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Business Logistics of Informal Lending

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Abstract

We at Small Enterprise Finance Center have been interacting with SMEs across India for quite some time and very often we hear Credit being the biggest hurdle for their growth; if not the availability, the interest rates. There is ample evidence that many small businesses use loans from private informal moneylenders for their business purposes despite the rapid growth of Indian banking sector and SME friendly credit policies.

There have been many attempts to find out the cost of capital for moneylenders and margins made by them compared to the formal financial sector. Most of these had been based on interactions with borrowers than with the moneylenders themselves due to their low visibility and unwillingness to reveal details about their businesses.

The aim of this research paper is to know how moneylenders are organized, how they do the business, and effects of changing legal environment on them.

Instead of taking the already treaded path of interacting with borrowers to know about moneylenders, we directly interacted with moneylenders to get first hand information and a peek into their operational set up etc. This also helped us to know the moneylenders' side of story and constraints they face instead of already known issues faced by borrowers. We used our personal contacts to get access to the moneylenders in small towns and also interacted with pawn brokers and other finance providers in metro city.

We interacted with 11 moneylenders from 3 small towns of Maharashtra and our findings are mainly derived from the responses of them to our detailed questionnaire covering aspects related to starting capital, employees, clients, legislations etc.

We find that moneylenders have constraint to their growth with the moneylender himself becoming the bottleneck. All the important decisions are taken by the moneylender himself and the employees play only a supporting role. Thus there is a limitation to the number of transactions the moneylender can handle and thus becomes the upper limit to his lending business.

We also find that moneylenders face high cost of capital due to reasons like using own funds for lending and occasionally using resources form friends and family. This also puts limitation to the size of lending business one moneylender can do.

We find that none of the lenders use any kind of promotional tools for acquiring new clients and expanding their business. New clients come through word of mouth publicity by existing clients. Lenders are more worried about screening the clients than getting new clients.

Other interesting finding is that, not all moneylenders are successful. There are regular new entrants to the market and some get out of this business. Main reason for getting out of the lending business seems to be higher defaults and inability to ensure repayments. Thus once the capital employed is over, the lender has no other option but to get out of the business. Client of such a failed moneylenders are often left to themselves to find new lender on their own.

We did extensive literature review related to money lending. Our research reconfirms the existing literature in a few areas, including the importance of personal relationships but also disagrees with earlier research which find that moneylenders use land as collateral, but not gold. In our study, we find that moneylenders are relying on land as collateral to a much lesser extent, as it becomes impossible for moneylenders to take over the land if the borrower defaults. Another typical intuition that is not confirmed in our findings is that moneylenders rely much less on interlinked loans (loans in which the credit is tied to the exchange of labor or goods or services) than often believed.

We also tried to find out the impact on informal money lending due to stricter legislations and changing legal environment in India. We found that many of the moneylenders are either turning into registered moneylender or avoiding riskier clients like farmers. They are also insisting on more liquid assets like gold / silver jewellery instead of farm land or house. This in turn is drying up the availability of credit to the poor farmers and the legislation which is meant to protect and serve for their benefits is worsening their situation.

I. Introduction

Moneylenders have been a topic of intense debate in policy circles and academic research alike. On the one hand they are often condemned and accused of operating exploitative lending monopolies, which charge extremely high interest rates and use questionable credit enforcement methods. On the other hand economists contend that informal lenders can play a positive role in providing access to finance more rapidly and flexibly than many banks in developing countries, and often provide credit services to those who would otherwise have no access to credit at all. The crucial question at the heart of the debate is whether money lenders are solving a market failure or exploiting it.

However to make any progress on answering this question we need to first understand the cost of capital and operations of these lenders. While we will not be able to answer the question whether money lenders on net are good are bad for an economy, we aim to shed light on the internal dynamics and economic constraints of the money lending business. This is a crucial first step in demystifying this controversial part of the financial sector. Due to the difficulty of collecting data on this sector – these businesses are likely to be operating in the grey economy and thus be wary of scrutiny, while clients are often ashamed of their borrowing – very few studies have been carried out which can shed light on a typical moneylender's lending operations. We present data from a series of interviews with eleven moneylenders in a small town in South Western India, including details of the business operations of these moneylenders.

We argue in this paper that many of the observed behaviors of money lenders might be driven by the internal constraints that those lenders face themselves rather than pure extortionary behavior. Some of our findings in this study will be in contrast to existing intuitions about the money lending industry. Our evidence suggests that moneylenders on average seem to face many internal constraints to their operations which severely limit their ability to diversify risks, to exploit economies of scale in lending, or expand the size of their businesses. On the employment side, moneylenders have few employees and cannot trust employees to do higher end jobs. All loan-granting decisions take place only through the moneylender himself but are not delegated to employees, which limits the moneylender's business since his own time becomes a bottleneck. Thus they find it necessary to perform many of the crucial functions of the business themselves,

including setting the parameters of the loan (interest rate, period, etc), and handling any delinquent accounts, for example deciding whether to waive the interest if the client is in danger of defaulting. Having only a few trustworthy employees to help with the more mundane work such as collecting payments also limits the ability of the business to expand. This means that the exact nature of their screening technology, relying on relationships and recommendations of other clients, also prevents money lenders to diversify their risk and exploit economies of scale. In turn it leaves a moneylender highly exposed to local shocks.

Secondly, we find that the implicit cost of capital for most moneylenders is very high since they rely on their own financial resources, occasionally supplemented with funds from family and friends. Thus they are limited in the extent and speed with which they can expand their businesses by drawing in additional funds. Also, default rates are quite high, 15% on average with minimum of 5% and going as high as 40%, so that the expansion of a moneylender's own capital is limited by these recurrent defaults. Finally, customers are recruited through networks and personal references, and moneylenders also require collateral and guarantees for most customers. This limits their ability to easily expand their customer base. For these reasons, our evidence is that successful moneylenders are limited in their ability to expand.

If these internal constraints keep even very successful moneylenders from growing beyond a limited size, there will be unmet demand which can encourage new money lenders to enter the market. However, if there is heterogeneity or scarcity in the supply of talented of moneylenders there could be excess turnover of money lenders if some of the entrants are unable to manage their portfolios well. This could not only have adverse effects on the new moneylenders but also on their clients. In a world where all access to finance relies on relationships and building a track record with your lender, even good clients can be barred from credit after their moneylender drops out, since they cannot easily communicate their track record to other lenders.

In fact, while the moneylenders we interviewed had all been in the business for an average of 15 years, they estimated that the average annual turnover rate of money lenders in this local market was 7.1%. Some of these new entrants failed, mostly from not recouping enough loans due to an inability to identify good and bad borrowers. However, even the experienced moneylenders we

interviewed were evidently not able to expand enough to fill the demand for credit in this market, since they reported that their operations were at maximum capacity either due to shortage of good borrowers or due to lack of capital.

Finally, our study presents evidence concerning the impact of changing government regulations on the sector of informal money lending. In particular, the Indian government recently passed a new legislation which decreases the ability of moneylenders to claim land as collateral in case of default. Anecdotal evidence from money lenders and clients suggests that in response informal lenders have drastically reduced the amount of lending they undertake and are trying to switch to other forms of collateral such as gold (but those types of collateral are usually less easily available in a farming community). While this evidence is only suggestive it supports the above findings that moneylenders do not merely rely on personal networks but insist much more on hard information and collateral than common believes make us believe.

In contrast to most of the existing literature our research relies on information that we collected from interviews with moneylenders rather than their clients. We focus on the internal structure and working of the moneylenders' business. Studies that do involve data from moneylenders are often based on interviews with one moneylender or "a few" moneylenders for example Sarap (1990), Siamwalla et al (1990), Bolnick (1992), Kashuliza (1993), and Reddy (2007). We found only two studies, Aleem (1990) and Siyongwana (2004), which were based on interviews with more than 10 moneylenders. Aleem's important work examined the cost of capital and its return for moneylenders, but did not focus on internal organization of moneylenders. Siyongwana (2004) examines micro lenders in South Africa, and includes some information on the details of the businesses.

Our findings reconfirm the existing literature in a few areas, including the importance of personal relationships. As with Timberg and Aiyar (1984), Bell (1990), Siamwalla et al (1990), Basu (1997); Siyongwana (2004), Nadan (2005) and Reddy (2007), we find that moneylenders rely on personal relationships to screen borrowers and/or to enforce repayment. Contrary to Kashuliza (1993) and Basu (1997), however, we do find that moneylenders still face very high rates of default (15% on average).

Yes, different from other studies we find that access to formal collateral, e.g. gold and land, is very important for moneylenders rather than relying solely on social networks. One previous study focused on historic Palestine, Nadan (2005), did find most loans were secured with collateral. But most other studies suggested a much lesser reliance on collateral, e.g. Aleem (1990), Basu (1997), Bhattacharyya (2005), Sarap (1990), Swaminathan (1991), and Ghate (1992),. Finally, Swaminathan (1991) and Basu (1997) find that moneylenders use land as collateral, but not gold. In our study, we find that moneylenders are relying on land as collateral to a much lesser extent, as it becomes impossible for moneylenders to take over the land if the borrower defaults especially if it's a farmland.

Another typical intuition that is not confirmed in our findings is that moneylenders rely much less on interlinked loans (loans in which the credit is tied to the exchange of labor or goods or services) than often believed. Many previous studies such as Sarap (1990), Aleem (1990), Bell (1990), and Basu (1997) did find that most loans were interlinked. Our results are more in line with Bhattacharyya (2005), since we find that the group of moneylenders we interviewed did not engage in interlinked loans.

Finally, previous studies by Iqbal (1988), Sarap (1990), Aleem (1990) and Bolnick (1992) suggest that moneylenders have considerable monopoly power. However, we find a slightly more complicated dynamic. Interest rates in our study ranged from 1-3% per month which put them at the lower end of the range of interest rates described in the literature. However, the turnover rates in the market are very high as well, about 7.1% per year. In fact, as with Timberg and Aiyar (1984), we find that the moneylenders operate in a competitive market that is characterized by many new entrants who try to attract market share by offering lower interest rates. However, existing money lenders have local information monopolies about their clients. Therefore it is risky for a client of an existing moneylender to switch to a new entrant, since there is a chance that those will go out of business again.

The remainder of this paper is structured as follows. Section II describes the data collection. Section III summarizes the results and finally section IV concludes.

II. Data Collection

The vast majority of previous research in this field has been based on interviews with borrowers rather than on information obtained from moneylenders themselves. In our research, we focused on detailed interviews with moneylenders in order to examine the market from the moneylender's point of view, and to learn about their business practices and organization. The difficulty in obtaining this type of information is that most informal moneylenders are not registered and hence circulate "black money". They do not wish to operate openly for fear of attracting a government agency's attention and risking fines and/or closure of their business. Likewise, the details of these transactions are typically kept secret. Moneylender clients may have worried about their financial indebtedness becoming public with a subsequent loss of face, and thus were reluctant to speak with our research team. [1]

As earlier literature has suggested, personal contacts are important in this sector. Moneylenders lend mainly to people they know directly or to those who are vouched for by reliable people known to the moneylender even if they ask for collateral. To get access to informal moneylenders, we decided to make use of personal relationships one of the researchers has with moneylenders in several rural areas of Maharashtra. Thus we chose 3 towns in the state of Maharashtra (Marathwada region), each with a population of less than 40,000. Our team member had relatives in each of these towns and through them was able to contact and interview 11 moneylenders. Despite the personal relationships with the interviewees and going through very strong contacts, a few moneylenders chose not to reveal very much about their business. On the other hand several were very open about their business and shared almost all of the details.

[1] Despite being a major city in India and having a huge presence by formal financial institutions (banks), the city in which we initially chose to work reportedly also had many informal financiers working under different guises, including vehicle financiers, pawn brokers and basic informal lenders. We were able to gain interviews with a few vehicle financiers and pawnbrokers, but we wished to also interview basic informal moneylenders. Although we were not able to contact any informal moneylender, their presence was not denied by anyone we met. However, despite approaching moneylenders in this city through known sources such as their clients or other financiers, all the informal moneylenders refused to discuss their business with our research team.
We did interview a few businessmen who regularly borrow from such moneylenders. Though they provided us with data about their access to credit, the average interest rates charged and other information, these business owners were reluctant to provide any contact details for their moneylender. The business owners reported that they were worried that their moneylender might take offense at them having divulged details of their transactions with him to outsiders and might retaliate by cutting off future credit to the business owner.

The interviews involved both specific and open-ended questions. Topics included the moneylender's source of capital, the selection and screening of customers, the typical procedure for getting a loan, rough estimates of interest rates, typical loans sizes, estimates of the moneylender's total numbers of loans and capital outstanding, the number of employees and staff procedures, and how the moneylender handled the cash involved. Some moneylenders were not comfortable answering some questions. The survey instrument can be obtained from the authors by request. Although we pressed them to a certain degree, in the interests of gaining the most overall information, we did not insist on their answering every question. Each interview with a moneylender lasted close to an hour and was conducted either at their office or their home.

III. Results

Our interviews with eleven moneylenders in neighboring small towns in Maharashtra State reveal two main themes. First, successful moneylenders are highly constrained in their ability to increase the size of their businesses for several reasons, including an inability to delegate work to employees, a lack of capital and a reliance on personal networks for finding customers. As a result, the market is characterized by high demand relative to supply, and a combination of well-established moneylenders and a churning of newly-entered moneylenders. Secondly, we report on the effects of changing government policy towards the moneylending sector, including some potentially adverse effects on clients' access to finance. Summary statistics for the main variables we collected are listed in Table 1.

III.A. Size of Moneylenders' Businesses

The moneylenders in our sample were all long-standing businesses in this sector; however their operations were modest in size. Of the eleven moneylenders interviewed, six declined to state the size of their outstanding portfolios, but the remaining five described portfolios that ranged from INR 600,000 to INR 4,500,000 ($14,000 - $106,000). Regarding the number of clients, of the eight who agreed to answer this question, seven moneylenders had

between 50 and 300 clients with approximately 40-150 loans outstanding at any one time[2], while one had 2500-3000 clients and averaged 700-800 loans.

By comparison, the Indian government's rule for designating a business engaged in providing or rendering of services as a "Micro or Small Enterprise" is that the company's "investment in fixed assets in plant & machinery (equipment) does not exceed INR 2 Crores." (INR 20,000,000 or $ 470,000). Thus if we consider the outstanding loans to be an indication of the capital assets of the moneylenders' businesses, they would fall into the same size range as formal businesses in the Micro and Small Enterprise. Also, the average per capita income in this area (Marathwada) of Maharashtra is estimated to be Rs. 9500 ($ 223)[3]

III.B. Lending Practices and Customer Recruitment

Moneylenders in our sample tend to offer loan amounts in the range of INR 100 to INR 500,000 ($2.5 to $12,000), with loan maturities that range from 15 days to 2 yrs. Reported market interest rates generally range from 1.5% to 5% per month which is on the lower end of interest rates reported in the literature. However, occasionally the interest rates were reported as high as 20% per month. All but one moneylender offered small loans and then offered bigger loans if the initial loan was repaid.[4] The average number of loans per customer over time varied across moneylenders. Four firms reported that each client typically received 2-3 loans over time, one firm said 7-8 loans, and one firm said 15-20 loans.[5] Customers typically repaid using "bullet payments," or daily or monthly payments. A bullet repayment is a one-time settlement in which the borrower repays the principle amount along with the interest accrued up through the date of the settlement.

With regard to acquiring new customers, none of the moneylenders used advertisements of any sort for attracting new clients. Since moneylender businesses are informal, they do not

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[2] Information on the 40-150 loans outstanding is based on response from four of these seven moneylenders. Two declined to give this data and one stated that he saw around 15 "transactions" a day.
[3] Based on NSDP data mentioned in Abdul Shaban, 'Regional Structures, Growth and Convergence of Income in Maharashtra', Economic and Political Weekly, May 2006.
[4] Two moneylenders did not agree to answer this question.
[5] Three moneylenders did not agree to answer this question; two moneylenders said they made "many" loans to the same client over time.

even put up a display board stating that money is lent at this location. Only those moneylenders who have officially registered as moneylenders typically put up display boards. The main medium of reaching new customers is through word of mouth via existing customers. There is reportedly no dearth of people who need credit and clients work hard to find those willing to lend. As remarked by one moneylender, even if he were to sit on top of a hill in the Himalaya, borrowers would still find him so as to obtain credit. Similar sentiments were expressed by other moneylenders. One method to increase the size of a business, while maintaining the same number of customers, is to lend larger amounts to existing good borrowers. There are reportedly many long-time moneylenders who now stick to a very few good borrowers who borrow very large amounts and for longer durations. These borrowers have very high creditworthiness and can often repay the loans if the moneylender needs funds at short notice.

With lots of demand for loans and difficulty in the legal enforcement of contracts, the challenge for moneylenders is to screen borrowers. Five of the moneylenders said that ensuring repayment was the most difficult part of the business. Six moneylenders said that 5-10% of their clients default, while two moneylenders said that 30-40% of their clients default while one moneylender reported very low default rate.[6] These rates are quite high, much higher than those reported in the literature, and must have a large impact on the moneylender's business. Not surprisingly, moneylenders say they are very choosy about their clients. The participants in our sample lend to people they know or to those who are referred by guarantors who the moneylender knows. Guarantors agree to pay the loan or part of the loan, in case the new client defaults. We find that more experienced moneylenders are better at weeding out bad from good borrowers. Moneylenders who have been in the business for a long time also have long-time clients, who they know and trust. Interestingly, almost all moneylenders reported that they avoid lending to relatives since it is difficult to be strict regarding the terms of the loan and asking for repayments.

Traditionally, moneylenders are reported to resort to the threat of physical violence force in order to enforce the repayment of loans. However, the participants in our study said that due to increased legal restrictions and enforcement of existing laws, moneylenders are much less able

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[6] Two moneylenders did not agree to answer this question.

than before to use force to extract repayments. In fact it is interesting that they did not flat out deny the use of force but cited recent changes in government and public scrutiny as a reason for the reduction. Enforcement of repayments neither facilitated by moneylenders sharing information about bad borrowers or cutting off these borrowers' access to funds from other moneylenders. Moneylenders in our sample report that there is little communication of this type between moneylenders, so that borrowers have more freedom to default without consequences. Several papers including Hoff and Stiglitz (1998); Bose (1998) and Ghosh and Ray (2001) discuss the issue of enforcement via sharing of information among moneylenders. Ghosh and Ray (2001) have a model with multiple equilibria in which moneylenders either all share or all do not share information with each other.

The moneylenders in our study reported that they cannot be too pushy when asking for repayments and they are willing to negotiate with clients who are late in their payments. All the moneylenders who responded to this question reported a surprisingly high fraction of late payments.[7] Three moneylenders stated that 25-50% of clients were late on at least some payments, while three others said the proportion was 80-90% of clients. One moneylender reported a late payment rate of 5-10%, while another reported that non-salaried employees which constitute about 70% of his clientele, are often late with payments. Thus moneylenders seem to be under considerable pressure from the high number of late payments and especially the high rate of default. Screening borrowers is thus a crucial skill and one that moneylenders learn through experience. We will show in later sections that moneylenders do not trust their employees to screen borrowers, which leads to limits on the growth of even the most successful moneylender's business.

III.C. Sources of Capital

All of the moneylenders in our sample use their own savings, money from other businesses and/or family resources as their source of initial capital. Of the four firms that agreed to share the size of their starting capital, two began with INR 10,000 (about $230) and two began with INR 1,500,000 (about $35,000). Most moneylenders continue to rely on their own funds as

[7] Three moneylenders did not agree to answer this question.

a source of capital after getting started. If they are seen to do well in the lending business, their friends and relatives who have excess cash sometimes pass funds to the moneylender and earn a nominal interest of about 1% per month in return. The moneylender is typically charges 2-3% monthly interest from the loans of these funds, so the net is 1-2% per month for the moneylender, minus any defaults.

Normally these funds are given to the money lenders for a long term and the settlements are done on a yearly basis. These fund providers are not concerned about the actual returns the moneylender is able to generate so long as they receive their 1% monthly return. These investors do not interfere in the moneylender's business nor do they decide where the funds should be employed. Still, in spite of occasionally loaning funds from friends or relatives, most moneylenders rely principally on their own supply of capital, which limits their ability to grow.

III.D. Employee Policies

The informal moneylenders we interviewed operate independently from each other and all except one had employees working for him. The moneylender is at the core of his business, and all decisions regarding the business are made by him. Employees play only a supporting role, with little opportunity for decision making. Their job is typically to complete tasks as instructed, including reminding borrowers about their payments due, collecting repayments from borrowers, and occasionally delivering money to the borrowers. No employees are allowed to decide who receives a loan. Employees are all paid a fixed salary which has no commission or performance component.[8] Seven out of eleven moneylenders maintain their account books on their own. A few who have been in the business for years and have an employee, who have been working with them for years and who has earned their trust, ask such employees to maintain their books.

Employees are hired only through personal connections, or via the moneylender's other businesses if he has a side business. Employees are each assigned certain clients to collect from, for example clients in the same office building. The advantage of this is that the employees get to know the clients so they can understand them better. The disadvantage is that if they get to know

[8] Moneylenders are reluctant to even to pay for performance in collections, because employees might let loans become delinquent in order to collect a bonus later for recouping the delinquent loan.

the clients too well, the employees and clients could collude against the moneylender, with the employee acting leniently at the time of repayment collection. Moneylenders balance these two factors when assigning employees to collect payments in certain locations. In fact several of the moneylenders told us that they continue to communicate directly with their clients without letting their employees know. This allows them to check if an employee is cheating them.

Thus, because of their inability to delegate the core of their business – deciding who can and cannot get loans, and monitoring repayment – to employees, moneylenders are severely constrained to operating on a small scale. They are limited in their business by the number of hours they themselves have available to screen borrowers.

III.E. Business Duration, Entry and Exit, and Market Structure

The money lending market in these small towns that we surveyed is characterized by many moneylenders who have been in business for a long time, and also a significant number of new entrants each year. This structure is consistent with a market in which demand exceeds supply but where established (competent) moneylenders are constrained in how much they can grow, leaving room for new, potentially less competent entrants. We find evidence that established moneylenders tend to have long-time clients whom they trust. Newer moneylenders are faced with difficulties in screening borrowers and therefore experience higher rates of default.

The eleven moneylenders we interviewed had been in business an average of 15 years. Six moneylenders had taken over a family business and for these moneylenders the average years they had been in business was 25.67 years. Many of these moneylenders told us that there were numerous new entrants and also many businesses exiting the market. Therefore it seems that in this market moneylenders do not appear to have a monopoly, judging by the number of new entrants. Also, there does not appear to be collusion in this market. However, individually moneylenders may enjoy somewhat of a local monopoly with regard to an existing customer. Customers tend to use only one or two moneylenders since it takes time to build up trust with each moneylender. Only wealthier borrowers also tend to use more than one moneylender. So, a moneylender may be able to extract some rents from a good customer since the client would not immediately be able to gain the trust of another moneylender. On the other hand, many new entrants to the money lending market tend to have low standards for borrowers, which gives

those borrowing from any monopolistic moneylenders another option and could lessen the effects of any individual-level monopoly.

One possible problem with multiple new entrants into the money lending business in addition to longstanding firms is the possibility of a borrower getting into too much debt. While each individual moneylender may be able to estimate the borrowing capacity of a borrower, especially if the moneylender is experienced, if the borrower is borrowing from multiple sources, he or she may become over extended. The moneylenders interviewed reported that this was happening more frequently now and that as of yet there was no coordination among moneylenders regarding this issue.

We surveyed the existing moneylenders who we interviewed to understand the entry and exit dynamics in the market. We in fact also tried to reach some of the failed entrants in the market, but those people declined to talk to us. The money lenders we surveyed reported that it was rare for moneylenders to fail, but that they did happen. Across the board, existing moneylenders identified the main reason for failure as an inability to distinguish good from bad borrowers, and the consequent losses from defaults. They did not recall instances of moneylenders going out of business because of the changing legal environment or because of theft on the part of employees.

In general, new moneylenders are under pressure to lend a lot of money in the beginning, because they have dedicated certain funds to the enterprise and need to loan the money out for it to make any return. But since they are new to the business they don't have experience screening borrowers and thus tend to incur high losses with these initial loans. Moneylenders that learn how to screen borrowers eventually succeed, while those who have trouble screening borrowers may have high numbers of defaults and be forced to go out of business. New, successful moneylenders said that all aspects of the business were tough at first, but that the process is much easier now that they are experienced.

Our interview partners suggested that the typical reasons for the failure of money lenders are: (1) that lenders gave only uncollateralized loans, (2) lent very small amounts to each client, (3) mainly used other people's money as capital, which means they may have not been able to make any profits after paying for their own cost of capital, (4) were unable to identify good borrowers

who would either repay or who could be forced to repay and finally (5) did not keep careful tabs on employees and had a good daily reporting system for payments collected by employees.

III.F. Changing Legal Environment

Recently, there has been increasing pressure by the Indian government on informal moneylenders, including in the state in which our study was undertaken, Maharashtra. Specifically, a general belief has developed that farmers' suicides are due to their indebtedness which in turn is due to high interest rates charged by informal moneylenders. In response, in the middle of 2007 some state and local governments have enacted new anti-moneylending legislation, or have increased their enforcement of existing legislation. In the state of Maharashtra, due to new legislation,[9] agricultural land owned by a farmer can no longer be seized and sold by the moneylender if the farmer is unable to repay his loan. At the same time, clients of moneylenders are becoming more aware of the existing laws and of their rights. The net result is that it has become more difficult for moneylenders to collect payments or collateral when a client defaults on a loan especially if the collateral is in the form of farm land or farmer's house.

The moneylenders we interviewed stated that this has had an adverse impact of restricting credit to certain types of borrowers such as farmers. In response to this changing environment, moneylenders have responded in several ways. The most common responses we heard is to (1) limit the portfolio to clients who are very well-known to him personally, (2) only lend money to a few big clients with whom the lender has long-term relationships, (3) greatly reduce the size of the overall loan portfolio, and most frequently (4) only allow liquid forms of collateral that can be seized easily, for example gold and silver jewelry.[10] Finally, in response to new laws and greater enforcement regarding the seizure of farmers' land, many moneylenders no longer consider a farmer's land or house as collateral, which leaves farmers with nothing to pledge as

[9] All the moneylenders interviewed said that the home minister at the time of the interviews, R. R. Patil, had brought in this legislation sometime during 2002-5. Unfortunately, we were not able to confirm this legislation change in any official source.

[10] Accepting gold and silver jewelry as collateral can be risky for the moneylender as he has to determine that the collateral was not stolen. If the jewelry is later found to be stolen, then the moneylender loses the collateral and thus the value of the loan. They may also have to pay bribes to the police to come out of a case in which there was stolen collateral, with a clean record.

collateral and thus they are unable to get any loans. Four moneylenders reported that because of this their lending to farmers has almost completely dried up.[11]

On the enforcement side, moneylenders report a decrease in the use of force against defaulters. With greater enforcement of existing anti-moneylender legislation, borrowers occasionally threaten to report a moneylender's business if the moneylender pressures them to repay. Consequently, some moneylenders are going soft on their defaulters since they do not want to risk their lending business. In addition, for loans for which the moneylender has taken collateral such as gold jewelry, an increasing fraction of the loans, the moneylenders do not bother about the repayments since they have already secured their loan with the collateral in their possession.

A final development due to the changing legal environment is that many moneylenders are registering as formal moneylenders. Out of 11 firms in our sample, four were registered moneylenders, four had cover business which was registered, and the remaining three firms were unregistered. Interestingly, a major portion of most lenders' business continues to be informal. Only a small portion of the total business is typically reported and operated through the registered money lending process. For established customers, the paperwork is done as per the registered moneylender rules, but in practice the actual interest rates charged are often higher than the officially reported rates and are equal to the previous rates when the business was entirely informal. For new customers, if the moneylender has a slight doubt about whether the client will repay, he will follow the official moneylending process. Then, in the case of default, the legal route will be open to the moneylender to be able to force the client to repay the loan.

One consequence of the increasing pressures on the informal lending markets, is to reduce the access to credit for many borrowers. Clients experiencing reduced or no access to credit include farmers with no other assets other than their land and their house, borrowers who do not know the moneylender well, and borrowers who do not have collateral in the form of gold jewelry. While some borrowers may have gained from the reduced use of force by moneylenders to extract payments or from the lower interest rates offered by registered moneylenders, these

[11] Four moneylenders reported reducing their exposure to farmers, three moneylenders continue to lend to farmers, and the remainder had either never lent farmers or did not answer the question.

benefits must be weighed against the cost of reduced access to credit for many clients, including most farmers.

IV. Conclusions

We benefited from a unique data set based on eleven interviews with moneylenders in several small towns in Maharashtra, which provides detailed information on the internal workings of the moneylenders' businesses. We find evidence to suggest that moneylenders on average face internal constraints to their operations along with several dimensions which limit their ability to diversify risks and expand the size of their businesses. First, money lenders use highly personalized screening and monitoring skills to make loan decisions and they do not have the operational capabilities to delegate loan initiation to employees. This means that the money lender's business is constraint since their own time becomes a bottleneck. Secondly, we find that the implicit cost of capital for most moneylenders is very high since they rely on personal finances and default rates and late payments are quite high, the reported average is 15%.

These factors explain why even successful money lenders can be limited in their ability to expand their business. As a result, there will be unmet demand which can encourage new money lenders to enter the market. We indeed find that this market is characterized by two classes of lenders: on the one hand there are experienced money lenders who have been in the business for a long time and seem to have low default rates among their clients and on the other hand a steady stream of new entrants of lenders who turn over frequently and have high default rates among their clients. However, if there is heterogeneity or scarcity in the supply of talented of moneylenders there could be excess turnover of money lenders if some of the entrants are unable to manage their loan portfolios. This could not only have adverse effects on the new moneylenders but also on their clients. In a world where all access to finance relies on relationships and the ability to build a track record with your lender, even good clients can be barred from credit after their moneylender drops out, since they cannot easily communicate their track record to other lenders.

We also find that the recent changes in the legislation of the money lending industry and stepped-up enforcement in India has led to some positive factors such as (1) moneylenders using less force in enforcing repayments by borrowers and (2) more transactions are being carried out through the formal system, which limits the interest rate that can be charged. However, we also find adverse effects from this regulation: Many moneylenders can no longer rely on agricultural property as collateral, which reduced their ability to provide credit to farmers. In general, we find that as a response to the regulations moneylenders are only willing to lend to people who are personally well known to them or who can provide liquid collateral such as gold and jewelry. This means that large fractions of the population including farmers, are unable to access this form of finance and maybe experiencing significantly reduced or eliminated access to credit.

As a final note, we want to highlight again that our study does not claim that there are no examples of extortion and exploitation among money lenders. However, researchers and policy makers need to also take into account that high interest rates charged by money lenders might not be purely due to monopoly rents but are in part a result of the internal organizational constraints of these businesses. By their very nature the lending model of money lenders relies heavily on personal relationships and their ability to make judgment calls on the clients' credit worthiness. This type of relationship lending seems to entail high transaction costs, limits the amount of task delegation to employees and thus creates implicit constraints to the amount of geographic and operational diversification of the business. As a result money lenders are unable to diversify their risks across a larger portfolio of clients, which invariably leaves them exposed to idiosyncratic and regional shocks. These factors might explain the high default rates reported by money lenders in our study and in turn the high interest rates.

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Table 1 – Summary statistics

Variable	Min	Max	Mean	Number of non-answers	Central range[12]	Notes
Money lending experience						
Overall average time in business	2 yrs	44 yrs	15 yrs	-	2 – 44 yrs	
For those overtook family business	10 yrs	44 yrs	25.67 yrs	-	10 – 44 yrs	
Ownership status						Two moneylenders had partnership firms and had registered their lending business. The remainder were either sole proprietors or family businesses.
Sole proprietors			6	-		
Partnership/family business			5	-		
Legality of business						Though some moneylenders had their business registered, their interest rates and modus operandi was more or less similar to other un-registered moneylenders.
Registered moneylenders			4	-		
Cover/allied business registered			4	-		
Unregistered money lending			3	-		
Amount of starting capital	INR 10,000 ($[13] 230)	INR 1,500,000 ($ 35,000)	INR755,000 ($ 17,500)	7	INR10,000 to 15,00,000 ($ 230-$35,000)	Only a few moneylenders had set aside a sum for lending business. Most of them used profits from allied business for lending and shifted focus to money lending for higher returns.
Source of capital						All the moneylenders except 3 had allied businesses and put excess cash from that business into their money lending business.
Own Resources			10	-		
Borrowed from other sources			01	-		
Number of clients	50	3000	470	3	50-2750	One of the moneylender deals mainly with other moneylenders hereby reducing the risk of default
Size of current portfolio	INR 600,000 ($ 14,000)	INR 5,000,000 ($120,000)	INR 2,120,000 ($ 50,000)	6	INR 600,000 to 4,500,000 ($ 14,000-$106,000)	Most of the moneylenders were apprehensive about answering this question and the amounts could be very much lower than the actual business they do.

[12] Central range was prepared by considering averages of the ranges provided by the respondents. Eg. If the responses were 100, 700-800, 150, 40-50, 150; the central range would be 45 (avg. of 40 and 50) – 750 (avg. of 700 and 800).
[13] All amounts calculated at Rs. 42.6 per USD and rounded off to the nearest significant number.

Variable	Min	Max	Mean	Number of non-answers	Central range	Notes
Number of outstanding loans	40	800	239	6	45-750	One of the moneylender said he daily transact with 15 customers but not sure about how many loans were outstanding at that moment.
Number of loans per customer over a period of time				3		
2 to 3 times			4			
7 to 8 times			1			
15-20 times			1			
Many times			2			
Loan amount	INR 100 ($ 2.5)	INR 500,000 ($ 12,000)	NA[14]	2	NA	All the moneylenders except one, confirmed that they offer smaller loans initially and then offer bigger loans later, based on the clients' repayments.
Loan duration	15 days	2 yrs				
Interest rates charged	1.5% per month	5% per month	2.34% per month	3		Interest rates charged by the moneylenders whom we interviewed could be on a lower side since all of them lend only based on collateral. Rates as high as 20% per month are seen for un-collaterized loans.
Fraction of clients late on repayments	5%-10%	90%	54.06%	3	5% to 90%	Delays in repayments are considered normal. And since the interest is calculated as per the actual no. of days the principle amount is due, most of the moneylenders do not worry about it.
Fraction of clients who default	5%	40%	15%	3	7.5% to 35%	Since most of the loans are secured against default by collateral, net loss to the moneylender would be very low.

[14] All the respondents except one said that it was very difficult for them to tell the avg. loan amount since loan size varied a lot.