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LEVERAGING EVIDENCE FOR ACCESS AND DEVELOPMENT

Expensive but Worthwhile: Resolute Informal Financier Markets

Twice the price, half the trouble

The financial needs of the rural Indian population are still largely met by informal sources. Our in-depth study of rural markets in Tamil Nadu shows that people are willing to pay more than twice the price that formal credit sources demand to informal financiers[1]. **We find that financiers set an average annualized interest rate of 54%, whereas Microfinance Institutions in the same area levy 25% in interest fees.** Yet almost a third of loans are taken through this channel, despite explicit efforts at increased financial inclusion in these areas. To put this into perspective, the average monthly household income in our sample is Rs. 10,000; so for a standard loan of the same amount, people in our study areas are willing to pay an additional third of a monthly income in fees (Rs. 3,000).

To understand why rural populations opt for higher interest rates on credit from informal sources, and in an effort to study the informal money lending market in the rural districts of Ariyalur, Thanjavur, and Pudukottai in the state of Tamil Nadu in southern India, Evidence for Policy Design (EPoD) researchers from Harvard and Duke Universities, in partnership with IFMR LEAD conducted a pilot survey on financiers. While there is significant qualitative and anecdotal research on informal markets in India, this is the first-of- its-kind quantitative data set that compiles information on financier operations and their client relationships. The data used for these results was collected during a pilot survey of 124 financiers in these districts between May 2015 and July 2015.

Box 1: Expensive, but worthwhile?

Flourishing of Informal Financiers: Despite high penetration (60-80%) by formal finance institutions in rural Tamil Nadu, informal financiers continue to thrive. Over 50% of the loan portfolio of households is made up of informal loans.

High Pricing vs Flexible Loan Terms: Although informal loans from financiers bear higher interest rates, they offer convenient terms of repayment that are unmatched by formal sources.

Different avenues of investment: Formal and informal loans serve different purposes, the former being primarily used for business and farming inputs, and the latter for day-to-day consumption smoothing.

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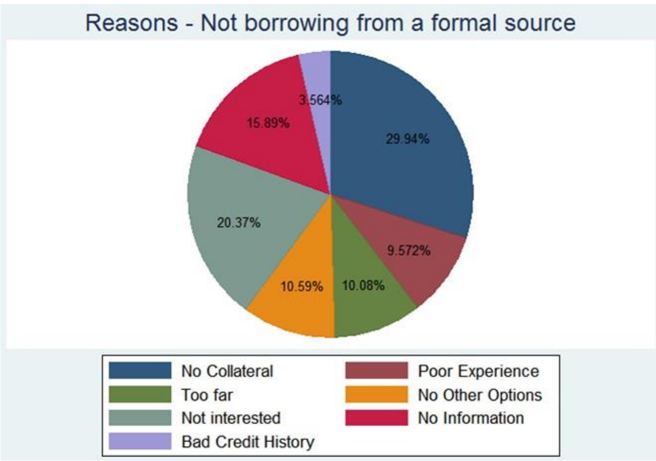
[1] We define financiers as individuals whose only profession is money-lending. They are not necessarily from the local community, and are known to travel large distances to disburse loans/ collect payments on a daily basis.

Sustained Informal Markets

Households are heavily indebted – 80% of our sample reporting a current outstanding loan above Rs. 2,000 – so access to credit is not the problem. Survey data from households in our study areas, with an average total of four loans per household, reveal that as many as 27% of all outstanding and repaid loans are from financiers and moneylenders[2].

Figure 1



Moreover, over 50% of the loan portfolio (number of loans) of the average household is made up of informal loans. Most households who rely upon financier loans do not complement them with formal credit. Of all the households who reported at least one financier loan, only 13% of them reported having at least one loan from an NGO/MFI; the rest of their loans are all from other informal options (e.g. moneylenders, pawn brokers, etc.).

This data sheds light on why financiers succeed in rural areas in spite of high penetration (60-80%) by State- sponsored financial tools and large-scale Microfinance Institutions. There are aspects of the informal financier market that cater to the unique financial demands of rural India (that are currently unmet by formal channels). These informal-market characteristics explain the continued dependence upon informal financial channels, and highlight certain shortcomings of formal banking that are hampering efforts at financial inclusion.

[2] We define moneylenders as wealthier members of the local community who lend money to fellow villagers etc. This is not their primary profession.

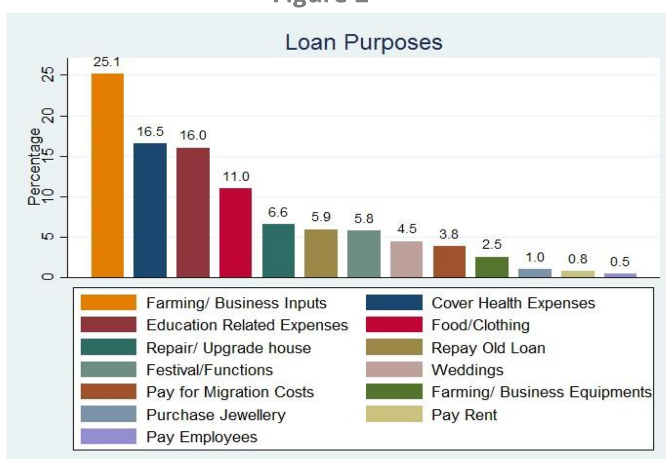
I. Different Avenues of Investment

Formal and informal loans provide very different avenues of investment; the former being used for business and farming inputs, and the latter for day-to- day consumption smoothing. The financial needs of the rural Indian population, which are largely not for investment, are still met by informal sources. This hints towards the reasons informal markets thrive.

Financiers stated that clients used their loans for farming/business inputs (25%), to cover health (16%) and education (16%) related expenses (Figure 2).Many use financier loans to pay for food/clothing (11%) and daily consumption smoothing. Their clients seek cash flow.

When posed the same question, household answers confirm this trend even more strongly. 41% of financier loans were spent on food and clothing, and 22% of all informal non-financier loans were used for general farming expenses and inputs. If a client cannot borrow from one financier for some purpose, they will simply turn to another financier – one informal source for another

Figure 2



As well, 94% of financiers observe confidentiality and do not share client details with other financiers in the market.

How can NGOs, NBFCs, and Corporations tailor their products and services to cater to these unmet demands of the poor? In recognizing that the majority of India's rural population depends on seasonal, agricultural, or unorganized-sector wages, where consumption- smoothing is the priority and such loans are needed and valued. Until products and KYC assessments become more flexible to meet these needs, the rural poor will continue to be reliant on informal markets.

II. Convenience Compensates Interest Rates

Informal loans from financiers have higher interest rates, but they compensate for this by offering convenient terms of a loan, which is unmatched by formal sources.

Table 1: Terms of financier loans

N=372	Principal Amount (Rs):	Loan Duration: (days)	Effective Interest Rate: (Annualized)
Mean	8985.73	93.57	0.54

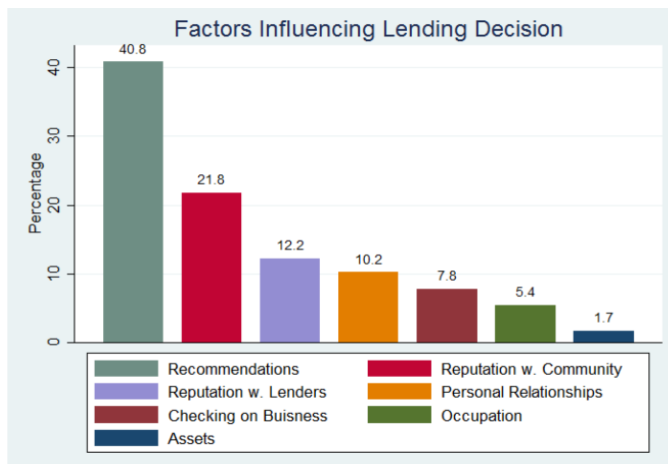
When a financier is requested for a loan, the average turnaround time is a maximum of 4-5 days (high-frequency customers can expect funds on the same day), and 98% of the time there is no demand for any type of collateral. Financier loans are usually for a period of about 100 days, and repayment is collected in-person by them either daily or weekly, at the borrower's doorstep. If needed, financiers are also flexible in repayments and often allow an end-grace-period without consequence. In a milieu of low-income households, this insurance mechanism is indispensable. The personal trust and social pressure that comes from these relationships also prevent default.

What gives way for this imbalance between formal and informal operations? **From a policy perspective, how can formal sources match this level of convenience and incentive, while not compromising their focus on profit- making pursuits?** Our data suggests that innovations in implementation such as incorporating a door-to-door service, digitizing KYC norms for faster approvals, can to some degree match the types of services while pursuing economies of scale to keep costs low. The use of new technology and the government's JAM trilogy for example, is crucial; however, offering simple-to- understand products to build trust and demonstrate cost benefits from formal finance is equally important.

III. Social Cohesion & Collateral

Social collateral works through different mechanisms in formal and informal sources. This difference translates more successful repayment and lending cycles with informal sources.

Figure 3



People do not trust formal sources as much as they trust financiers. **Figure 1** illustrates the main reasons cited by households for not taking out any loan from a formal source. Our data is consistent with macro-level data purporting that the lack of documentation and the inflexible identification requirements are among the top reasons that rural populations abstain from formal institutions, instead seeking informal sources to meet their financial needs. With 98% of financier loans not requiring any collateral, financiers compensate for their monitoring and functioning costs by synthesizing their own social capital. **Figure 3** highlights that "recommendations from trusted sources" and "client's reputation in the community and with other lenders" and "personal relationship with the client" are the defining factors while establishing a relationship between a financier and a client.

Later, when deciding the principal loan amount to grant, all financiers agree that "personal knowledge of the client" is important to their decision. Whereas in a Self-Help Group or a ROSCA, the social collateral within and among group members is tantamount and can make or break the group's financial success, financiers invest in creating social capital on an individual basis.

So, rather than tying people within a group to depend on each other's financial responsibility, a financier uses information about individual reputation and social capital as a mechanism to prevent default, offsetting the risk of no collateral.

In a policy context, how might formal sources leverage a different model of social collateral to gain reassurance and offset the lack of collateral and documentation about a particular rural customer?

Alternative credit scoring models using psychometric approaches or wider data-sharing agreements between institutions e.g. between mobile operators to use alternative data sources (with the individual's consent) could make up for some of the limitations here and should be encouraged. One should not forget, however, that the "reputation collateral" of financiers also excludes certain groups that are socially disconnected, so simple replication of the informal model might not be desirable.

Bridging the (In)formal Market Gap

As part of the goals of poverty alleviation, financial inclusion has come to occupy center stage in India's development and growth strategy. A large part of India's population remains without access to formal financial services, and instead largely turn to informal banking solutions. In this scene, financiers are omnipresent in the rural Indian landscape, distinct from and in addition to moneylenders.

There are several factors that make financiers such an appealing financial option – including their flexible repayment structures, the close and frequent proximity to them, their high but not exorbitantly exploitative interest rates, and many others. Ultimately, they are in a greater position to cater specifically to their clientele – whose requirements are volatile and dynamic, this leads to loan terms that are demand-driven in rural populations. Of note, this policy brief highlights the need for a dynamic and adaptive view of social collateral in making formal banking more successful and reliable in rural areas.

It is of course true that formal sources are occupying an increasingly large proportion of the financial inclusion space in this context, but a look into why informal lenders are still thriving can allude to the "gap" that formal establishments must still seek to fill to expand and deepen their role in alleviating poverty.

This policy brief reinforces the essential idea that lifting poor households out of poverty through financial inclusion entails far more than just offering products, being physically present and innovating complex products. The poor still use informal sources for money. They do not "resort to" informal means, but rather seek them out deliberately.

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