social contracts in the microfinance group liability model of micro finance plays an important role in preventing borrower to abuse this provision and creditor’s taking advantage of a borrower’s weakness.

In microfinance, group lending is used since it is believed that the interdependence between borrowers created by group lending contributes significantly in obtaining high repayment rates. The attributes of group lending, for instance joint liability, is said to mitigate problems created by adverse selection and moral hazards through mechanisms of peer selection
and peer monitoring. The lender can get the benefit of monitoring and screening and still avoid the transaction costs by the mechanisms arising from the use of group lending (Murdoch & Armendariz 2005). “Besides the benefits resulting from the structure of group lending it is also indicated that using the borrowers’ social assets can create possibilities of further enhancing the performance of group lending. This is done partly by letting the group impose so called social sanctions on defaulting fellow group members”. Besley and Coate (1995) argued that the “high repayment in microfinance sector implies that the occurrence of social sanctions can alone improve repayment rates in group lending”. However, when we draw parallel in formal lending, despite a legal framework in place and presence of strong regulatory mechanism, the rate of default is considerably higher. The question arises, is the concept of social capital relevant only for better repayment ratio in microfinance sector? Why social capital has not been able to put effective deterrence against default in banking sector? Despite the presence of an all-encompassing contract, which could be enforced with the help of courts, the repayment here is not as impressive.

Haldar and Stiglitz have observed that “there are two possible reasons for individuals to repay loans. (i) fear of consequences, which could be legal, economic, or social punishment, or (ii) belief that it is right to pay and that, they have been socialized to repay”. The survey of the literature as well as field interviews suggest the reasons behind the success of microfinance high rate of repayment, without the security or legal contracts or collateral. Haldar and Stiglitz suggest that “the dynamic incentives are applicable on both group lending and individual-based lending and it is important to remember that dynamic incentives have been used within the formal bank sector throughout history, although the term is more related to microfinance”. The above explanation has both economic and social aspect to it. It starts as a social aspect and culminates into economic reality. “The client has dynamic incentives, which consists of one threat and one opportunity. The threat is to be cut off from future loans and the opportunity of borrowing increasingly larger amounts and the fear of social boycott” resulting in possible erosion of social capital. Murdoch (1999) finds that the incentives may increase, if borrowers anticipates larger loans with time, if payment obligations are met timely. This model encourages long-term
borrower-lender relationship, unlike in the past where the perceived short-term association to the bank lowered the repayment incentive. The use of dynamic incentives can help the MFIs overcome lack of information problems and improve the efficiency. Both the “threat” and the “opportunity” drive borrowers to form a coherent group. As such dynamic incentives are closely related to both peer selection and peer monitoring. Indeed, some critics of the original microfinance model claim that incentive mechanisms like that of the moneylenders, are prevalent, which uses brute force, intimidation, and threats as recovery tool. A high repayment may be ensured by limiting the outreach, lending to well off and safe projects. Outreach is important to make sure that MFI is reaching to the needy, but microfinance is not designed thus. For instance, homeless is unlikely to be granted a loan, as such person may not have capacity to repay. So, regardless of what MFIs around the world write in their mission statements, microfinance is not designed to reach the poorest of the poor.

An alternative set of explanations of the working of microfinance focuses on “social capital”, which has two different meanings. (i) “implicit contracts” or “social contracts” enforced through a repeated game, where the members of the society (group) have strategies that serve to enforce the desired behaviour. (ii) broader interpretation of social capital sees being connected and maintaining the affection and respect of those with whom one is closely connected, as an essential aspect of advancing one’s own sense of well-being. Social ties, relations and trust among individuals are often being referred to as social capital, which has received increasing attention among researchers the past few years. There seem to be conflicting results in whether the existence of social capital is a great contributor to high repayment rates or not. The study by Ahlin and Townsend (2007) found that strong social ties between group members were negatively correlated with the repayment ability of the group. However, there exist some forms of social capital that promotes social sanctions and these can be useful in group lending, whereas social capital that in some way obstruct the use of social sanctions can lead to negative effects on repayment rates.
Zeller (1998) stresses on a common thread among most NGO based credit organizations is to offer training / courses to their clients and hence they interact with their clients beyond just offering financial services. This is imperative to establish long term commitment and mutual trust, which is beneficial for both the lender and the borrower. The borrower may be less inclined to “take the money and run” if she feels that the lender is willing to help her improve her situation over the long term. At the same time, the lender may be less harsh [in times of difficulties] if they can see that the borrower is really committed to the task. The training covers a broad spectrum of subjects ranging from business topics (e.g. entrepreneurial skills) to more family-oriented issues such as health, education etc.

2.6 Inter-institutional Linkages in India

Money and Credit has been an essential part of human life since time immemorial. David Graeber in his book Debt - The First 5000 Years (2011), traces the history of money and debt in various civilizations of the world. His study traces the emergence of money and debt from ancient barter system to the present highly specialized money and debt instruments. In the Indian Context, reference of money and credit (debt) could be traced back to ancient Vedic literature. It is found in writings of Vasistha, Manu, Kautilya and Buddha. However, debt was not seen by them uniformly. For instance, lending was allowed by Vasistha, Manu and Kautilya. However, Buddha believed that, the debt was not a good. In Manusmriti, paying the interest or lending the money on interest was not a sin. However, lending with unreasonably high rate of interest was considered a minor sin. In writings of Vasistha, a moneylender in order of growth of his capital, charge interest, monthly the eightieth part of a hundred. In Manusmriti, just 2 in hundred, 3, 4 & 5 (and not more) was monthly interest according to the order of the castes (varna), i.e. from Brahmni (2 percent), Kshatriya (3 percent), Vaishya (4 percent) and Sudra (5 percent). Manu also permitted to sue the defaulter in the court of a King, who was free to exercise all means - fair or foul to ensure recovery. Even in death, Manu did not absolve the debtor from his debt and debt was to be paid by the family of the borrower. Kautilya linked the rate of interest to the risk involved and purpose of the loan sought, however, in Kautilya varna system was not
given importance for application of rate of interest. Annual interest chargeable as per the Arthshastra of Kautilya was; 15 percent for non-commercial loans, 60 percent for less risky commercial loans, 120 percent for risky commercial loans and 240 percent for foreign trade. In the writings of Kautilya, concept of sureties was also found, which could have been any one of the blood relatives or acquaintances. In the event of default, such sureties were liable to pay debt.

In the Buddhist era, debt was not considered to be a good thing and Buddha emphasized that being free from loans is one of the greatest happiness for a worldly person. Buddha however says that if a person takes loans and uses in business, which helps him to prosper, loan could be taken. Yet, Buddha believed that ‘generosity’ (dāna), should be exercised by the rich and wealthy people rather than debt to help others. There is not much literature after Buddha till about medieval period (Mughal era) on the idea of money and debt. Mughal empire had a common monetary system and, free movement of goods and a system of land allocation and taxation throughout the empire was prevalent. Moneylending and indigenous banking services provided by certain castes was found all over the empire. The rate of interest varied widely and depended upon the security offered. Repayment normally took place in kind, by labor service or sometimes even by the sale of the debtor’s children and farm produce or other assets. While cultivators got finance from moneylenders of various kinds, indigenous bankers were concerned with the financing of trade, nobles, the state, and later the East India Company. Indigenous bankers were primarily merchant bankers. Commercial interest rates varied considerably according to the place and the usage of the debt.

Though, in the Islamic law, there was prohibition on charging interest, state received finance from “indigenous bankers; treasurers, minters, money changers and financiers”. The population was heavily indebted to the moneylenders and landlords. Historians feel that this was one of the causes of rebellion, which ultimately led to the decline of Mughal empire. Leonard (1979) ascribes decline of Mughal empire to moneylenders and indigenous bankers, “as the rise and maintenance of Mughal empire
required strong central administration and a coalition with strategically important groups and institutions to keep opposing elites, subdued”.

After the arrival of British, a monetized market economy emerged, which was developed on the medieval era financial system. The indigenous banks of this period were multi-purpose enterprises, which did not enjoy state protection or control. Therefore, they were always on a look out for opportunity in any type of business or trade. For example, when the trade in Surat harbor declined for lack of state protection, they engaged themselves in revenue collection or financing other emerging powers, which proved to be the cause for the rise of the company western India (Subramanian, 1987). However, Britishers business acumen guided to free themselves from dependence of indigenous bankers by issuing government bonds and institutionalizing their own banks. This coincided with a step-by-step reduction of the functions of indigenous bankers.

Bank of Hindustan was founded in 1770, which ceased its operation in 1832. General Bank of India was setup in 1786 and it ceased in 1791. Oudh Commercial Bank operated during 1881 to 1958. State Bank of India has its roots in 1806 originally known as Bank of Calcutta. In pre-independence India, there were more than 600 banks. Allahabad Bank (1865), Punjab National Bank (1894), Bank of India (1906), Bank of Baroda (1908), Central Bank of India (1911) are some of the larger and more successful banks setup in later 19th and early 20th century. Bank of Bengal (1806), Bank of Bombay (1840) and Bank of Madras (1843) merged into a single entity and called Imperial Bank of India, which later in 1955 became State Bank of India.

Dhanagare (1991) has concluded that due to increased rural indebtedness, British eventually interfered with money market in late 19th and early 20th century passing legislations on money lenders and usury. Their hesitated due to the “dilemma of depending on money lenders for pre-financing land revenue payments by cultivators, while also fearing” revolt due to increasing indebtedness. Under new laws, registration and licensing of professional money lenders was stipulated. They were now required to have proper account keeping and had to issue receipts for
payments by debtors. These developments culminated into formation of RBI in April 1935, on the recommendations of Hilton Young Commission.

The banking system of this phase was characterized by small size and suffered from high rate of failures, hence, public confidence was low. Therefore, people relied on unorganized sector i.e. money lenders and indigenous bankers of Multanis, Nattukotai Chettiyars, Marwaris, Pathans, Gujarati Shroffs and Kallidaikurichi Brahmins and various rich and dominant social groups. They combined banking with trade, commission agency business and hire-purchase financing. Their dominance is visible in the data published in 1951, which indicates that about 96% of the credit came from unorganized lenders. However, Timberg & Aiyar (1980) have concluded that, with remarkable increase in bank branches and initiatives by RBI and Government of India, there has been formidable decline of informal finance.

The role of money lenders and indigenous bankers has always been mattering of debate. While some call them pro-development, others believe they were regressive and exploitative. However, indigenous Bankers are identified by some as indispensable links in the “money market with neglected sectors of the economy”. Various committees and commissions have suggested integration indigenous bankers into “formal money market”, but “indigenous bankers’ association” has rejected this.

Despite a long tradition of banking and finance, a large section of the rural population continues to reel under poverty and thus is vulnerable. Poverty has many dimensions, which includes lack of availability of productive resources and suitable livelihood opportunities. Hence, credit is recognized as most potent tool for poverty alleviation. However, despite RBI and GoI efforts promotion financial inclusion including the cooperative movement to facilitate credit, access to credit by the poor and needy remains a major concern.

Hence, linkage between FFIs, SFIs and IFIs is being emphasized as a way forward in ensuring financial inclusion. However, the nature, magnitude and impact of these institutional linkages have not been explored much in Indian context. There is reasonable amount of literature on Banks, Financial
Institutions, MFIs / NGOs and Financial Inclusion. Few studies in late 1990s and Early 2000 have been carried out on linkage between the formal, semi-formal and IFIs. However, large numbers of such studies are conducted outside India. Further, the institutional composition of Indian financial system has undergone remarkable changes since Bell published his study on linkage between formal and IFIs in India in early 1990s, after which, most of the work on India focus on Microfinance Institutions / NGOs and issues related with their operation. Such literature generally focuses on the ways funds from Banks / Financial Institutions and Multilateral agencies is generated and contractual linkages are generally not looked at and its impact on financial inclusion not assessed. Thus, it becomes imperative to understand the role played by various players in the financial market and linkages among them. The proposed study would concentrate on this important aspect of the financial sector in the country. It would focus on SRN and Varanasi in Eastern Uttar Pradesh, to explore the subject.

In less developed societies, where population is largely excluded from the financial system, there has been a growing concern from the Governments and Central Banks to integrate the population into it, with the intent to reduce poverty and ensure livelihood. In the process, while certain countries have encouraged informal financial intermediaries amidst some regulation, there are countries, which have prohibited the traditional informal sector from operation. For instance, there have been laws regulating money lenders by various state governments in India and China. Though, later, financial intermediaries were promoted to meet the gap in financial inclusion, which is indicative of a definite linkage between formal and IFIs in the country.

The linkage among financial institutions has undergone change in the above stated phases of development of financial system in the country. While, during the first phase, there was little or no linkage as this phase was marked by absence of SFIs, whereas, informal institutions largely were not supported by the FFIs. The strategy during this phase of the financial planning was to promote cooperative movement and setting up of large number of RRBs and Cooperative Banks. The second phase was marked with emergence of SHGs, at times promoted by Banks themselves. The
SHGs were also promoted by certain Government Agencies as part of the poverty alleviation programs, and on the other hand by Non-Government Players, such as NGOs.

The third phase had greater interaction among FFIs on the one hand and semi-formal and informal institutions on the other. However, the sector was largely unregulated and both SFIs and IFIs operated in the sector without much of interference from the FFIs. With the Andhra Pradesh crisis, the interaction among FFIs and SFIs and IFIs has undergone a sea change. The relationship now is more formalized, and terms of interaction are documented. The roles and responsibilities are well defined, and all the players must function under some regulatory framework provided by the Government / RBI.

In the pre-independence India, which was sparsely urbanized, and its economy was primarily agrarian, almost all the financial needs in the rural India was met by money lenders and indigenous bankers. Though, Reserve Bank of India was promoting the cooperative movement right from the first plan period, the credit to the rural sector through this route was limited. On the eve of first five-year plan in 1951, credit through cooperatives and commercial banks was a meager 4 per cent of the total rural credit. With a view to ensure supply of the credit to rural areas, Agricultural Refinance Corporation was constituted in 1963 followed by nationalization of commercial banks in 1969 and again in 1980. Other important measures taken towards financial inclusion were rapid expansion of the banking network, introduction of lead bank scheme and setting up of RRBs followed by formation of NABARD (Bhatia & Chatterjee, 2010). However, despite these institutional interventions, large section of population continues to be excluded. Finance for all, a World Bank Group Report has summarized the financial inclusion data for all the countries. It has been observed that there is wide variation in financial inclusion data for these countries. On the one hand, there are countries such as Nicaragua and Tanzania (5 percent), Papua New Guinea (8 percent) and Armenia (9 percent), where financial services are available to limited number of people. On the other hand, Countries such as Singapore (98 percent), Luxembourg, Sweden, Denmark and Finland (99 percent) and Netherlands (100 percent) have a high
inclusion. With financial services availability to around forty eight percent of the adult population, India is almost at the middle of the spectrum. Which is far higher compared to Pakistan (12 percent), Bhutan (16 percent), Nepal (20 percent) and Bangladesh (32 percent) but lower than Sri Lanka at 59 percent.

On the further granular analysis of the data on inclusion in India, we would find that large number of banks have presence in urban areas. Rural finance continued to be neglected by Commercial Banks, which is largely left to Regional Rural Banks. The priority sector targets are not met by most Commercial Banks, which result in parking of the target shortfall with RBI / NABARD in the form of priority sector bonds. Clearly, despite the spread of banking facilities, there are concerns that Banks have not been able to serve vast segment of the population, especially the under privileged sections (Bhatia & Chatterjee, 2010). In the above backdrop, RBI in its annual policy statement of 2005-06, for the first time put special focus on financial inclusion. In the said policy statement, RBI encouraged banks which were providing extensive services and disincentives those, which were non-responsive to the banking needs of the community.

The financial inclusion is a comprehensive and holistic process of ensuring access to financial services and credit to vulnerable and marginalized groups in the society. The financial inclusion has been a key factor to ensure inclusive growth, which was a key objective of 11th five-year plan. The 12th five-year plan was a step further in that direction and provided for faster, more inclusive and sustainable growth. It emphasized that “the growth is inclusive when it creates economic opportunities” for people and ensures equal access of productive resources to them. However, objective of inclusion cannot be ensured by the commercial banks / FFIs since looking at the geography and population of the country, no effort appears enough to serve the vast masses. Therefore, a mixed strategy appears a more logical way of integrating the masses into a unified financial system, wherein role of informal institutions such as money lenders and indigenous bankers is equally critical. However, as resources of such institutions are limited, they need a strong and concerted support from the formal sector, hence; linkage is important and critical for financial inclusion.
Linkage is a process, where, two or more entities forge an alliance to share the scares resources in a manner that the resources are utilized in a manner to benefit of large segment of targeted people. In the context of financial resources, on the one hand Government of India has taken several initiatives to reach out to hitherto exclude sections of the society; on the other hand, Reserve Bank of India has been trying to ensure that every citizen is financially served. In last a couple of decades, the number of financial intermediaries has grown and the variety of new instruments to cater to the varied interests of the investing community has increased, hence, understanding the linkage among various institutions assumed importance.

The Task Force (2010) constituted by the GoI has stated that institutional finance includes; (i) banks and other widely held financial institutions, both public and private (ii) state owned financial institutions, and (iii) user owned institutions such as Self-Help groups and their federations, both primary agricultural credit societies and the new generation thrift and credit cooperatives. Thus, institutional agencies include – government, cooperative agencies, commercial banks, including regional rural banks, insurance, provident fund, financial corporation’s / institutions, financial companies and other agencies, whereas, non-institutional agencies include landlord, agriculturist money lenders, professional money lenders, traders, relatives and friends, doctors, lawyers, other professionals (Pradhan, 2012). The empirical evidence suggests that in India though the role of the IFIs has declined over time, but it continues to have a significant presence in the financial sector.

The supply demand constraints of the present financial system have led to the exclusion of more than 11.20 crore rural households from the formal financial system (Report of CFI, 2008). NSSO survey of farm households for 2003 out of 8.93 crore farm households 4.59 crore, which 51.4 percent did not have availability of credit either from institutions or from non-institutional sources. Looking at large unbanked section of the population, there is a need for intermediation. Therefore, microfinance institutions have expanded their outreach and large number of people
especially women have been initiated as beneficiaries of some banking services. Such intervention has been loosely called microfinance, which was defined at the “Microcredit Summit 1997” as "programs that provide credit for self-employment and other financial and business services (including savings and technical assistance) to very poor persons". However, with introduction of deposits, insurance and other financial services, microfinance has assumed a larger role.

Microfinance has now come to be referred to as small-scale financial services provided to people who work in agriculture, fishing and herding; who operate small or micro-enterprises; who provide services; who work for wages or commission; and other individuals and groups at the local levels of developing countries both rural and urban (Robinson, 1996). Clearly, the subject matter of microfinance has been people, largely in unorganized sector with no definite source of income to meet their daily consumption needs / livelihood. As a service delivery mechanism, microfinance is all inclusive activity, which meets the financial needs of the people in a definite geography.

To be effective in service of the people, the NGOs / Microfinance Institutions need huge amount of money, which may come largely from formal financial institutional sources. It is estimated that there are more than 10 thousand microfinance institutions, comprising a wide range of institutional forms - credit unions, cooperatives, non-government organizations (NGOs), government agencies, private companies and commercial banks. However, only about 500 of these MFIs are suitable for investment. These are self-sustaining and have appropriate governance, business processes and accounting standards in place (Microfinance Market Outlook 2014).

The micro finance sector has largely been an unregulated sector in India; hence, authentic data is not available in public domain. However, it has been estimated that at the end of financial year 2014, the outstanding assistance to the sector was around ₹ 24500 crore. With a change in the regulatory framework and the end of uncertain period post the AP Crisis,
the outstanding portfolio is set to grow rapidly (Microfinance Market Outlook 2014).

To serve such a large sector, fund raising is most critical issue for microfinance institutions. Trusts, cooperatives, societies and not-for-profit entities face greater difficulty in resource mobilization. On the contrary, for NBFC-MFIs, the fund mobilization is reasonably easier. In India, not-for-profit MFIs constitute a majority and must depend, largely on donations and grants from Government, NABARD, SIDBI, Donor Agencies and Social Investors / Entrepreneurs etc.

Since, Microfinance Institutions are not banking companies; their sources of fund are also unlike that of banking companies. The funding pattern of MFIs in more mature markets, such as in Latin America and Europe, resembles some similarity with the commercial Banks in India, where Capital, Deposits, Borrowings, Bonds and Stocks are the main sources of funds, which are Deposits from the customers, borrowings from the public-sector banks, bonds and stock market.

Compared to the above, the Indian Micro Finance Institutions have an altogether different funding pattern, which vary also due to their constitution. The Micro Finance Institutions in the country have following types – NBFC-MFIs, Section 8 companies, Trusts and Societies, Coopératives, Partnership Concerns, Limited Liability Company / Partnership. Among the top 25 Micro Finance Institutions, none is Partnership Concerns / LLP / LLC, whereas 9 are NBFC-MFIs, another 9 are Trusts or societies, 4 are section 25 companies and 3 are co-operatives. Based on their constitution and ownership pattern, the capital composition of these entities also varies. NBFC-MFIs generally have large capital base compared to trust, societies and section 25 companies, primarily due to the RBI requirements. Some of such MFIs, which have established suitable system and procedures, can mobilize deposits, whereas, few, which have grown and have ensured regulatory compliance, have now been permitted to raise funds through bonds and the stocks routes. However, large numbers of MFI’s still work on borrowed funds from banks and donation / investments from multi-lateral agencies / social investors.
Traditionally, financing for Indian MFIs has been largely contributed by banks since lending to microfinance Institutions assists banks in building a Priority Sector Lending portfolio which is mandated by regulation to form 40% of banks’ lending. Though funding for Microfinance through Bonds were initiated by organizations such as IFC, Morgan Stanley, Blue Orchard, Standard Chartered Bank to raise money to lend to commercially viable microfinance institutions which offer affordable small loans to the poor.

Many MFI sector experts feel that there is need for deregulation to enable these institutions source cheaper funds from the market. They feel that deposit generation may be permitted to them at par with Banks. However, for Reserve Bank of India deposit mobilization is a complex phenomenon in banking services, for which NBFCs are not prepared. The regulator must ensure that the MFIs not only have requisite paraphernalia to enable it to mobilize the resources but also to ensure safety of the money of the depositors, which could be ensured only, when the MFI has attained certain economies of scale. The intrinsic strength of the MFI should be such that sudden change in market should not render it cash less.

The importance of MFIs borrowing from SCBs and AIFIs is that it permits them to enjoy interest rates and maturities that would be difficult to get from domestic or international commercial lenders. Borrowings from Banks / FIs allow MFIs to reduce liquidity uncertainties. At the same time, the interest rates charged by these sources are clearly positive in real terms. This avoids the creation of serious distortions in the financial system and at the same time prepares MFIs to increasingly access commercial financing.

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