CHAPTER 9

Credit in the Financial System

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In Class VIII, you read about money and different kinds of accounts in a bank. You may be aware that people borrow money from various sources like friends, relatives, money lenders, banks etc. Agricultural labourers usually borrow money from their employers and work for less than market wages. Different kinds of credit arrangements are an important component of the financial system of a country and play a crucial role. In this chapter, we will read about the different aspects of the credit system.

Bank deposits as money

Modern forms of money include currency - paper notes, coins and bank deposits. You read about them in Class VIII.

Banks accept deposits and also pay an amount as interest on the deposits. In this way, people's money is safe with the banks and also earns an interest. People have the right to withdraw the money as and when they require. Since the deposits in the bank accounts can be withdrawn on demand, these deposits are called demand deposits.

Demand deposits offer another interesting facility. It is this facility which lends it the essential characteristics of money (that of a medium of exchange). You have read of payments being made by cheques or by electronic means instead of cash. Since one can withdraw money in cash or make payments by cheque, it makes these deposits work like any other form of money such as currency notes. Since demand deposits are accepted widely as a means of payment, along with currency, they constitute money in the modern economy.

You must remember the role that the banks play here. But for the banks, there would be no demand deposits and no payments by cheques against these deposits. The modern forms of money - currency and deposits - are closely linked to the working of the modern banking system.

- Why are demand deposits considered as money?
- Are the deposits kept at the bank also insured by the government? Find out the details.
- Do you think that fixed deposits that people keep with banks would easily work like money? Discuss.

This entire system is supervised by the government's Reserve Bank of India so that the promise made by the banks to honour withdrawals in cash or payment by cheque is always kept. The government has to ensure that people's trust in the money kept with the banks in the form of demand deposits or as fixed deposits is always maintained and their money is available for use and accepted by all. The Reserve Bank issues guidelines for this system and examines its working so that people's trust is maintained. Similarly, the government has to ensure that the supply of notes and coins is in adequate amount and in good condition, so that people don't face problems in the currency being used.

Loan Activities of banks

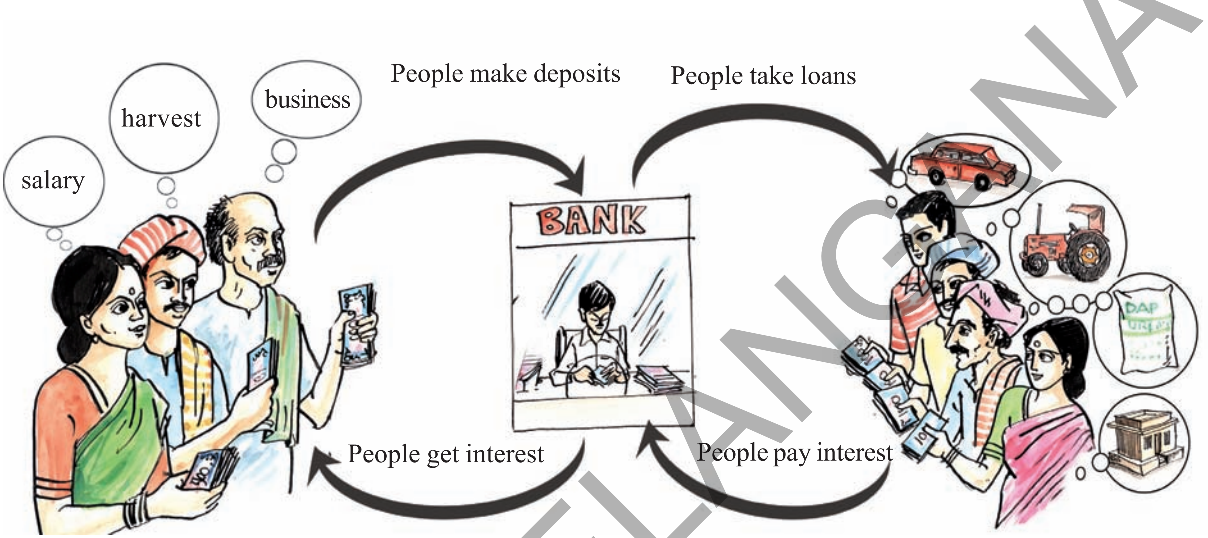

Fig 9.1 : Circular flow of money - through a bank

What do the banks do with the deposits which they accept from the public? There is an interesting mechanism at work here. Banks keep only a small proportion of their deposits as cash with themselves. For example, banks in India these days hold about 15 percent of their deposits as cash. This is kept as provision to pay the depositors who might come to withdraw money from the bank on any given day. Since, on any particular day, only some of its many depositors come to withdraw cash, the bank is able to manage with this cash. This is how banking started because banks all over the world found that they could keep their promise of paying cash on demand by keeping only a small fraction of the money in cash.

Banks use the major portion of the deposits to extend loans. There is a huge demand for loans for various economic activities. We shall read more about this in the following sections. Banks make use of the deposits to meet the loan requirements of the people. In this way, banks mediate between those who have surplus funds (the depositors) and those who are in need of these funds (the borrowers). Banks charge a higher interest rate on loans than what they offer on deposits. The difference between what is charged from borrowers and what is paid to depositors is the primary source of income for banks.

- What would happen if all the depositors went and asked for their money at the same time?
- Talk to someone who has taken a bank loan. What was the purpose and how did he/she approach the bank?
- Interview a bank manager. What are the different loans that they have given? Are there any activities for which they would not give loans?
- Apart from banks people keep deposits in other institutions such as housing societies, companies, post office schemes etc. Discuss how is that different from bank deposits?

Why people require credit

Compared to the past, people's need for credit has increased. This may be due to a variety of reasons. In agricultural practices, earlier most of the inputs were supplied by the farmers themselves. They used their own cattle for ploughing and took help from family members for sowing seeds and manuring their farms. The new farming practices require substantial amount of cash in hand – to buy seeds, fertiliser, pesticides etc. and to pay for ploughing, threshing, harvesting and hired workers.

The increased availability of consumer goods in the market and arrangements for finance has also increased the variety of credit arrangements. We get a variety of goods – ranging from essential food grains to utensils, home appliances and furniture etc, on credit now a days. Manufacturers and sellers of these goods encourage people, particularly those with regular monthly incomes and having bank accounts, to buy on credit and pay in monthly installments. For example, if you purchase a television for Rs.20,000, you can pay Rs.5000 initially and pay the rest every month over one or two years. People also borrow money to make the payment of school/ college fees and for health services. One of the major reasons for indebtedness is the need to borrow for medical requirements.

As business and trade increases, people's requirement of loans also increases. A substantial part of a business is financed by borrowings from various sources. The idea is to earn more than what they have to pay as interest. How does this work? We would examine this through the examples given below.

Two Different Credit Scenarios

It is festive season two months from now and the shoe manufacturer, Anil, has received an order from a big trader in town for 3,000 pairs of shoes to be delivered in a month's time. To complete the production on time, Anil has to hire a few more workers for stitching and pasting work. He has to purchase the raw materials. To meet these expenses, Anil obtains loans from two sources. First, he asks the leather supplier to supply leather now and promises to pay him later. Second, he obtains a loan in cash from the trader as advance payment for 1000 pairs of shoes with a promise to deliver the whole order by the end of the month.

At the end of the month, Anil is able to deliver the order, make a good profit, and repay the money that he had borrowed.

A large number of transactions in our day-to-day activities involve credit in some form or the other. Credit (loan) refers to an agreement in which the lender supplies the borrower with money, goods or services in return for the promise of future payment. Ali borrows money on credit to meet the need for working capital for production. The credit helps him to meet the ongoing expenses of production, complete the production on time, and thereby increases his earnings. Credit therefore plays a vital and positive role in this situation.

Swapna, a small farmer, grows groundnut on her 3 acres of land. She takes a loan from the moneylender to meet the expenses of cultivation, hoping that her harvest would help repay the loan. Midway through the season, the crop is hit by pests and the crop fails. Though Swapna sprays her crops with expensive pesticides, it makes little difference. She is unable to repay the money to lender and the debt grows over the year into a large amount. Next year, Swapna takes a fresh loan for cultivation. It is a normal crop this year. But the earnings are not enough to cover the old loan. She is still caught in debt. She has to sell a part of the land to pay off the debt.

In the rural areas, the main demand for credit is for crop production. Crop production involves considerable costs of seeds, fertilizers, pesticides, water, electricity, repair of equipments, etc. There is a minimum span of three to four months between the time when the farmers buy these inputs and when they sell the crop. Farmers usually take crop loans at the beginning of the season and repay the loan after harvest. Repayment of the loan is crucially dependent on how good the crop was and subsequently, the income generated from farming.

In Swapna's case, the failure of the crop made loan

- Fill the following table:

	Ali	Swapna
Why did they need credit?		
What was the risk?		
What was the outcome?		

- Supposing, Ali continues to get orders from traders. What would be his position after 6 years?
- What are the reasons that make Swapna's situation so risky? Discuss the following factors: pesticides, role of moneylenders and climate.

repayment impossible. She had to sell part of the land to repay the loan. Instead of being helpful for Swapna to improve her earnings, the credit left her worse off. This is an example of what is commonly called debt-trap. Credit in this case pushes the borrower into a situation from which recovery is very painful.

In one situation, credit helps to increase earnings and therefore, Anil is better off than before. In another situation, because of the crop failure, credit pushes Swapna into a debt trap. She is clearly in a trouble some situation than before. Whether credit would be useful or not, therefore, depends on the risks in the situation and if there is some support in case of loss.

- People also require credit for consumption and to manage many socio-cultural situations. Marriages require a huge expenditure on both bride and groom's side which compel families to borrow. Do you think there are other reasons for people borrowing money in your area? Find out from your parents and teachers and discuss in the class.

Terms of Credit

Every loan agreement specifies an interest rate which the borrower must pay to the lender along with the repayment of the principal. In addition, lenders may demand collateral (security) against loans. If the borrower fails to repay the loan, the lender has the right to sell the asset or collateral to obtain payment. Property such as land titles, bank deposits, gold are some common examples of collateral used for borrowing.

Collateral

Collateral is an asset that the borrower owns (such as land, building, vehicle, livestock, bank deposits) and uses this as a guarantee to a lender until the loan is repaid.

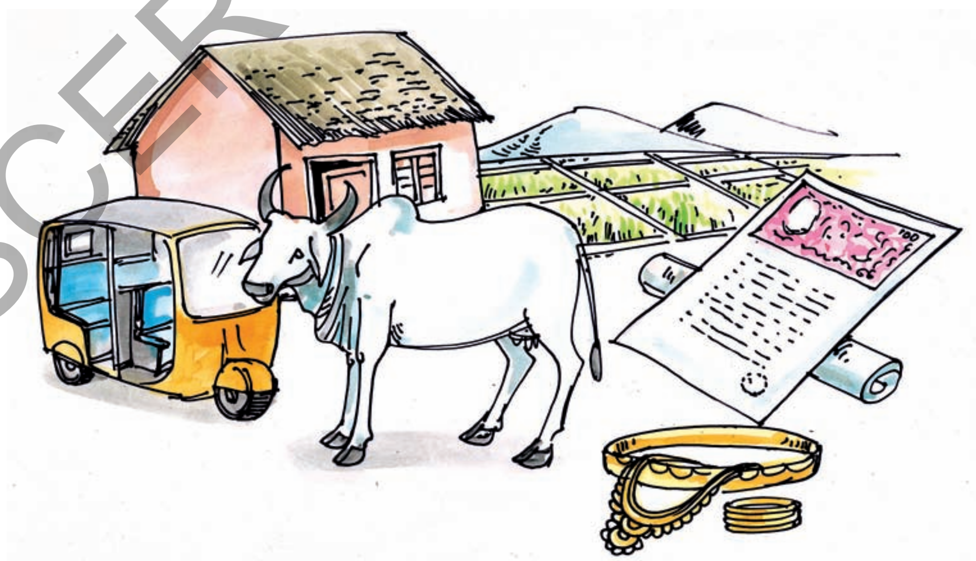

Fig 9.2 An immovable or movable property as collateral

Sivakami, a teacher has taken a loan of Rs. 5 lakhs from a bank to purchase a house. The annual interest rate on the loan is 12% and the loan is to be repaid in 10 years in monthly instalments. She had to submit the documents showing her employment records and salary before the bank agreed to give her the loan. The bank retained the papers of the new house as collateral, which will be returned to Sivakami only when she repays the entire loan with interest.

Interest rate, collateral and documentation requirement and the mode of repayment together comprise of what is called the terms of credit. The terms of credit vary substantially from one credit arrangement to another. Depending on the nature of the lender and the borrower, the terms of credit vary. The next section will provide examples of the varying terms of credit in different credit arrangements.

- Why do lenders ask for collateral while lending?
- How does the demand for collateral affect a poor person's capacity to borrow?
- Fill in the blanks choosing the correct option from the brackets:

  While taking a loan, borrowers look for easy terms of credit. This means ______ (low/high) interest rate, ______ (easy/tough) conditions for repayment, ______ (less/more) collateral and documentation requirements.

Variety of Credit Arrangements: Example of a Village

Vasu is a small farmer and he needs loans for cultivation on his 1.5 acres of land. For the last few years, he has been borrowing from an agricultural trader in the village at an interest rate of 3% per month i.e 36 % per year. At the beginning of the cropping season, the trader supplies the farm inputs on credit, which is to be repaid when the crops are ready for harvest.

Besides the interest charged on the loan, the trader also makes the farmers promise to sell the crop to him. In this way, the trader can ensure that the money is repaid promptly. Also, since the crop prices are low after the harvest, the trader is able to make a profit by buying the crop at a low price from the farmers and then selling it later when the price has risen.

Arun is a farmer and has 7 acres of land. He is one of the few persons to receive a bank loan for cultivation. The interest rate on the loan is 10% per annum and can be repaid anytime within 3 years. Arun plans to repay the loan after harvest by selling a part of the crop. He then intends to store the rest of the crop in a ware house in the nearby town and apply for a fresh loan from the bank against the cold storage receipt. The bank offers this facility to farmers who have taken crop loan from them.

- List the different sources of credit in the above examples.
- Underline the various uses of credit in the above passages.
- Can everyone get credit at a cheap rate? If not, we can?
- Tick the correct option(s):

(a) Over the years, Rama's debt
- will rise.
- will remain constant.
- will decline.

(b) Arun is one of the few persons to take a bank loan. One reason for this is
- He is an educated person.
- Banks demand collateral which everyone cannot provide.
- Interest rate on bank loans is the same as the interest rate charged by the traders.
- There is no documentation work required for getting bank loan

- Talk to a few people to find out the credit arrangements that exist in your area. Record your conversation with them. Are there any differences of opinion in the terms of credit?

Rama is an agricultural labour working in a neighbouring field. There are several months in the year when Rama has no work and needs credit to meet the daily expenses. Expenses on sudden illnesses or functions in the family are also met through loans. Rama has to depend on her employer, a landowner, for credit. The landowner charges an interest rate of 5% per month. Rama repays the money by working for the landowner. Most of the time, Rama has to take a fresh loan before the previous loan has been repaid. At present, she owes the landowner Rs. 5,000. Though the landowner does not treat her well, she continues to work for him since she can get loans from him when in need. Rama tells us that the only source of credit for the landless people is the landowner-employers.

- Fill the following details for Sivakami, Arun, Rama and Vasu.

Particulars	Sivakami	Arun	Rama	Vasu
Loan Amount (in Rupees)				
Duration of loan				
Documents required				
Interest rate				
Mode of repayment				
Collateral				

Formal and informal sources of credit in India

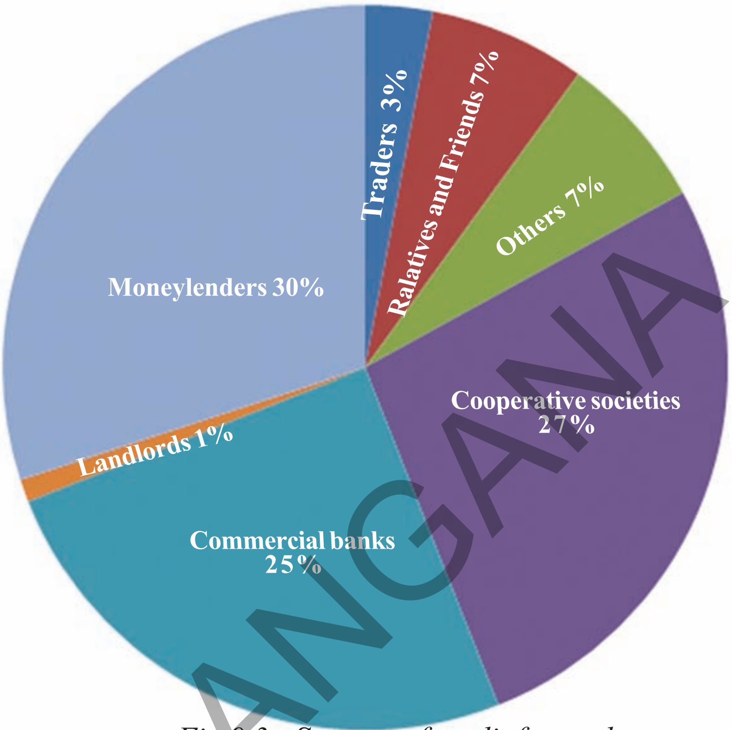

Fig 9.3 : Sources of credit for rual Households in India in 2003

In the above examples, we saw that people obtain loans from various sources. The various types of loans can be conveniently grouped as formal and informal loans. Among the formal loans, the loans are from banks and cooperatives, the informal loans include loans from money lenders, traders, employers, relatives and friends etc. In the pie-chart, you can see the various sources of credit to rural households in India. Out of every 100 rupee credit required by rural families, Rs.25 was available from commercial banks. Besides banks, the other major source of cheap credit in rural areas is the cooperative societies (or cooperatives). There are several types of cooperatives such as farmers' cooperatives, weavers' cooperatives etc. You will also notice that money lenders are an important section of informal credit providers in India.

From the data given above (fig. 9.3) complete the following table and discuss the changes that one can observe from 1961 till date.

Credit Sources	Source of credit (in %)			
	1961	1971	1981	2003
Cooperatives and Commercial banks	10.3	24.4	58.6	?
Government and other formal sources	5.5	7.3	4.6	?
Total of formal organisations	?	?	?	?
Moneylenders	62.0	36.1	16.1	?
Traders	7.2	8.4	3.1	?
Landlords	7.6	8.6	4.0	?
Relatives and friends	6.4	13.1	11.2	?
Other sources	0.8	2.1	2.4	?
Total of informal organisations	?	?	?	?
Total percentage	100.0	100.0	100.0	100.0

New Initiatives

The RBI has been taking steps for improving the financial access to people in rural areas. Banks operate in rural areas either through branches or through Business Correspondents (BCs). A Business Correspondent is an approved bank agent providing basic banking services using a Micro ATM (terminal). These Business Correspondents encourage people in rural and remote areas to open bank accounts, save money and also use loan facilities provided by the banks. Bio-metric smart card identification systems are used to open these accounts.

Aadhaar Enabled Payment System (AEPS) :

- *AEPS* is a new payment service offered by the National Payments Corporation of India (NPCI) to banks, financial institutions using 'Aadhaar' number and online UIDAI authentication through their respective Business Correspondent service centres.
- The customer needs his/her bank account linked to their Aadhaar number with the bank offering the AEPS service.
- A customer can at present avail the following four services using *AEPS* through the micro-ATMs at BCs:
  a. Cash Withdrawal
  b. Cash Deposit
  c. Balance Enquiry
  d. Fund Transfer

The RBI ensures that the banks give loans not just to profit-making businesses and traders but also to small cultivators, small scale industries, to small borrowers etc. Besides RBI, National Bank for Agricultural and Rural Development (NABARD) is another organisation that facilitates formal credit organisations in rural India.

Even though the amount of bank loans given for agriculture have been increasing in recent years, a considerable section of farmers still do not have access to bank credit. In 2011, there were 14 crore farmers in India. Out of this, only about 5.3 crore farmers had agricultural loan accounts. This means that more than two-third of farmers do not have access to bank loan facilities. These nearly 9 crore farmers have to rely on informal sources of credit such as money lenders and traders. They charge exorbitant rates of interest as you have seen in the earlier examples.

Formal and Informal Credit: Who gets what?

There is no organization that monitors and regulates the credit activities of lenders in the informal sector. They are able to lend at whatever interest rate they can force upon the people.

There are some major differences between the way formal and informal credit providers operate in India. The formal credit providers follow certain rules and regulations framed by government and in particular, the RBI, and they also expect their clients also to follow certain procedures. However, informal credit providers do not follow such government rules and they evolve their own procedures. Formal credit providers also have to match certain expectations of government which is not required for the informal credit providers. When the borrower is unable to repay as per the agreed terms, formal credit providers cannot use any illegal ways to get back the credit, where as informal credit providers use many coercive and illegal ways of getting the money back which at times leads to borrowers committing suicides.

Compared to the formal lenders, most of the informal lenders charge a much higher rate of interest on loans. This means that the cost to the borrower of informal loans is much higher. Although many states have laws to protect its people from informal credit providers such as money lenders from charging a high interest rate, these laws are not sufficient to make the money lenders charge low interest rates but are yet to be enforced effectively.

Higher cost of borrowing means a larger part of the earnings of the borrowers is used to repay the loan. Hence, borrowers have less income left for themselves. In certain cases, the high interest rate of borrowing can mean that the amount to be repaid is greater than the income of the borrower. This could lead to increasing debt. Infact people who might wish to start an enterprise by borrowing may not do so because of the high cost of borrowing.

For these reasons, banks and cooperative societies need to lend more. This would lead to higher incomes because many people could then borrow cheaply for a variety of different needs. They could grow crops, do business, set up small-scale industries etc. They could set up new industries or engage in business activity. Cheap and affordable credit for all is crucial for the country's development.

The rich households are availing cheap credit from formal lenders whereas the poor households have to pay a heavy price for borrowing from informal sources.

- The following table shows how urban families borrow from two sources in 2003 (in percentage). Read the table carefully and fill in the blanks in the passage given.

Description of the Borrower Households	Formal Credit (in %)	Informal Credit (in %)	Total Credit (in %)
Poor Households	15	85	100
Households with few assets	47	53	100
Well-off Households	72	28	100
Rich Households	90	10	100

Source: India's Debit and Investment Survey-2003 by N.S.S.O. conducted Report No.501, Dec 2005.

The table above shows the share of formal and informal sources for people living in urban areas. The people include both rich and poor households. You can see that .....per cent of the credit needs of the poor households are met from informal sources. Formal sources of credit account for only .....per cent. Compare this with the rich households. What do you find? Only ......percent of their loans are from informal sources, while ..... per cent is from formal sources. You would find a similar pattern in rural areas.

What do all these suggest? First, the formal sector still meets only about half of the total credit needs of the rural people. The remaining credit needs are met through the informal sources. Most of the loans from the informal lenders have very high interest rates and do little to increase the income of the borrowers. Thus, it is necessary that banks and cooperatives increase their lending, particularly in the rural area, so that the dependence on informal sources of credit reduces.

Second, while formal sector loans need to expand, it is also necessary that everyone receives these loans. At present, it is the richer households who receive formal credit whereas the poor have to depend on the informal sources. It is important that the formal credit is distributed more equally so that the poor can benefit from the cheaper loans.

- What are the differences between formal and informal sources of credit?
- Why should credit at reasonable rates be available for all?
- Should there be a supervisor such as the Reserve Bank of India that looks into the loan activities of informal lenders? Why would its task be quite difficult?
- Do you think that the low share of formal sector credit for poorer households has been one of the factors for farmer distress in our country? Discuss.

Self-Help Groups for the Poor

In the previous section, we read that poor households are still dependent on informal sources of credit. Getting a loan from a bank is much more difficult than taking a loan from informal sources.

Bank loans require proper documents and collateral. Absence of collateral is one of the major reasons which prevents the poor from getting bank loans. They have a few assets to keep as collateral. Informal lenders such as the moneylenders, on the other hand, know the borrowers personally and hence are often willing to give a loan without collateral. The borrowers can, if necessary, approach the moneylenders even without repaying their earlier loans. However, the moneylenders charge very high rates of interest and do not reveal the terms of the transactions and harass the poor borrowers. They also have ways of linking this credit to buying the produce at a cheap rate or forcing them to provide labour.

In recent years, government and Non Government Organisations (NGOs) have tried out some new ways of providing loans to the poor. The idea is to organise rural poor, in particular women, into small Self Help Groups (SHGs) and pool (collect) their savings. A typical SHG has 15-20 members, usually belonging to one neighbourhood, who meet and save regularly. Saving per member varies from Rs. 25 to Rs. 100 or more, depending on the ability of the people to save. Members can take small loans from the group itself to meet their needs. The group charges interest on these loans but this is still less than what the moneylender charges.

After a year or two, if the group is regular in savings, the group is eligible for loan from the bank. This bank linkage enhances the loan amount available to all the members. Loan is sanctioned in the name of the group and it ensures that the loans are paid back. The trust and pressure among the members makes this possible. Important decisions regarding the savings and loan activities are taken by the group members. The group decides the terms of credit. Also, the group members are jointly responsible for the repayment of the loan. Any case of non-repayment of loans by any one member, it is followed up seriously by other members in the group. Because of this feature, banks are willing to lend to the poor women when organised in SHGs, even though they have no collateral as such.

Collateral usually kept by banks is not necessary. These loans are meant to create self-employment opportunities for the members. For instance, members take small loans for releasing mortgaged land, for meeting working capital needs (e.g. buying seeds, fertilizers, raw materials like bamboo and cloth), for buying housing materials, for acquiring assets like sewing machine, handlooms,cattle etc.

Moreover, SHGs are the building blocks of organisation of the rural and urban poor. Not only do women become financially self-reliant, the regular meetings of the group provide a platform to discuss and act on a variety of social issues such as health, nutrition, domestic violence, etc.

- How is a loan to an SHG member different from an individual loan by a bank?
- Some SHG groups charge very high interest rates for loans to its members? Is this fair? Discuss.
- Find out: What is the role of a federation of SHG groups?

Financial Literacy

Financial Literacy is the process of equipping oneself with knowledge and information on financial matters. Taking interest in financial literacy helps one to have better financial planning, puts them in a better position to achieve their financial goals and protect onself from frauds and debt traps. It aims to inculcate savings habits, improve the understanding of financial products leading to effective use of financial services and thus helps is better money management. Further, financial literacy facilitates easy access to financial services.

Financial literacy material is available on the website of Reserve Bank of India (www.rbi.org.in). The financial literacy material available now covers subjects such as features of genuine bank notes, know your Reserve Bank, how RBI touches the life of the common person, caution against emails/ sms offering huge sums of money from abroad, caution against providing bank account details on internet, information of loan products available from banks, why save with banks?, grievance redressal mechanism, Banking Ombudsman Scheme, caution against depositing money in un-incorporated bodies/ un-licensed entities, Deposit Insurance (Are my deposits safe in banks?, What is Deposit Insurance and Credit Guarantee Corporation) etc. Financial literacy information is available in brochures/ pamphlets prepared by RBI and other banks. Further, RBI has developed comics on financial literacy subjects for the benefit of the school children. 'Raju and the Money Tree', 'Money Kumar and Monitory Policy' etc. are the names of the comics that can be downloaded from the RBI website mentioned above. In addition to the above, for the benefit of illiterate persons in rural, urban and remote areas, State Level Bankers Committee (SLBC), Combined Andhra Pradesh has prepared an audio CD on the benefits of saving with banks.

Financial Literacy is an important adjunct for promoting financial inclusion, consumer protection and ultimately, financial stability. Financial inclusion and financial literacy need to go hand in hand to enable the common man to understand the need and benefits of the products and services offered by formal financial institutions. In India, the need for financial literacy is even greater considering the low levels of literacy and the large section of the population that are still out of the formal financial set-up. Financial literacy has assumed greater importance in recent years as financial markets have become increasingly complex and the common man finds it very difficult to make informed decisions. Further, in view of higher percentage of household savings in our country, financial literacy can play a significant role in the efficient allocation of household savings and the ability of individuals to meet their financial goals.

Keywords

1. Demand deposits
2. Economic activities
3. Cooperative societies
4. Commercial banks
5. Informal sources of credit

Improve your learning

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1. Most of the credit needs of the poor households are met through informal sources. The dependence of richer households on informal credit is less. Do you agree? Use the data given on page 114 to support your answer.
2. How are the high interest rates on loans harmful?
3. What is the basic idea behind the SHGs for the poor? Explain.
4. Talk to a banker and find out the different purposes for which people in urban areas generally take loans?
5. What is the difference between bank loans taken directly and through SHG?
6. Read paragraph 3 under the heading 'Self Helf Group for the Poor' and answer the question: How are SHGs working in your area?
7. What are the services rendered by the banks in fulfilling the needs of farmers?

Project

Has there been any incident of farmers committing suicide in your area? If so, find out the reasons and make a report, discuss in the classroom by adding a few newspaper clippings related to this issue.