

Alternative ways of managing supply side in microfinance: Study of rrbs, Cooperative societies, Chit Funds and informal lenders

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ABSTRACT: Ideation of Microfinance happened when formal finance failed to make a dent in poverty. But this self-proclaimed panacea for poverty, ‘microfinance’, has also failed in many instances questioning the feasibility of microfinance institutions. Though microfinance is a recent phenomenon in India, there have been many institutions created with the mission of helping poor and alleviating poverty. We look at some of these institutional mechanisms like cooperative societies and Regional Rural Banks that Indian government tried for poverty reduction. Decades of these efforts on poverty reduction has not succeeded well, and informal finance still exists and continues as a major source of support for poor. We would closely look at the aspects which can be adopted widely, hence helping the overall poverty reduction efforts.

Keywords: Cooperative Societies, Informal finance, Microfinance, Microfinance Institutions, Regional Rural Banks

I. INTRODUCTION

Since independence, India has been fighting poverty and has been commissioning various programs to eradicate poverty. Every five year plan, planning commission of India had a mandate of poverty eradication as a major thrust area. Fifth Five year plan had removal of poverty and self-reliance as one of its objective (Planning Commission, 1974), Sixth Five year plan had increase in national income with decrease in poverty and unemployment (India, Planning Commission, 1981), Tenth Five year plan planned reduction of poverty ratio by 5 percentage points (Planning Commission India, 2007).

Poor people have been getting financial help from various sources which can be categorized into formal, semi-formal and informal financing methods. *Informal finance* is defined as contracts or agreements conducted without reference or recourse to the legal system to exchange cash in the present for promises of cash in the future (Schreiner, 2001). Intuitively, we have money lenders, friends, relative, etc. *Formal finance* includes commercial banks which are majorly governed by Government policies for any commercial entity. *Semi-formal* finance does not come under government’s financial system but they are recognized by governments like Cooperative banks, chit funds, MFIs, etc.

Supporting poor in villages have been difficult because of poor infrastructure, sparse population, small transaction sizes and monsoon based agricultural sector, hence Government of India promoted various types of institutions like cooperative societies, regional rural banks, microfinance institutions. The government moved from centralized model to decentralized model – such as cooperatives and groups, which had inherent advantages in serving the poor (Johnson et al., 2006). In this chapter we look at the other forms of microfinance which were initiated by Government long before Microfinance was formally initiated, and also touch upon recent developments like post offices acting as banks and business correspondent model.

II. Primitive framework for poverty reduction

i. Primary Agricultural Cooperative Credit Societies (PACs)

In the early 1900s, the first public sector credit societies were established as PACs. PACs are specialized rural credit institutions based in individual villages or groups of villages.

Cooperative Society Act of 1904 was enacted to enable formation of "agricultural credit cooperatives" in villages in India under Government sponsorship during British rule. Since then, various acts kept the improvements in cooperative societies. The Administrative Reforms act in 1919 transferred the responsibility from Government to individual Provinces. PACs are short-term cooperative credit institutions and are part of a three-tier rural credit cooperative system with PACs at the village level, federated into District Central Cooperative Banks (DCCBs) at the district level, and State Cooperative Banks at the state level. PACs are members of the DCCB which, in turn, are members of the State Cooperative Bank.

ii. Land Development Banks (LDB)

Shortly thereafter, Land Mortgage Banks Act in 1930, the state land mortgage banks were founded, which later became the LDBs. LDBs are cooperative institutions that lend primarily for long-term purposes. In some states, the land development banks lend to farmers through branches of the central land development bank (the unitary system). In other states, primary land development banks are independent credit societies and are federated at the state level.

In 1935, formal recognition of the importance of agricultural lending was recognized with the establishment of the Reserve Bank of India, with a separate agricultural credit department. After independence, the All-India Rural Investment Survey found that only 7.2% of farmers' cash borrowing in 1951-52 was from the formal sector. The objective of the bank is to provide long term credit to cultivators against the mortgage of their lands.

iii. Credit Unions/Credit cooperative societies

Credit unions are defined by Berthoud & Hinton (1989) as being co-operative societies that offer loans to their members out of the pool of savings that are built up by the members themselves. Credit unions are nothing but cooperative societies. Credit Unions are defined as

‘constituted as democratic organizations, controlled by their members based on the principle of one member, one vote’ (Barron, 1992).

Rochdale Society of Equitable Pioneers was the first successful cooperative institution setup in 1844 (Fairbairn, 1994).

Although India inherited a basic network of credit cooperatives from the colonial era as early as 1900, the Reserve Bank of India’s (RBI) first decennial All-India Debt and Investment Survey in 1951 found that 93% of rural households relied on informal finance (Refer Table 1). This finding inspired a strong political commitment to establishing formal sector alternatives to the curb, which was popularly viewed as being exploitative and even ‘evil’ (RBI, 1954). The All India Rural Credit Survey Committee (AIRCSC) after examining the whole issue of rural credit concluded that ‘there was no alternative to the co-operative form in the villages for the promotion of agriculture credit and development (RBI, 1954). Hence, throughout the 1950s and 1960s, the government actively promoted the expansion of cooperatives ‘to provide a positive institutional alternative to the moneylender, something which will compete with him, remove him from the forefront, and put him in his place’ (RBI, 1954, p. 481–482)—or more generally, to enhance the availability of agricultural credit and alleviate rural poverty. In 1958, the National Development Council (NDC) adopted a Resolution on National Policy on Co-operatives. The Government of India has since provided massive financial, technical and administrative support to co-operatives both directly and indirectly through State governments (Dwivedi, 1996 p. 13-14). (Singh, 2000 p. 343) Cooperatives were considered to be better as compared to other institutions as they involved local people and mobilizing resources. All these advantages should have helped co-operatives in improving their competitive position as a business organization vis-à-vis their competitors. However, RBI (1969) stated that cooperatives had short comings and there was a need for them to be strengthened.

iv. Regional Rural Banks (RRBs)

RBI (1969) stated that there were certain black spots indicating short comings in the co-operative credit and added by and large big farmers alone were benefited by co-operatives and small farmers were completely left out of the purview of the co-operatives. The original objective of the RRBs was to bring progress with social justice to the rural poor, who were generally denied access to financial services from rural cooperatives as well as commercial banks (Machiraju, 1999). Puhazhendi &

Jayaraman (1999) state that the purpose of setting up of the RRBs all over the country in 1975 was with the view to provide low cost banking facilities to the weaker sections of the society. RRB was supposed to _combine the local feel and familiarity with rural problems, which the cooperatives possess, and the degree of business organization, ability to mobilize deposits, access to central money market and modernized outlook, which the commercial banks have' (Narasimham Committee, 1975, p.23). The Indian government's rationale was to fulfil a -social banking purpose that commercial banks driven by profitability alone would not consider (Pande, 2007).

The Banking Commission-1972 recommended establishing an alternative institution for rural credit and ultimately Government of India established RRBs. Initially five RRBs were instituted in 1975 in five states in Haryana, West Bengal, Rajasthan, with one each and two in Uttar Pradesh, which were sponsored by different commercial banks with the view to provide low cost banking facilities to the weaker sections of the society (Puhazhendi & Jayaraman, 1999). The Government of India, the concerned State government and sponsor banks own RRBs with the issued capital shared in the proportion of 50 percent, 15 percent and 35 percent, respectively.

III. Phases of Reforms and Mission Drift

The stated rationale for the first set of bank nationalization was to make credit available to weaker sections of the society, remove them from the clutches of money lenders and to increase banking access. In the mid-1970s, India's rural financial system went through another expansionary stage with the establishment of regional rural banks (RRBs) at the district level, farmers' service societies at the village level, and further growth of nonbanking finance companies. Even though the number of bank branches tripled during 1969-79, the government considered rural access to be too low at 37,000 people per rural bank branch; therefore, in 1980 another seven commercial banks were nationalized to extend their outreach in rural areas (AFC, 1988, in Nagarajan & Meyer, 2000, p. 172).

Though the RRBs were intended to be low-cost institutions, a land mark court ruling in the year 1993 granted the staff of RRBs equal pay and perquisites as were available to the staff of commercial banks. This _added to the bank's already escalating costs' (Bhatt & Thorat, p.13) and questions about improving their efficiency through restructuring began to be asked. RRBs underwent various reforms since its inception and have been subjected to many efforts by government to revamp its RRB operations and to make them financially viable.

Narasimhan Committee Report (1991) came out with various options for rehabilitation of RRBs including expansion of investments avenues. In 1996, investment policies for RRBs were made at

par with commercial banks and in 2000 non-resident account deposits were also allowed (RBI, 2013). Between the year 2000 and 2004, loans disbursed by RRBs more than doubled reflecting the efforts taken by the banks to improve credit flow to the rural sector (Misra, 2006). Misra also stated that though this growth in credit when seen in isolation gives an impression of the impressive strides made by RRBs in disbursing credit, they account for a very small proportion (around 3 per cent) of the total assets of the Indian banking sector, despite their significant branch network. The Credit-Deposit (C-D) ratio of RRBs at all-India level has come down from 123 per cent during 1981 to as low as 43 per cent by the triennium ending 2000 as cited in Shah (2007). The decline in C-D ratio of RRBs is mainly due to diversion of substantial portion of their resources in investments instead of lending in rural areas (Shah, 2007). Shivamaggi (2000) adds that the major problem faced by RRBs in India is the lack of staff motivation and specialization despite local recruitment of staff.

Second phase of reforms were from 2004-2010. In this phase amalgamation of RRBs with same sponsor banks were initiated. Amalgamation of RRBs started from September, 2005. This was an initiative by Government of India (GOI) to amalgamate 145 out of 196 RRBs. The Vyas Committee recommended the amalgamation of RRBs into State level institutions as it felt that the process of amalgamation would lead to significant reduction in cost of administration and economies of scale (RBI, 2004). Kumar (2008) has argued against the amalgamation of RRBs stating that it was hurting rural credit and built case for de-amalgamation of RRBs. RRBs were permitted to undertake insurance business, accept Foreign Currency Non Resident deposits and were also allowed to participate in consortium lending with sponsor banks (RBI, 2013). The government tried to help the RRBs with their goal, but the RRBs have proven to be financially unsustainable and inefficient in loan delivery (Bhatt & Thorat, 2001).

The **third phase** of reforms is from 2010 onwards. The branch licensing policy was liberalized which allowed RRBs to open branches in Tier 3 to Tier 6 centres (with population of up to 49,999 as per 2001 Census) without prior approval from the Reserve Bank, subject to certain conditions (RBI, 2010). This policy was further liberalized in August, 2012 to also include Tier 2 centres (RBI, 2012). The second phase of consolidation commenced from October, 2012 with amalgamation of RRBs across sponsor banks within a State.

This was directly reversing the government's objective of RRBs to increase the outreach to the rural poor. The government's reforms were actually made to make RRBs financial viable, and making them commercial. If government allowed the RRBs to invest like commercial banks, they will be improving their financial earnings, but there seems to be no reason for them to serve rural poor as the margins are less and it is risky to lend to poor. Many RRBs are actually achieving better results by

moving away from their mission of serving the poor—either by putting their money into investments and lending to non-poor clients (Mosley, 1996; Rosenberg, 1999). The latter is partly evidenced by a gradual increase in the average loan size and the continued bias against women borrowers (Ghosh, 1998; Kaladhar, 1997). Misra (2006) analysed the RRBs from 1994-2003 and found that investments contribute positively to the financial performance of the profit making RRBs. This clearly showed the mission drifts for RRBs.

As a result, the dependence of the rural poor on informal credit continues to be significant (Machiraju, 1999; World Bank, 1997). Reports on Trend and Progress of Banking in India shows that number of branches of RRBs was only increasing despite the amalgamation that started in 2012. This shows that government initiatives were increasing the branches, but was it serving the purpose of RRBs.

Table 1: The Share of Rural India Debt by Source

	1951	1961	1971	1981	1991	2002
<i>Institutional Agencies</i>	7.2	14.8	29.2	61.2	64	57.1
Government	3.3	5.3	6.7	4	5.7	2.3
Co-op. Society/bank	3.1	9.1	20.1	28.6	18.6	27.3
Commercial bank incl. RRBs	0.8	0.4	2.2	28	29	24.5
Insurance	--	--	0.1	0.3	0.5	0.3
Provident Fund	--	--	0.1	0.3	0.9	0.3
Others institutional agencies*	--	--	--	--	9.3	2.4
<i>Non-Institutional Agencies</i>	92.8	85.2	70.8	38.8	36	42.9
Landlord	1.5	0.9	8.6	4	4	1
Agricultural Moneylender	24.9	45.9	23.1	8.6	6.3	10
Professional Moneylender	44.8	14.9	13.8	8.3	9.4	19.6
Traders and Commission Agents	5.5	7.7	8.7	3.4	7.1	2.6
Relatives and Friends	14.2	6.8	13.8	9	6.7	7.1
Others	1.9	8.9	2.8	4.9	2.5	2.6
<i>Total</i>	100	100	100	100	100	100

*: includes financial corporation/institution, financial company and other institutional agencies.

Note: Percentage share of different credit agencies to the outstanding cash dues of the households as on 30th June.

-- denotes not available.

Source: All India Rural Credit Survey (1954); All India Debt and Investment Survey, Various Issues.

IV. Chit Funds

Chit Fund is an Indian concept of Rotating Savings and Credit Associations (ROSCAs). ROSCAs are famous throughout the world. Indian version of ROSCAs dates to the ancient times when rice was pooled among village women on a rotational basis (Krishnan, 1959; Nayar, 1973; Radhakrishnan, 1975). As per Simcox (1894) origin of chit funds can be tracked 1000 years ago, known as the 'Malabar Kuri' system existed from ancient Dravidian times.

A more general description has been provided by Shirley Ardener as an association formed upon a core of participants who agree to make regular contributions to a fund which is given, in whole or in part, to each contributor in a rotation (Ardener, 1964). ROSCAs provide goods or benefits that are missing or under-provided in the community and are one of the most common informal financial systems found in the developing world (Ardener, 1964; Geertz, 1962)

Economic studies of ROSCAs have stressed the role of informal credit markets in regional economic development, often in comparison with regulated markets (Chu, 1995).

A chit fund can have various chit schemes running for a specified value and duration. These schemes have a specific number of members who contribute a certain amount regularly to the 'pot'. Every month this 'pot' is auctioned and highest bidder wins the 'pot' for that month. The prized subscriber wins the sum of money equal to chit value less the discount and the fixed fee to the foreman/promoter. This means that subscriber pays upfront interest rate (discount) which is distributed among rest of members as 'dividend' and in the subsequent month; the required contribution is brought down by the amount of dividend. There can be many variations to this method depending on the type of chit fund. The discount paid by the winner is like an interest on any loan paid up front.

The chit fund works on principle of accepting deposits and disbursing the credit. In this mechanism there are no surplus funds to be loaned out except when foreman mixes chit business and money lending operations. Hence the capital requirement of chit fund is less.

There are about 30000 chit operators in whole of India through their District & State Associations having a turnover of nearly 30,000 crores per annum, **but do not represent the unregistered sector, which is almost 100 times the size of our industry (All India Association of Chit Funds (AIACF), 2012).** A number of chit funds in India are registered as companies, partnerships, and sole proprietorships under the All-India Chit Funds Act 1982 or the state acts (Rutherford & Arora, 1997). The state's rationale for regulating them is to increase the security of the members' contributions and to reduce the incidence of defaults. As such, organizers are required to have licenses and make security deposits with the Register of Chit Funds; the cost of collecting the pot

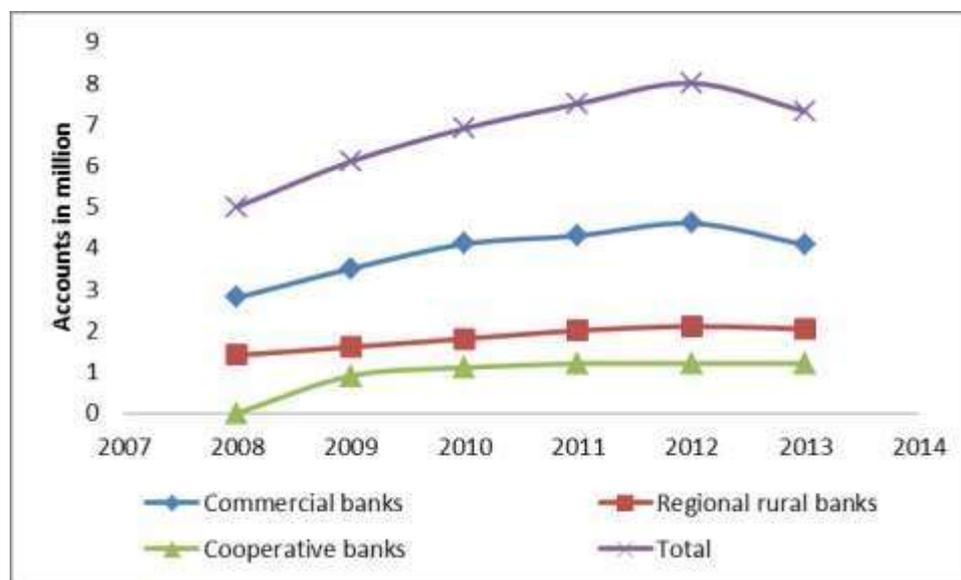
(i.e., the de facto interest rate) is capped at 30% of the size of the pot; and chit funds are limited to a maximum of 60 months (Ghate et al., 1992, p. 197). The chit fund comes with a limitation of non-availability to all; chit pot is awarded to only one person at a time which makes it difficult for it become widely available.

V. Existence of informal finance:

Banerjee and Duflo (2007) document that 95 percent of all borrowers living below \$2 a day in Hyderabad, India access informal sources even when banks are present. A Rural Finance Access Survey 2003, conducted by the World Bank and National Council of Applied Economic Research (NCAER), revealed that 79 per cent of the rural households had no access to credit from formal sources (Basu, 2005).

In case of Thailand, Siamwalla et al (1990) find that approximately 75 per cent of those active in the credit market used the informal sector, even after the rapid government-sponsored expansion of rural credit via the BAAC (Bank for Agriculture and Agricultural Cooperatives). Figure 1 shows that despite such a push from government for formal sector, SHGs did not increase the number of savings accounts held with banks. This clearly shows that the efforts were not yielding results.

Figure1: Number of SHGs holding Savings Accounts 2008-2013



Source: Adapted from *Microfinance India State of Sector Report 2012* by Puhazhendhi (2012)

There are many evidences of borrowers who have been borrowing from both formal and informal sectors. There are many borrowers who simultaneously borrow from formal and informal sectors (Kochar, 1997) in rural north India. Bell et al. (1997) report similar participation in both sectors in their study of the north Indian state of Punjab. Das-Gupta et al. (1989) provide evidence from Delhi, India where 70 percent of all borrowers get credit from both sectors at the same time. There seems to

be much interest from borrowers to go for informal finance even after the presence of formal finance options.

However, we have that percentage of non-institutional lenders going down from 92.8 in 1951 to 42.9 in 2002. (Refer Table 1).

But in more recent times it has increased from 36% to 42.9% from 1991 to 2002. A state wise analysis from All India Debt and Investment Survey shows that 15 out of 20 major states have shown increase in the borrowing from informal sources **Error! Reference source not found.**
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Lot of literature study argues that Microfinance can adopt many things from informal finance (Ardener & Burman, 1995; Bouman 1995; Burkett, 1988; Caskey, 1994; Christen 1989; Graham 1992; Von Pischke 1992). A study of credit rationing in rural India confirms that this is due to the combination of limited access to formal credit and continuing high demand for such credit (Swain, 2002). Informal finance offers flexibility and convenience (Sanderatne, 2003). Adding custom tailored financial products (Baydas, et al., 1995), and low transaction costs (Kochar, 1997; Udry, 1990) make it indispensable. Roe (1979) and Timberg & Aiyar (1980) held the view that informal credit markets provided valuable services that were not adequately met by modern financial corporations. Bouman (1999) asserted that informal credit markets responded quickly to short term financing opportunities, and allowed low income people access to service, not available to them elsewhere.

Siamwalla et al (1990) concluded that only the injection of funds into rural areas will not lower the interest rates or drive out informal lenders out of business.

Nayar (1992) describes four major types of informal finance in India and identifies their strengths. It is argued that informal finance is often conducted more efficiently than formal finance in terms of loan processing, the ability to make small and short term loans, and effective loan recovery.

Meyer & Nagarajan (1992) call -benign neglect to be followed for informal finance because any effort to regulate informal finance will only add cost to government and do no good to poor. A large economics literature has also argued that informal institutions have a comparative advantage in monitoring (the peer monitoring view as in Stiglitz (1990) and Arnott & Stiglitz (1991)) and enforcement capacity. Pawnbrokers, village corner shops, grocery shops etc. offer quick loans. The coexistence of formal and informal finance has not received as much attention as recent theoretical work on microfinance (Banerjee et al., 1994, Ghatak & Guinnane, 1999).

Table V-1: Summary of Informal Financing

Interpersonal lending – loans extended among friends, relatives, neighbours or colleagues	Financial authorities do not interfere with casual, interest free lending
Trade Credit	Trade credit, forward sales
Moneylenders, loan sharks – loans from professional and non-professional money brokers, typically at high interest rates	Mahajan and Chettiar bankers – Some are registered as finance companies, trusts, banks and partnership firms
Rotating Savings and credit organizations (ROSCAs) – indigenously organized savings and credit groups	Chit funds – registered as finance companies, partnership and sole proprietorship.
Pawnshops – extend collateralized loans with interest	Legal if licensed
Indigenous banks, money houses, finance companies – mobilizes savings and extend collateralized loans	Deal with short term credit (hundis) combined with trade for financing trade – committees have made efforts to formalize them
Social organizations, mutual benefit funds – registered entities that are supposed to serve lower income populations	Nidhi companies, mutual benefit societies, permanent funds (mainly Tamil Nadu) – committees have recommended that they be regulated more stringently

Report of the Technical Group to Review Legislations on Money Lending (RBI, 2006) states reasons for dependence on money lenders:

- Limited outreach of formal credit institutions
- Banks do not like to deal with marginal farmers
- Moneylenders do business at –doorstepll and respect privacy
- They lend for consumption purposes without hesitation
- Inadequate and delayed credit from formal sector

VI. Conclusions:

Government had pursued many initiatives for helping poor like launching new programs, institutions, etc. Indian government also helped this institution in their goals but in turn they

made them to drift from their mission of helping poor. Microfinance was brought in to help poor because the formal finance had not achieved the expectation from government. But Microfinance was also termed as failure after AP crisis hit the sector. After discussing many forms of alternative ways of financing, we have seen that dependence of informal sector has not been removed. 100 years of government efforts has not put an end to informal financing. Government needs to introspect as to why money lenders, chit funds, pawn brokers and other informal finance continue to exist. Tsai (2005) state that RRBs have not performed, banks have been saddled with soft loans to priority sectors and cooperatives have been slave to political patronage. The existence of informal sector could be because of various reasons, and might provide pointers to how any organization strive to help the poor organize themselves. Money lenders are available 24/7 and the transaction remains private. In addition they have flexibility in terms of loan amount, term and repayment. Poor is willing to pay very high interest for this. RRBs, Cooperatives and MFIs should try to emulate the best practices of informal finance. Microfinance should set up their offices in similar locations where pawn shops are set and should be serving on weekends and evenings when most of the borrowers are likely to visit (Schreiner, 2001). These initiatives though difficult can make miracles to the poor and free them from clutches of exorbitant interest rates of money lenders.

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