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PRIVATE FINANCING FIRMS IN KARNATAKA: A BOON FOR TAX DODGERS

D. RAJASEKHAR

CENTRE FOR DEVELOPMENT STUDIES
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INTRODUCTION:

The growth of government financial institutions in India both in terms of number of branches and quantum of credit has been impressive, especially in the post-bank nationalization period. However, the mushroom growth[1/] of non-banking financial companies[2/] - which include chit funds, nidhis, loan companies and other finance companies - suggests that institutional credit sources are inadequate to meet the variety of demands for credit. Such growth of informal credit sources would not only make monetary policy less effective,[3/] but also can frustrate it (Sundaram and Pandit, 1976, 1984 and 1985)[4/]. Formulation of effective policy on informal credit sources would become extremely difficult in the absence of systematic studies on the functioning of these institutions. Although there are studies[5/] on chit funds and nidhis, there are, however, very few[6/] on the functioning of the Private Financing Firms (FFs). Among them, the studies by Banking Commission (1971) and M. Sreenivas (1975) did not have primary data to explain the functioning of FFs; hence, they could make only preliminary observations. Nevertheless, the former provides us with a case for and against the regulation of FFs. In contrast, Prakash (1984) provides an interesting account of the functioning of FFs in Kerala with adequate primary data. However, he is silent on questions such as types of borrowers[7/], total amount of unaccounted money generated by FFs, regulation of FFs, safety of depositors' money and so on.

GROWTH OF PRIVATE FINANCING FIRMS:

Private financing firms[8/] are mostly partnership firms accepting deposits from the public and making advances at higher rates of interest. The origin of FFs is generally traced to Madanapalli town in Andhra Pradesh. Though FFs are of recent origin (FFs sprang up from 1964 onwards), they made a rapid progress (both in terms of the number and magnitude of operations) and became prominent in South India and Gujarat. In Kerala, there are 4079 financing firms (locally referred to as "blade companies") registered under the Moneylender's Act.[9] However, the Working group on "Private Financial Unincorporated bodies" noted that there are 11261 FFs functioning in the State with a fund of Rs. 2000 crores.[10] In Madanapalli (Andhra Pradesh) there were 50 FFs in 1970. In Anantapur district there were 60 FFs (in 1971) of which, 42 were located in Anantapur city itself. The total deposits of all the FFs working in the district were estimated to be Rs. 75 lakhs (Banking Commission, 1971; 105). These FFs are seem to be coming up on a large scale all over Andhra Pradesh.[11]

It was estimated (in 1970) that the number of FFs was 70 in Bangalore City and 137 in the then Mysore state (Banking Commission, 1971; 105). By 1972, the number of FFs had crossed 100 in Bangalore City alone (M. Sreenivas, 1975; 94). Though data on the number of FFs in Karnataka are not available, it is estimated[12] that in Bellary town (Karnataka) alone there are 275 FFs. Such a growth of FFs is alarming as it has implications for monetary policy and generation of black money. The efforts of the government in the past to reduce the influence of these FFs yielded only partial results.[13]

This paper, which is based on a survey of eight[14] FFs in Bellary town aims at (1) probing the factors responsible for the growth of FFs (2) documenting and analysing the functioning of FFs and (3) critically examining the type of borrowers, the use-pattern of the borrowings and also to estimate the black money generated by the FFs. The survey was carried out in the months of November and December of 1985 and the data collected pertain to the year 1984-85. The selection of the study area was motivated partly by the fast growth of the FFs in this town in recent years and partly by our familiarity with the area. Purposive sampling was adopted in the selection of FFs.

This paper is divided into four sections. In the first section, the factors contributed to the growth of FFs in Bellary town are explained. While the functioning of FFs is explained in the second section, in the third section the arguments for and against the regulation of FFs are put forward. In the final section, concluding remarks are provided.

SECTION 1

GROWTH OF FINANCIAL FIRMS IN BELLARY TOWN

Bellary, with population of 1.92 lakhs (in 1981), is one of the several towns in south India which witnessed a rapid expansion in the number of FFs during the last decade. In order to know the growth of FFs in Bellary town over time, we collected data on the years of inception from 51 randomly selected firms. Though a few firms started as early as in 1971, the majority of them came up only after 1980 (Table 1).

Table 1

Year of Inception of the FFs in Bellary Town

Year	No. of FFs Opened	Per cent
Before 1978	4	7.8
1979	5	9.8
1980	6	11.8
1981	9	17.6
1982	7	13.7
1983	13	25.5
1984	4	7.8
1985	3	6.0
Total	51	100.0

Source: Survey data.

Between 1980-83, 69 per cent of total firms were started. In 1983 itself, 26 per cent of the firms were established. The factors which contributed to such growth are the following. (1) Decline of the traditional forms of moneylending. (2) Expansion of business activities due to (a) transformation of dry cultivation into wet (b) growth of the town, and setting up of new business establishments. (3) Restrictions on credit for business purposes from formal credit institutions. (4) Procedural formalities in obtaining credit from the commercial banks, and (5) Accumulation of surplus by certain strata of the society.

As in any cotton trading town, the informal credit market was active even in the early decades of the present century. The Madras Provincial Banking Enquiry Committee (1930) stated that there were 7 Nidhis[15/] in Bellary town with a paid-up capital of Rs. 4.8 lakhs. Commission agents in the cotton trade were the principal borrowers from these Nidhis. They, in turn, used to lend money to farmers in the surrounding villages. These were largely controlled by Marwaris. Besides, moneylenders played a crucial role in the lending operations of the town. Though the commission agents were playing the role of money-lenders as far as agricultural credit was concerned, they themselves were borrowing from the professional moneylenders. The Enquiry Committee noted that these moneylenders, who were mainly Komatis and Marwaris, were not advancing loans to agriculturists in the surrounding villages but to the commission agents, retail and wholesale traders.

The number of registered moneylenders both in the Bellary taluk as also the district was significant in 1957. While the number of money-lenders kept on increasing in the taluk, it sharply declined in the district, especially after 1961 (Table 2).

Table 2. Growth of Registered Moneylenders in Bellary Taluk and District

Year	Bellary Taluk		Bellary District	
	No. of Money_lenders	% of Variation	No. of Money-lenders	% of Variation
1957	236	—	1257	—
1961	394	67	1866	48
1966	564	43	827	-66
1971	654	16	1180	43

Source: Mysore District Gazetteers, Bellary District, 1972, p.251.

However, the rate at which the number of moneylenders grew, had fallen in the district as well as taluk, due to stringent money-lending rules and enhanced licence fee, which came into force as a result of enactment of the Mysore Moneylenders Act, 1961 and the Mysore Pawn Brokers Act, 1961.[5] This fall was sharper in the district than in the taluk. The fact that most of the moneylenders in Bellary taluk continued to stay in the business and that new people had entered indicates that the credit needs were felt more in the Bellary taluk as compared to the other parts of district.

However, the dominance of the moneylenders (in the taluk as well as the town) had declined due to the following factors. (i) Traditionally business people were borrowing from moneylenders. However, there was a sea-change (from 1979 onwards) in the business activities (see below). The businessmen who were earlier operating with less capital, needed larger sums as their business expanded. The individual moneylenders, with meagre resources, could not rise up to the occasion. (ii) Besides, financing business activities like cotton trade and liquor was a risky affair which the individual moneylenders were not prepared to handle. Around this time (i.e.,1970), the phenomenon of FFs was widely prevalent in Bangalore and the idea spread to the Bellary town as well. A few groups of moneylenders started FFs which became successful ventures. Soon, others followed and by mid-1970's people with business and moneylending background started establishing FFs on a large scale.

Expansion of Business Activities: Till about 1950 Bellary was a famine stricken district.[17] The growth of population consequently was at an annual rate of 0.4 per cent between 1901 and 1941. The total cropped area increased by 2 per cent between 1901 and 1941. In other words, the agrarian economy was almost stagnant in the pre-independence period. However, a new era in irrigated agriculture dawned in 1963, when the Thungabhadra Project was finally completed. Consequently, there has been a significant increase in the area irrigated over the past two decades.[18] Compared to other taluks in the district, Bellary benefited most from this project. For instance, 91 per cent of total area under High-level Canal is situated in this taluk. This resulted in changes in the cropping pattern favouring high value food crops and commercial crops.[19] Wide-spread irrigation facilities favoured the adoption of high yielding varieties in this area from 1966 onwards. With the introduction of HYV's the demand for fertilizers has increased significantly.[20] As a result, the yields and production of all major crops registered significant increases.[21] Most of the production found its way to the regulated markets in Bellary town. Table 3 reveals that there was a substantial increase in the Volume of arrivals and value of selected agricultural products during the period 1967-68 to 1982-83.

Table 3: Market Arrivals of Selected Agricultural Commodities into Regulated Market, Bellary (1967/8-1982/3).
(Volume in thousand quintals and Value in Rs. lakhs)

3-Year average ending with	Cotton		Groundnut		Paddy	
	Volume	Value	Volume	Value	Volume	Value
1969-70	48	102	53	67	63	55
1972-73	52	127	44	74	19	15
1975-76	49	172	37	94	32	41
1978-79	69	314	20	54	71	86
1981-82	93	477	19	72	93	126
1982-83@	53	304	50	217	118	192

@ Single year figure.

Source: Annual Reports of the Agricultural Produce Market Committee, Bellary, Various Issues.

Table 4 shows a corresponding increase in the number of functionaries operating in this market. Significantly, this increase in the market arrivals and market functionaries has been very rapid from 1975-76 onwards.

Table 4: Number of Market Functionaries Operating in the Regulated Market, Bellary (1969/70-1982/83).

3-Year average ending with	Wholesale Traders	Retail Traders	Commission Agents	Importers	Exporters
1971-72	92	257	104	13	4
1973-74@	94	400	124	18	13
1979-80	132	298	145	36	31
1982-83	183	349	163	54	37
1983-84*	188	119	163	62	43

@ Two year average. * Single year figure.

Note: The data for the years 1974-75 to 1976-77 are not available.

Source: Same as in Table 3.

With the increase in agricultural production and market arrivals there was a concomitant expansion in business activities. For instance, the number of fertilizer shops in Bellary town had increased from 111 in 1982-83 to 140 in 1983-84. With the establishment of professional colleges like government medical college in 1961, a hospital and other offices, the number of salaried employees has increased. These factors have hastened the process of urbanization. The population of Bellary town has increased at an annual rate of 4.6 per cent during the sixties and the rate has gone up to 6.1 per cent for the seventies. The corresponding rates for the state are 3.2 and 5.1 per cent respectively. In order to meet the growing needs of the increasing population several shops and business establishments had to be opened. In other words, business started expanding at a faster rate from mid-sixties onwards. Consequently, there was also an increase in the demand for credit by businessmen.

Had the institutional credit facilities expanded in tune with the expanding business, the FFs could not have come up in the town on such large scale. There was, no doubt, an increase in the number of branches of commercial banks in Bellary town as well as the total amount of advances made in Bellary District as a whole. It is clear from table 5 that the

Table 5: Expansion of Commercial Banks in Bellary Town

Period	No of banks set up	Per cent
Before 1955	6	18
1955–1965	3	9
1965–1975	9	26
1975–1985	16	47
Total	34	100

Source: Office of the District Kead Bank, Bellary.

expansion of bank branches was quite impressive in Bellary town, especially after 1965. In Bellary town while population per branch was 10432 in 1971, it declined to 8063 by 1981. Though advances by commercial and other banks increased (from Rs. 3.5 crores in 1966 to Rs. 19.4 crores in 1982 and to Rs. 39.2 crores in 1984), the percentage of credit made available to retail and wholesale traders and businessmen fell from 17 in 1982 to 14 in 1983 and to 11 in 1984. At the all-India level also, the percentage of credit available for retail trade and small businessmen declined from 2.57 in 1980 to 1.75 in 1981 and to 1.68 in 1982. This was due to the restrictions imposed on credit disbursed for business purposes in the early eighties.

Besides, procedural formalities in the commercial banking system had also favoured the rise of FFs. The commercial banks give loans on the basis of turnover shown in the account books. Since the actual turnover of the businessmen will be far higher than what is shown in the account books, the credit obtained from commercial banks will be inadequate for them to carry on business operations. Moreover, they find borrowing from commercial banks a cumbersome and time consuming process. The commercial banks would ask for several documents – like security, licence certificate, account books, documents from various officials and so on – and it takes enormous time for satisfying these conditions and obtain the loans. For instance, on the arrival of goods from elsewhere, the businessmen need credit for releasing the same on such occassions, they find it difficult to ensure prompt disbursal of loans after meeting all the conditions. In contrast, FFs do not insist on such conditions, hence, the demand for credit from FFs increased.

The migrant farmers from Coastal Andhra[22] had played significant role in the rise of FFs. Since these farmers were largely tenants, it was difficult to obtain institutional credit for agricultural purposes without owned lands here. They had to largely depend on the private sources of credit. After realising surplus in agriculture, they started investing them in FFs, with an idea of exercising control over them.

Thus, as a result of decline in traditional forms of moneylending and the rapid expansion of business in Bellary town, the urban bourgeoise felt a dire need for credit, At the same time, as a result of transition from dry agriculture to irrigated agriculture, the newly emerging bourgeoisie from the hinterland also needed credit. These two classes found the solution in the then fast spreading innovation of informal credit market viz., private financing firms.

SECTION II

FUNCTIONING OF THE FINANCING FIRMS

As noted earlier, in Bellary town there are 275 FFs There is a significant variation in their scale of operations.[23] While 70 per cent of total firms have an annual turnover below Rs 5 lakhs, 15 per cent of them have between Rs. 5 to 10 lakhs. Another 10 per cent of them have an annual turnover of Rs. 10 to 20 lakhs. Only 5% of them have an annual turnover of more than Rs. 20 lakhs. Since there is significant variation in the scale of operations of these firms, care was taken in the selection of FFs and hence, we believe that they are fairly representative. Eight FFs were selected for an intensive study and their annual turnover -wise distribution is given in Table 6.

Table 6: Annual Turnover-wise Distribution of Sample Firms

Annual Turnover (in Rs)	No of FFs	Per cent
Below 5 lakhs	5	63
5 to 10 lakhs	2	25
10 to 20 lakhs	1	12
Total	8	100

Source: Survey data.

Since the partnership firms with capital less than Rs. 1 lakh are excluded from the purview of the Banking Laws (Miscellaneous Provisions) Bill, 1963, the FFs were started with an initial capital of less than Rs 1 lakh each. However, since carrying on business operations with such a small amount was difficult, each member was asked to deposit amounts ranging from Rs. 5000 to Rs. 4,0000 in the firm. The occupation-wise distribution of share capital and deposits is given in Table 7.

Table 7: Occupation-wise Distribution of Share capital and Deposits by Partners (1984-85). (amount in thousand rupees)

Occupation	Share Capital		Deposits by partners		Total Capital	
	Amount	%	Amount	%	Amount	%
Liquor shop	109.7	14	140	15	249.7	15
Commission Agent	74.5	10	102	11	176.5	10
Cloth business	119.6	16	144	15	263.6	15
Stationary Mart	19.80	3	30	3	49.8	3
Kirani Business	79.2	10	105	11	184.2	11
Fertilizers Trade	39.6	5	55	6	94.6	6
Foodgrain Trade (wholesale)	49.5	6	85	9	134.5	8
Financier	49.6	7	57	6	106.6	6
Services	59.8	8	51	5	110.8	7
Cultivation	59.8	8	84	9	143.8	8
Salaried Employee	59.5	8	54	6	113.5	7
Others	39.7	5	40	4	79.7	4
Total	760.2	100	947	100	1707.30	100

Source: Survey data.

It is evident from the Table that though per firm share capital is less than Rs 1 lakh, the deposits of partners in each firm crossed Rs 1 lakh. However, these deposits are kept under different fictitious names and interest amount on them is unaccounted.

The number of partners in a firm will usually be 10. An analysis of the occupations[24] of partners revealed that 73 per cent of total partners are businessmen. Since these firms mainly cater to the financial needs of businessmen, it is understandable that they came forward to start the FFs themselves. As shown in Table 7, these businessmen included liquor shop owners, cloth merchants, commission agents, wholesale merchants, kirani (provision) merchants and partners in financing firms. Nearly 15 per cent of total partners came from the categories of salaried employee and services. Interestingly, 8 per cent of total partners are cultivators who are mostly migrant farmers from Coastal Andhra.

Another interesting phenomenon is the concentration of the ownership of FFs in a few hands. It appears that a business house is a partner in as many as 10 firms. Even among the partners of the sample firms, nearly 39 per cent have shares in more than one firm. Another phenomenon is the nominal partnership. Usually a person, with a sizeable amount of unaccounted money, starts a firm with his close friends, relatives and workers in his enterprises as nominal partners. By paying the share capital on their behalf he not only converts black money into white, but also realises significant chunk of profits. It has a negative side also. Since mobilization of deposits from the public depends on the reputation of partners, movement of funds into such firms will be largely restricted.

Partners, besides the share in total profits, would get sitting fee ranging from Rs 40 to 75 for the monthly meetings. Though such meetings would hardly take place every month, it has become customary to deduct the expenditure on monthly meetings to show as low profit as possible in the annual profit and loss account. The managing partner takes active part in the functioning of the firm. Besides having a share in the profits, he is eligible to take a monthly salary of Rs. 500 (in one firm he gets 10 per cent of total profits as his salary). The rest of the staff is poorly paid.[25]

The sources of funds for these firms are share capital and deposits by partners and the public. There are four types[26] of deposits from the public. (1) Temporary deposits with a time period of less than 3 months, earn 17 per cent rate of interest. (2) Fixed deposits with the time period of more than 3 months, earn 18 per cent. (3) Cash certificates which enable its holder to claim double the deposit amount after 48 months and triple the amount after 75 months. However, the firms are discouraging these cash certificates, because they involve huge payment at a time. (4) Pigmy deposits (meaning collections made at the door of the depositors in small amounts) for which the rates of interest differ; a borrower gets 6 per cent rate of interest, non-borrower gets 8 per cent and a partner obtains 3 per cent. Besides, the firm has to give 3 per cent discount on these deposits to the pigmy collector.

In addition to paying attractive rates of interest, the firms provide good services to the depositors. They allow the customers to collect the interest periodically. In case of the non-local customer, the interest amount would be sent to him at firm's expense. The depositors also have the facility to withdraw the money at a short notice. Besides, the depositors receive promissory notes and legally valid documents. Moreover, the movement of deposits into FF depends on the reputation of its partners. People deposit money because of their confidence and trust in the partners, who are usually their close friends and relatives. The partners would give them personal assurance that they would pay the money from their pocket, in the event of the collapse of the firm. All these factors have helped attracting large amounts of deposits from the public.

In 1984-85, our sample firms obtained Rs. 34.7 lakhs as deposits from the public. Since risk is involved in keeping deposits in the FFs, the depositors prefer to keep them as temporary, as is evident from Table 8.

Table 8: Types of Deposits from the Public (1984-85)

Type of the Deposit	Amounts (Rs in lakhs)	Per cent
Fixed deposits	7.92	23
Temporary deposits	25.34	73
Pigmy deposits	1.49	4
T o t a l	34.75	100

Source: Survey data.

The FFs in Bellary as a whole attracted Rs. 11.41 crores. An analysis of occupation[27/] of the depositors in the sample firms revealed that private moneylenders' share in the total deposits is 34 per cent (table 9).

Table 9: Occupation-wise Distribution of Deposits from Public (1984-85)

Occupation	Amount (in Rs. lakhs)	Per cent
Private moneylender	11.18	34
Salaried employee	4.51	13
Housewife	2.98	9
Retired employee	2.53	8
Cultivator	3.93	12
Kirani merchant	5.63	17
Cloth merchant	1.22	4
Contractor	0.86	2
Others	0.42	1
Total	33.26	100

Sour.-- Survey data.

As we noted above, the moneylending business was brisk till 1970 and since then the FFs have replaced moneylenders. Moneylenders prefer to keep their money as temporary deposits. By keeping temporary deposits, moneylenders not only get higher rate of interest than what is paid in the banks, but also have facility to withdraw at any time to give it to their customers, if there are any, at still higher rates of interest.28/ Among others, agriculturists, salaried employees, housewives, retired people and kirani (provision) merchants are the important depositors. Kirani merchants keep their money in the off season and withdraw the amounts in the peak season.

It appears that the government's attempts to regulate the movement of deposits into these firms are thwarted by the clever tactics adopted by the depositors as well as FFs. As per the Banking Laws (Amendment) Act, 1983, a firm which has 10 members can mobilise deposits from not more than 250 persons. However, these firms are violating this rule. A firm, after crossing 250 depositors mark, start another FF with same partners and same management. Moreover, if the total interest amount payable to a customer exceeds to Rs. 1000 per annum, the tax on this amount should be collected at the source. In order to avoid this payment, people are advised by FFs to keep deposits less than Rs. 6000. Some people deposit the amounts under different names. Thus, although these two rules were aimed at the regulation of deposits into FFs, they were hardly effective.

<u>Lending operations:</u> There are two types of loans - hundi discounting and check discounting loans. Hundi discounting loans are further divided into two types; sight loans and daily repayment loans. Sight loans are to be paid back within prescribed time, which is usually 90 days. The borrowers of sight loans are forced to make daily deposit of Rs 10 to 20 which can be diverted for the repayment of loan, if the borrower fails to repay. The FF will give 6 per cent rate of interest on pigmy deposits. The firm will deduct the total interest amount at the time of issuing of loan. Under daily repayment, the total amount of loan, after the deduction of interest amount, will be divided into 100 daily instalments. The rate of interest will be charged only for 90 days, the remaining 10 days being the grace

period. The FFs also discount the post dated cheques. The cotton growers, who come to the commission agents for the sale of cotton, will be given post-dated cheques which are discounted by FFs. The commission agent suggests the FFs in which he is a partner of which firm discounts his cheques. Cheques are usually post dated for 30 days or less. In this type also the total interest amount will be deducted at the time of issuing of loan.

As per the Karnataka Moneylenders Act, 1961, the FFs should not charge more than 21 per cent rate of interest per annum. However, rate of interest would vary between 24 to 36 % per annum, depending on the type of loan, the customers and tightness of market (since the interest amount is deducted at the time of issue of loan, the rate of interest works out at 39.5 per cent per annum in some cases) It is 27 per cent per annum to the regular and credit-worthy customers and it is inversely related to the amount borrowed. As the funds would get accumulated in the off season, the managing partner himself would ask his co-partners and/or regular customers to take loans and naturally the rate of interest will be low at 24 per cent. However, the rate of interest will invariably be 36 per cent on cheque discounting loans.

As far as the procedure of sanctioning of loan is concerned, a customer, along with a surety, has to fill in the application form for loan and submit the same. The responsibility of the two parties (i.e., customer and surety) in the repayment of loan is joint and several. The managing partner would then send in the application form to the working committee - which consists of 5 to 6 active partners, who know the businessmen of the town - for its assessment of the applicant and the loan would be granted on its approval. In case of any stalemate, the decision would be taken in an emergency meeting convened by the managing partner. Loans will be mainly given to local merchants and agriculturists living in the surrounding villages. The renewal of loans is allowed only once; hence, it is learnt that, defaulters borrow from other firms for repayment of the outstanding loans, as exchange of information is poor among the firms, due to competition. However, the facility to renew the loan for more than once does exist in some firms.

The size of the loans issued depends partly on the size of a firm. For instance, in one of the biggest sample firms, the maximum and minimum loans are Rs. 2 lakhs to Rs. 50,000 respectively. On the whole, while the minimum varied between Rs. 500 and 50,000, the maximum loan varied between Rs. 65,000 and Rs. 2 lakhs. Of the FFs which have an annual turnover of less than 5 lakhs, only once a FF has granted a loan of Rs 1 lakh. Otherwise, their maximum loan would be around Rs. 50,000.

In 1984-85, the sample firms lent an amount of Rs. 59.9 lakhs, and more than 90 per cent of it to the businessmen (Table 10). While liquor businessmen borrowed as much as 29 per cent of total amount, cotton commission agents borrowed more than 23 per cent.[29] Others include businessmen in fertilizers, foodgrains, stationery mart, provisions, cloth and petty-business. Cultivators borrowed 4 per cent of total funds. It is learnt that these FFs also finance the production of films and purchase of vehicles. It is estimated that the total amount lent by all the firms in Bellary was Rs. 20.3 crores in 1984-85.

Significantly, there is strong relationship between the occupation of partners and borrowers in the first three firms (Table 10) This association is significant in the fourth firm. Although such strong relationship is not apparent in case of other firms, the similarity of occupations is decernible. This could be because of two reasons; firstly, partners may themselves be borrowing for other business activities, although it is violation of rules and secondly, the partners may be helping the businessmen in their own field to get the loans from their FF. However, the latter proposition is unlikely, because after all they are competitors in the same field for credit and market. Hence, the former proposition may be more plausible than the latter one.[30]

Table 10. Occupation-wise Distribution of Total Capital (Share Capital & Deposits) by Partners and Amount Borrowed (1984-85)

Occupation	1		2		3		4		5		6		7		8		Total	
	A	B	A	B	A	B	A	B	A	B	A	B	A	B	A	B	A	B
Group 1																		
Liquor Business	57	52	52	73	-	-	-	-	-	-	12	34	-	16	-	31	15	29
Commission agent	14	6	13	2	20	4	-	24	20	67	11	16	-	26	13	50	10	23
Stationary Mart	-	-	-	-	-	-	-	-	12	1	-	17	16	4	-	-	3	4
Fertilizers	9	-	9	2	-	-	-	4	-	14	-	-	12	26	11	6	6	11
Others	11	18	13	8	-	19	-	5	-	9	-	-	10	17	-	3	4	10
Group's Total	91	76	87	85	20	23	0	33	32	91	23	67	38	89	24	90	38	77
Group 2																		
Cloth Business	-	-	9	7	36	6	56	20	15	1	23	10	-	-	-	-	16	5
Services	-	5	-	3	44	39	-	23	-	-	10	-	-	-	16	-	6	4
Kirani Merchant	-	8	-	-	-	32	-	5	5	5	35	13	21	-	13	10	11	6
Foodgrain Dealer	-	-	-	-	-	-	-	-	-	-	-	-	23	11	20	-	8	3
Cultivator	-	1	-	-	-	-	-	10	23	2	9	10	-	-	-	-	8	4
Salaried Employee	9	10	4	5	-	-	11	-	9	1	-	-	18	-	-	-	7	1
Financier	-	-	-	-	-	-	-	-	16	-	-	-	-	-	27		6	-
Group's Total	9	24	13	15	80	77	100	67	68	9	77	33	62	11	76	10	62	23
Total	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100	100

Notes: 1, 2, 3, ...8 indicate the sample FFs.
A = Percentage of total capital (share capital and deposits) by partners.
B = Percentage of total amount borrowed.

We have attempted to distinguish the business categories, which mainly lend or borrow the money. Some business categories - like liquor, commission agents, stationery mart, fertilizer and petty business - mainly borrow rather than lend money. These business categories have invested 38 per cent of total amount, while they borrowed as much as 77 per cent of total money (table 10). On the other hand, other business categories - like cloth business, kirani business, food grains dealer, financiers, services, cultivators and salaried employees - have contributed as much as 62 percent of total amount and borrowed only 23 per cent of total amount.

Thus, these firms essentially function like banks carrying out borrowing and lending. However, these FFs, like any other bank, are expected to maintain a certain portion of their assets in liquid form. Although the firms keep some cash reserve, they are not maintaining any standard liquidity ratio and it varies between 0.5 to 5 per cent. And also they do not maintain any fixed ratio between owned funds and the deposits from public. It varies from 1:0.5 in small firms to 1:16 in large firms.

The firms are generating significant amount of unaccounted money (hereafter UM). We have estimated the amount of UM generated by the firms in Bellary town as a whole from the amount of UM generated by the sample firms. As stated earlier, although the rate of interest charged by firms is shown as 21 per cent in the account books, they actually charge rate of interest ranging from 24 to 39.5 per cent. The amount of interest paid above 21 per cent is UM. Taking the factors which determine the rate of interest (i.e., the amount of loan, type of borrower and tightness of the market) into consideration we have worked out the average real interest rates for firms of different sizes. Since we know the net profit shown by the sample firms in their account books, the difference between this amount and the net profit calculated with real rates of interest gives us the UM.[31] Besides, as noted earlier, the partners would deposit some amount (to be used as initial capital) in different fictitious names. The interest on this amount would go to the partners and hence, this amount is also UM.[32/] The total amount of UM generated by all the FFs in Bellary is Rs. 88.97 lakhs in 1984-85. The percentage of UM to the total amount lent is 4.4, while the percentage of UM to total deposits is 7.9

SECTION III
CRITICAL REVIEW OF THE FINANCING FIRMS

The FFs have emerged as an important parallel banking system in many parts of the South India and in Gujarat. These FFs, which are supposed to function with less than Rs 1 lakh, have advantages like local knowledge and low cost of operation which can be utilized to the country's advantage. It was explained in the Loksabha that these firms are excluded from the purview of Banking Laws (miscellaneous Provisions) Bill, 1963, because their scale of operations is small, they are at the beginning stage and they can meet the credit needs of small borrowers. Thus, the FFs have a certain role to play in the economy. Notwithstanding these merits, regulations have to be imposed on FFs due to the folllowing reasons.

Although the FFs claim that they function with capital less than Rs 1 lakh, the total capital will invariably be more than Rs. 1 lakh. As noted above since carrying business with an initial capital Rs 1 lakh is difficult, every partner is asked to make deposits ranging from Rs. [illegible] to 40,000. If one accepts that these deposits can be treated as capital, the capital of each firm very well exceeds Rs 1 lakh and hence, they are no longer small firms,

Repayment of loans is so far good, due to a steady expansion of the cotton business in Bellary. However, if a business crisis leads to delay in the repayment of loans, the firms may find it difficult to repay the deposits. Secondly, there is problem of over trading Since the exchange of information among the firms is poor, a customer can borrow from various firms and this, if continued, may lead to collapse of the firms. Thus, the depositor's money is at stake.

Though the FFs claim to have registered under the Karnataka Moneylenders Act, it is learnt that many of them are not registered. Even if they are registered, the authorities, at the most, can fix ceiling on interest rates and they can not still safeguard the depositor's money. Since FFs are not banking companies, the deposits kept with them can not be insured by the Deposit Insurance Company. As stated earlier, the FFs do not maintain any standrad liquidity ratio or any particular ratio between their owned funds and deposits. Presisely because of this reason the FFs are able to offer higher interest rates on deposits. The difference between the rate of interest offered by FFs and that of by commercial banks is 7 per cent. Given the inflationary tendencies in the economy, this difference is big enough to attract the salaried and retired people to deposit their money with the firms even at a risk. In Bellary the mobilisation of deposits largely depends on the credit-worthiness of the partners. However, this can not be considered as a safeguard for depositors' money because "firstly each of the partner has a business of his own and it is unlikely that he would have surplus cash. Secondly, it is very difficult to assess the assets of partners" (Banking Commission 110; 1971). Moreover, the phenomenon of intra-group financing would seriously affect the interests of the depositors.

Next important question is ensuring that advances made by these firms are not put to undesirable uses. As noted earlier, the bulk of the firms' advances is used for unproductive purposes like liquor business. Fertilizer dealers borrow for hoarding the pesticides. Wholesale foodgrain dealers borrow for purposes of smuggling paddy from Andhra Pradesh into Karnataka and hoard the stocks. Not a single industrialist availed of these funds. Elsewhere also, the bulk of the amount was used for hoarding and speculative purposes and such misuse of precious savings of the community would affect the objectives of selective credit controls (Banking Commission, 111; 1971). Since the loans are utilized for unproductive and undesirable purposes, the borrowers are able to pay such an exhorbitant interest rate. The holding of stocks financed by FFs will tend to push up prices in so far as local, short term monopolies are in existence which enable the traders to jointly withhold stock from consumers. In any case, unless the businessmen are confident of making profits on the funds borrowed at exhorbitant interest rates they will not go for the loans. Thus, in effect these interest rates are borne by consumers.

Although FFs earn huge profits (by charging exhorbitant interest), there is no way by which government can tax them. As stated earlier, these FFs are generating significant amount of unaccounted money. Thus, the FFs are doing considerable damage to the economy.

With regard to regulation of FFs, the Banking Commission (1971) made the following recommendations, which may be classified into mild[33] and drastic categories. Mild recommendations allow the FFs to continue their operations with certain regulations and active supervision by the RBI. However, since this involves the supervision of large number of small FFs and hence, operationally next to impossible, the Commission recommended that FFs should not be allowed to do banking business. Since these are registered under Moneylenders' Act, they should stick to only moneylending business. Only public limited companies should be allowed to do banking business. These two sets of recommendations viz; mild and drastic, are mutually exclusive. However, the Commission was sceptical when it noted that "legislation .. may be helpful but would not meet the requirements of the situation partly because it is not always easy to administer the laws. This is particularly true when the number of units which have to be regulated or controlled is large. Also, loopholes can always be found" (115). Hence, it finally concluded that commercial banks should refashion their policies and procedures to satisfy the demands of borrowers and depositors.

Thus, it is difficult to arrive at easy solutions. This is especially true when the lobby of private financiers is powerful. A well intended law like restricting the number of depositors is challenged by several unincorporated bodies in the High Courts of Delhi, Madras, Hyderabad and Bangalore. Though these writ petitions were dismissed by the Division Bench of Delhi High Court in December 1985, the petitioners appealed to the Supreme Court and the matter is still . ling.[34]

The Trivandrum-based Chamber of Financiers, an organization of moneylenders, filed a writ petition in Kerala High Court challenging the recent amendment to Kerala Moneylender's Bill.[35] However, in view of protecting large sums of deposits in these unregulated firms, it is essential to bring them under some form of control. Since there will be problem in the regulation of vast number of FFs by RBI, it would be better to allow only public limited companies to do banking business. The FFs which register under Moneylenders Act, should be allowed to do only moneylending business and nothing else. Besides commercial banks should refashion their policies to compete with FFs for depositors and borrowers, because, as noted by Banking Commission, so long as the number of unsatisfied borrowers is large, FFs might continue to occupy a place in the deposit and lending business.

CONCLUSIONS:

For significant growth of FFs in Bellary town since 1978, factors such as transformation of dry agriculture and realization of surplus by certain agricultural communities from the hinterland, decline of the traditional forms of moneylending, expansion of business activities, urbanization, restriction imposed on credit disbursed for business and problems within commercial banking system are responsible.

Though these firms are supposed to start with less than Rs 1 lakh as initial capital, it is invariably more than Rs 1 lakh. Mainly liquor shop owners, cloth merchants and commission agents start the FFs. The interesting phenomena are concentration of firms in a few business houses and nominal partnership, through which tax dodgers convert black money into white. The sources of funds for these firms are share capital and deposits by partners and general public. In 1984-85, the firms in Bellary town obtained deposits worth Rs. 11.41 crores. The FFs are able to obtain deposits because of attractive interest rates, personal assurance given by partners and other facilities like periodic collection of interest amount, withdrawal of loan at short notice, etc. Mostly moneylenders, salaried employees, housewives and general merchants keep their money in these firms. Moneylenders and general merchants keep their money as temporary deposits, so that they can withdraw the money whenever they need it.

The FFs give two types of loans; hundi discounting loans and cheque discounting loans. The rates of interest on these loans vary from 24 to 39.5 per cent depending on the type of borrowers, size of the loan and tightness of the market. The loans which are given for short period i.e., below 90 days, can be renewed only once. The businessmen consist the bulk of the borrowers. Even among them, it was liquor businessmen, cotton commission agents, stationery shop owners, wholesale fertilizers and food grain dealers who borrowed the bulk of the amount. Another interesting phenomenon in these firms is intra-group financing. While the above categories mainly borrow rather than lend money, other categories like cloth merchants, financiers and salaried employees, agriculturists mainly lend rather than borrow.

Though the repayment of loans is so far good, a business crisis may lead to liquidation of several firms and consequently, there may be danger to the safety of depositors' money in these unregulated FFs. This question becomes all the more important, when these FFs are not maintaining any standard liquidity ratio or any ratio between owned funds and deposits and they use funds for intra-group financing. Another important question is their possible use of [illegible] for undesirable purposes. Such misuse of precious savings of the community would reduce the effectiveness of government policies. By exhibiting doctored accounts and resorting to several manipulations, the FFs are generating significant amount of unaccounted money and there is no way through which one can tax them. Thus, it is necessary to regulate these firms.

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NOTES

1. The growth of deposits of non-banking finance companies was quite impressive. For instance, between 1962 and 1968, their deposits increased from Rs. 135.5 crores to Rs. 477.8 crores i.e., an increase of 253 per cent. Between 1973 and 1982, these deposits increased from Rs. 747.8 crores to 5491.0 crores i.e., an increase of 634 per cent! For details see RBI bulletins of April, 1971 and November, 1983.

2. A non-banking financial intermediary is defined as "a company, corporation or firm, and financial institution.... any non-banking institution (1) which carries on as its business or part of its business the financing, whether by way of making loans or advances or otherwise, of trade, industry, commerce or agriculture or (ii) which carries on as its business or part of its business the acquishtion of shares, stocks, bonds, debentures, or debenture stock or securities issued by a government or local authority or other marketable securities of a like nature or (iii) which carries on as its principal business hire-purchase transactions or the financing of such transactions" (Banking Commission, 1971;7).

3. The study group on non-banking financial intermediaries felt that the scale of activities of these institutions in the late 1960's were not large enough to make the monetary policy ineffective. The study group cited that at the end of March 1968, the percentage of deposits of non-banking companies to the deposits of commercial banks was less than3.(Banking Commission 1971; 17-18) However, at the end of March 1982, this figure had increased to 12.5 thereby threatening the country's monetary policy. (RBI Bulletin, November, 1983)

4. Sundaram and Pandit argued that the informal credit markets affect the monetary policy. However, this view was questioned by Acharya and Mathur (1983; 1984), who argued that the informal credit markets do not affect monetary policy, unless one makes extreme assumptions regarding the relationship between organized and unorganised money markets. The debate is still inconclusive.

5. These studies include Nayar C.P.S. (1973) and M.A.Khan (1980). For an excellent review of informal credit markets in India, see Timberg T and Aiyer C.V.(1980).

6. These studies include Banking Commission (1971), M.A. Sreenivas (1975) and Prakash B.A. (1984).

7. Though Prakash (1984) gives broad division of occupations of borrowers like businessmen, agriculturists, salaried employees etc., he did not provide us with the further break-up of businessmen. This is a crucial indicator through which one can gauge the direction of money flow.

8. The FFs are generally referred to as "Finance Corporations". In fact, they should not be called so, for they are unincorporated bodies.

9. See a news item of Finance Minister's statement in Kerala Assembly, The Hindu, June 12, 1987.

10. See a news item in The Hindu, July 19, 1987.

11. See a news item in Business Standard, Thursday, December, 5, 1985.

12. This estimate was provided by the President of the Association of the Finance Corporations. Our discussions with other people concerned with FFs also corroborated this figure.

13. For example, the government sought to regulate the inflow of deposits into partnership firms, by enacting Banking Amendment Act, 1983, which restricts the number of depositors at 250 each for a 10-member partnership firm. However, it was reported that in Hyderabad these firms continued to violate the rules (Business Standard, op.cit.,). [illegible] resorted to raids on FFs, which violated the rules in various parts of Kerala (news item on "Blade Companies on Razor's edge", Indian Express, February 13, 1985). However, these raids were abruptly stopped allegedly due to the nexus between the private financiers and politicians. The present Left government, after passing the Moneylenders' Bill in May, 1987, conducted a series of raids and seized allegedly incriminating documents (see a news item in The Hindu, June 18, 1987).

14. Since our interest is to look at the amount of unaccounted money generated by FFs, types of borrowers and use-pattern of borrowed funds, we had to secretly examine confidencial records such as balance sheets, names and occupations of the borrowers and so on. Hence, we could collect data from only eight FFs. Nevertheless, the functioning of FFs was documented after the detailed discussions with various FFs, President of the Association of the Finance Corporations and other people concerned with FFs. We believe that the data furnished by these sources are fairly reliable,

15. Under this form of financial institution "the members joined and contributed a monthly instalment of Rs 1 for usually 84 months and at the end of eighty fifth month received back about Rs. 100. Loans were given to members on the strength of these subscriptions paid and balances not so lent were available for loans on other securities to the member and sometimes also to outsiders" For a historical account on Nidhis and Banking system in Madras Presidency, see The Madras Provincial Banking Enquiry Committee, Vol. 1, 1930, pp. 196. In order to know the present state of affairs of Nidhi see Banking Commission (1971).

16. Under these acts, all the moneylenders were asked to obtain licences from Registrar of co-operative societies. These acts specified the interest rates, enhanced licence fee, and asked the money-lenders to maintain regular accounts in respect of each loan advanced by them, issue receipts for every payment made by a debtor and furnish to a debtor, on demand, a statement of accounts or debt, showing the principal and the interest outstanding (K. Abhisankar, 1972; 250).

17. Excepting the second and fifth decades of 19th century, every other decade had experienced widespread droughts or famines. As for the 20th century, there was a famine in the district in 1931-32. In 11 years of the fourth and fifth decade, owing to adverse conditions, there were postponement of collections and remissions of land revenue in some or other parts of the distr ct (Francis, 1904; Abhisankar K. 1972).

18. While in 1960-61 the total irrigated area by different sources was 1.1 lakh acres, it had increased to 1.8 acres by 1970-71. It further increased to 2.9 lakh acres by 1983-84. To put it differently, while the percentage of the area irrigated to total cultivated area was 10 in 1970-71, it increased to 23 by 1983-84.

19. While the percentage of area under paddy and groundnut in Bellary taluk had increased from 3.4 and 6.0 in 1968-69 to 8.8 and [illegible] in 1983-84 respectively, the percentage of area under jowar declined from 33.7 to 18.7 during the same period. However, the area under cotton remained more or less constant at 37 per cent.

20. In Bellary taluk, between 1977-78 to 1983-84, the consumption of fertilizers had increased from 6 thousand tones to 10 thousand tones, an increase of 59 per cent. During the same period the consumption of fertilizers in Bellary district as a whole increased from 27 thousand tones to 52 thousand tones, an increase of [illegible] per cent.

21. Per acre yield rates of rice, jowar and cotton in Bellary district had increased from 12 quintals, 3 quintals, and 1 quintal in 1953 to 30 quintals, 15 quintals and 4 quintals in 1968 respectively. Corresponding to increase in yield rates the production of important crops also had gone up. The production of paddy, jowar, sugarcane and cotton in Bellary taluk had gone up from 13.3 thousand tones, 22.9 thousand tones, 5.8 thousand tones and 0.5 tones in 1968-69 to 20.1 thousand tones, 51.8 thousand tones, 28.3 thousand and 5.6 thousand tones in 1978-79 respectively.

22. These farmers started migrating to Bellary, Raichur, Anantapur and Kurnool districts when the Thungabhadra Project was commissioned. The pattern of settlement varied from time to time; but most of the late migrants were tenants. These farmers were instrumental in bringing the changes in cultivation practices, use of inputs and so on.

23. This classification has been arrived at after the discussion with the President of the Association of Finance Corporations and others concerned with the FFs.

24. It has to be clarified here that though a few housewives are partners, operationally they are not prominent. Since their husbands are employed or are partners in some other firms, they will be registered as partners. In such cases, the occupations of husbands are taken into account.

25. The staff (excluding the managing partner) consists of a clerk-cum-accountant, a pigmy collector and an office boy. The accountant, who gets a salary of Rs. 300, checks application forms for loans deposits and vouchers and prepares monthly and annual accounts. Pigmy collector, who gets a monthly salary of Rs. 150, collects the daily payments and pigmy (daily) deposits. The office boy, who gets Rs. 100 per month, will be at the beck and call of every one in the office. It is not uncommon to find one person doing the functions of both pigmy collector and office boy for a salary of Rs. 200 per month.

26. Besides these four types, the FFs in Bangalore started a few more innovative and imaginative schemes (like prize and gift schems, insurance cover, interest free accommodation, additional interest for women and children etc.) to attract deposits (Banking Commission, 1971; 106-7).

27. Since we could not collect occupations of the people, who kept their money as saving deposits, only occupations of people who kept money as temporary and fixed deposits are given.

28. Similar phenomenon is evident in Bangalore also (Banking Commission, 1971; 105).

29. The total amount given to commission agents is slightly misleading. As for as discounting the post-dated cheques is concerned, although the FF enters the name of commission agent as borrower, in effect some cultivator or some businessmen would have taken it.

30. This sort of intra-group financing is also prevalent among the FFs in Hyderabad (Business Standard, op.cit.)

31. The procedure is as follows.
Declared rate of interest = 21 per cent.
Average real rate of interest = 30 per cent
30/21* Declared net profit

The sum of the above gives us the amount of unaccounted money generated by each firm, by showing a lesser rate of interest.

32. The amount of deposits put bu partners is Rs.1.75 lakhs. In records they show that 18 per cent of interest is given to various depositors; but in practice this amount goes to partners themselves and hence it is unaccounted money generated by concealing the deposits of the partners.

33. The Banking Commission wanted the RBI to extend its authority over all the FFs with the following regulation. (i) No finance corporation may be allowed to work without a licence from the RBI (ii) A ratio may be prescribed between the owned funds of an institution and its deposit liabilities. (iii) Liquidity ratio may be suggested for them which may be lower than that in the case of commercial banks. (iv) Periodical inspections of the corporations may be undertaken on a sample basis by the regulating authority. (v) A ceiling on interest rates on deposit may be prescribed which may be higher than that prescribed for the commercial banks. (vi) In addition to the above, FFs may be classified as "approved" and "non-approved". Approved FFs are those which adhere to the guidelines of RBI and will have the following facilities: refinancing from the commercial banks and RBI, extension of deposit insurance and using these FFs as agencies of commercial banks for their advances to small traders and businessmen (Banking Commission, 112 to 115; 1971)

34. For details see Report on Currency and Finance, pp.212,Vol.1, 1985-86.

35. See a news item in Indian Express, June 24, 1987.

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