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Sectoral credit choice in rural India

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A B S T R A C T

This article examines the question, what makes a rural household a preferred choice for formal lenders? A sample selected ordered probit model is developed to address this question. While the selection equation models the determinants of access to credit, an ordered probit model is used to determine the factors affecting the choice of credit sources in hierarchical order. Using household data from six Indian states, this study finds corroborative evidence that relatively resource-rich households, even while staying at distant locations, enjoy greater access to formal creditors. It also identifies a new factor, i.e., interlinked credit, as a significant variable influencing access to formal credit.
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1. Introduction

Recognizing the importance of the agrarian economy in India's overall macroeconomic framework, significant policy initiatives have been undertaken since the British colonial period to reduce the existing imperfections in the rural credit market. Essentially, the government's rural credit policy emphasizes two approaches. One approach seeks to augment credit flow to rural sectors – both farm and non-farm – by expanding outlets of formal financial institutions. These institutions include public or private sector scheduled commercial banks[1] (SCB), regional rural banks[2] (RRB), and cooperative banks.[3] The second approach seeks to provide credit at more favorable terms, through rural credit planning, adoption of region-specific strategies, rationalization of lending procedures, reducing interest rates, and even providing different interest rates for the poor. Furthermore, the government has tried to rein in the operations of informal lenders, namely moneylenders. These legislations require one to obtain a license to run a money-lending business, impose ceilings on interest rates, and

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[1] Scheduled commercial banks (SCB) are comprised of those banks registered under the second schedule of India's central bank, i.e., the Reserve Bank of India's Act, 1934. They include both public and privately owned banks. Their operation is mostly spread over multiple districts and even across states.

[2] Regional rural banks (RRB) came into existence in 1975 with the main goal of catering to rural clients. Operation of RRBs is limited to a few districts. RRBs are jointly owned by the Indian government, the respective state government, and a sponsor bank, which is either an SCB or a state cooperative bank.

[3] Cooperative banks are financial institutions where owners are the customers. Primary agricultural cooperative societies (PACS) are localized units owned by local people sharing a common interest. PACS are involved in only deposit mobilization and lending activity. In cases where the cooperatives are also engaged in non-financial activities – such as selling of agricultural input, running consumer stores, trading of agricultural output, etc. – they are known as multi-purpose cooperative societies (MPACS). Others are district central cooperative banks (DCCB) and state cooperative banks.

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Table 1A
Categories of households according to credit sources.

Source of loan			Category of household
Formal	Semi-formal	Informal	
Yes	Yes	Yes	Loan outstanding with all three credit sources
Yes	Yes	No	Loan outstanding with formal and semi-formal sources
Yes	No	Yes	Loan outstanding with formal and informal sources
No	Yes	Yes	Loan outstanding with semi-formal and informal sources
Yes	No	No	Loan outstanding with a formal source only
No	Yes	No	Loan outstanding with a semi-formal source only
No	No	Yes	Loan outstanding with an informal source only
No	No	No	Without any credit facility

ensure transparency in operation. In spite of the conventional wisdom that, along with concessional pricing, broadening the formal credit delivery mechanism is capable of reducing rural households' dependence on informal credit channels (see for example Beck et al., 2007), increasing evidence suggests that the formal channel of credit is yet to make a serious dent in the domain of its informal counterpart. The World Bank's Rural Finance Access Survey (Basu, 2006) indicates that only 21 percent of rural borrower households are indebted to formal financial institutions in India.

Several explanations regarding the limited credit from the formal financial sector to rural households have surfaced in the literature. Starting with the contribution by Stiglitz and Weiss (1981), a growing body of literature highlights that fear of *adverse selection* and *moral hazard* leads to supply-side quantity rationing. Others attribute the poor coverage of rural borrowers to the formal lenders' lack of personal knowledge about the characteristics and activities of the target group, as well as their inability to monitor the loan.

Here, we build our analysis based on a number of stylized observations. First, as compared to lenders from the formal sector, the interest rates charged by informal lenders (e.g., moneylenders, commission agents, traders, and input dealers) are usually high (Sarap, 1990; Ghate, 2007; Pal, 2012). Second, formal credit is offered at a subsidized rate, which is often below the market-clearing price (Ghosh et al., 2001). However, despite these two facts, borrowers may actually bear higher transaction costs for formal lending, in terms of travel expenses for the repetitive visits, opportunity cost of wage loss, and even bribes to negotiate a loan (Mahajan and Ramola, 1996; Guirkinger, 2008). The applicant may therefore be *transaction cost-rationed* from formal financial sources to account for such added expenditure over that of the nominal interest rate (Guirkinger and Boucher, 2008). Third, in a closely-knit agrarian economy, the informal lenders' close proximity to the borrowers can obviate the need for marketable collateral (Boucher and Guirkinger, 2007), while formal sector creditors primarily resort to collateral-backed finance or ask for a suitable third party guaranty to ensure timely repayment (Hoff and Stiglitz, 1990; Mohieldin and Wright, 2000; Barslund and Tarp, 2008). The inability to arrange for either of the collaterals often keeps poor people out of the banking purview, in spite of feasible and promising investment ideas that could turn into profitable initiatives (Basu, 2006). Thus, the benefit of subsidized formal credit remains restricted within the resource-rich rural households. Fourth, even if credit is available from formal sources, it remains restricted for only production activities, neglecting substantial demand for consumption loans in a poor agrarian economy (Fisher and Sriram, 2002, p.40; Yadav et al., 1992).

This unequal access to credit opened the door for the evolution of the semi-formal sector, popularly known as micro-finance (Hassan, 2008). This includes self-help groups[4] (SHGs), linked with banks and cooperatives, as well as private microfinance institutions[5] (MFI). Microfinance lenders are clearly distinct from both the formal banking sector and the informal sector, as they extend loans to poor clients primarily based on a group guarantee in which an individual member stands as guarantor for other group members (Besley and Coate, 1995). The principle of joint liability in the form of peer monitoring and peer pressure ensures timely repayment of the loan, thus waiving the need for marketable collateral when negotiating a loan contract (Stiglitz, 1990; Johnston and Morduch, 2008).

For a scientific and empirical analysis of credit delivery in rural economies, one needs to undertake a micro-level study to identify the distinguishing characteristics of rural households. Such an analysis would be useful for understanding the reasons a group of borrowers approaches one type of credit institution instead of another. The analysis can also help in restructuring the rural credit policy for better impact. Given this backdrop, the study presented in this paper attempts to identify the factors determining rural households' choice of formal credit sources over both semi-formal and informal credit sources in India. The results suggest that formal lenders favor an agricultural household, possessing a minimum of two hectares of land and capable of offering marketable collateral, even staying at a distant location. Interestingly, we find that

[4] Self-help groups (SHG) are groups of about 20 poor people, belonging to common socioeconomic strata. They initially come together to save and use the corpus for internal lending within the group members. Usually after six months of saving, SHGs may approach banks or cooperatives asking for credit facility.

[5] Microfinance institutions (MFI) are financial intermediaries between self-help groups and the banks. They form groups of financially challenged people and extend credit facility to those groups after sourcing loan from donors, investors, or commercial banks.

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