

UNDERSTANDING THE DEMAND FOR BANK CREDIT BY MICROFINANCE INSTITUTION'S CLIENTS

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ABSTRACT

The process of financial inclusion for the urban poor requires households to access bank credit. However, banks often avoid serving the poor due to historical issues like high default rates and high transaction costs, making small loans economically unviable. This paper looks into the issue relating to households' demand for bank credit. The study, based on data from 368 MFI clients in Delhi slums, reveals an increase in bank account ownership among MFI clients, though many still face challenges in obtaining bank loans. The high rejection rates are due to collateral demands and incomplete paperwork. The majority avoided bank credit due to complicated paperwork, lack of collateral, and ignorance of loan procedures. MFIs fill this gap with group loans that require no physical collateral and offer easier access and flexibility.

Keywords: Microfinance Institutions, Urban Poor, Bank Credit, Saving Services

1. INTRODUCTION

Access to bank credit is the most important aspect of financial inclusion. The credit may allow households to make new investments or expand existing ventures, resulting in higher income and welfare. However, various studies suggest that banks and formal financial institutions generally avoid serving the poor due to historical reasons (high default rates, poor recovery, bad debts, etc.). The banks are faced with the problems of adverse selection, moral hazard, and high transaction costs while dealing with poor borrowers. Since providing such a small quantum of loans by the banks involves high transaction costs, it becomes an economically unviable proposition. Hence, the demand for small-size loans, usually by the poor remains largely unmet. According to Pitt and Khandker (1996), poverty tends to persist because the poor, lacking access to sufficient financial resources, are trapped in a vicious cycle characterized by low capital, productivity, income, and savings. Microfinance institutions (MFIs) aim to break this cycle by expanding the financial capital available to the poor. These institutions provide essential financial services to low-income individuals who are typically excluded by conventional banks due to their minimal savings, small loan needs, and lack of collateral. This paper examines the factors affecting households' demand for bank credit and the challenges they face when seeking loans from banks. For those who do not apply for bank credit, the study explores the reasons behind this decision. The analysis is based on primary data gathered in 2016 from 368 MFI clients, primarily women living in Delhi slums. It is hypothesized that the poor are hesitant to apply for bank loans due to the strict procedures involved.

Following the introduction, the subsequent section provides an overview of the existing literature on the demand for bank credit. Section 3 explains the database and the methodology used. Section 4 presents the results of the study. The last section concludes.

2. A BRIEF LITERATURE SURVEY

Household's Demand for Bank credit

Access to institutional credit is a crucial element of financial inclusion. However, banks often avoid serving the poor, primarily due to past experiences of low loan recovery rates. Despite the expansion of bank branches in urban areas, credit remains inaccessible to the poor, a reality confirmed by various studies. For example, Microfinance India (2006) found that while 40% of respondents had formal savings accounts, only 4% had secured loans from banks or non-bank financial companies (NBFCs), relying heavily on informal credit sources instead. Similarly, Nandhi (2011) revealed that 82% of migrant rickshaw pullers in Delhi lacked bank accounts and depended on informal sources—such as moneylenders, friends, and relatives—to meet their credit needs. A study by KC et.al. (2011) also found that although 62% of urban microfinance clients held bank accounts, only 11% had accessed bank loans, indicating continued reliance on informal credit.

This pattern suggests that households tend to save with formal institutions but prefer borrowing from informal sources due to the ease of access, trust, and familiarity they offer. As Microfinance India (2006) pointed out, simply holding a savings account with a formal institution does not automatically translate into the use of formal credit products. Many studies have indicated that people are hesitant to apply for bank credit. Microfinance India (2006) identified reasons such as a lack of awareness about available services, perceptions of having insignificant needs, and past rejections by

formal lenders. Similarly, KC et.al. (2011) reported that 30% of urban microfinance clients did not require the type of credit banks provided, 25% found the application process too complicated, and 11% were unaware of bank products and services. Comparable findings were observed in Ghana by Addo et al. (2017), where the main reasons farm households avoided bank loans included the lack of a guarantor (34%), no need for credit (27%), and complex procedures (15%). Most of those who applied for a bank loan but had their loan applications rejected did not know the reason for rejection (63%) followed by the absence of a guarantor (20%), and then not being able to provide collateral (11%).

One major challenge for the urban poor in accessing formal financial services is their inability to meet the requirements to open bank accounts, such as a permanent address, and the need for an "introducer" to facilitate the process (Microfinance India, 2006). MFIs have played a vital role in bridging this gap by promoting financial inclusion, often helping their clients navigate the account-opening process. Urban clients generally prefer informal service providers due to their convenience, flexibility, and doorstep services (Microfinance India, 2006).

MFIs, with their group loan schemes, have become a popular alternative to banks. These schemes offer the poor the ability to access loans without the need for physical collateral, as joint liability is used instead. MFIs also provide simple procedures, easy repayment options, and doorstep delivery of services, making credit more accessible to low-income individuals. This ease of access to credit is often more critical to the poor than lower-cost loans, which banks offer but are accompanied by lengthy bureaucratic processes and delays (Malegam Committee Report, 2011).

While initiatives like the Pradhan Mantri Jan Dhan Yojana (PMJDY) have significantly increased the number of bank accounts, the vital component of loan provision to the poor has been largely neglected. Most respondents with PMJDY accounts use them primarily for receiving government subsidies, such as LPG transfers, rather than for accessing loans. This highlights banks' failure to effectively reach the poor, and MFIs have stepped in to fill this gap by offering accessible financial services, contributing to their rapid growth and widespread popularity.

3. DATABASE AND METHODOLOGY

This study utilizes primary data collected from MFI clients, with a structured household questionnaire employed to conduct the survey. The total sample consists of 368 households residing in selected slums in urban Delhi, where MFIs are active. The MFIs were chosen through purposive sampling, while the sample households and slums were selected using convenience sampling. The sample is divided into two groups: a treatment group (T-group) and a control group (C-group), based on their access to MFI loans.

The T-group includes respondents who have already received loans from MFIs and have had at least three years of association with them. A total of 215 clients were randomly selected from the list of MFI clients, based on their willingness to participate, to form the T-group. The C-group consists of respondents who have been approved for their first loan from MFIs but have not yet received the funds. For this group, 153 clients were randomly selected from the MFI client list, also considering their willingness to participate. A survey of both the treatment and control groups, who shared similar socio-economic backgrounds, was conducted using a structured questionnaire during the last quarter of 2016.

4. RESULTS: HOUSEHOLD'S DEMAND FOR BANK CREDIT

Access to bank credit is the most important aspect of financial inclusion. To assess demand for bank credit, all respondents in both treatment (T-group) and control group (C-group) were asked the following questions: (a) Do you have a bank account? (b) Have you tried taking a bank loan? (c) Was your loan application accepted/rejected? (d) What are the reasons for rejection? (e) What are the reasons for not applying for a bank loan? The results are as follows.

Table 1: Percentage of households having bank accounts in the treatment (T-group) and control groups (C-group)

Percentage of households having a bank account	T-group before	T-group current	C-group before	C-group current
No-0 (%)	67.9(146)	4.7(10)	69.3(106)	55.6(85)
Yes-1 (%)	32.1(69)	95.3(205)	30.7(47)	44.4(68)
Total number of observations	215	215	153	153

Source: Author's estimates based on primary data. Note: Figures in parenthesis show frequencies of the variables.

Comparing the T-group and C-group w.r.t bank accounts as shown in Table 1, it is found that 32% of respondents in the T-group had bank accounts in the pre-loan period which increased to 95% in the post-loan period. However, for the C-group, this figure increased from 31% to 44% in the comparable period, which indicates a significant step up in financial inclusion by MFIs for those who availed of their financial services. One of the major reasons for the increase in the percentage of bank account holders in T-group has been the fact that MFIs after initial disbursement of loans of small

amounts in cash, give subsequent loans through cheques. The MFI's staff also facilitates the opening of bank accounts for their clients. Thus, MFIs help in achieving the goal of financial inclusion to a large extent by bringing their clients under the network of banking services.

Table 2: Percentage of households (having bank accounts) tried taking a bank loan in the treatment (T-group) and control groups (C-group)

Percentage of households who tried taking a bank loan	T-group	C-group
No-0 (%)	81(166)	94(64)
Yes-1 (%)	19(39)	06(04)
Total number of observations	205	68
Percentage of households whose loan application was accepted/rejected?		
Accepted-1 (%)	28.2(11)	50(02)
Rejected-2 (%)	71.8(28)	50(02)
Total number of observations	39	04
Reasons for rejection		
Demand collateral-1	35.9(14)	50(01)
Papers not complete-2	15.4(06)	0(0)
Any other-3	20.5(08)	50(01)
Total number of observations	28	02

Source: Author's estimates based on primary data. Note: Figures in parenthesis show frequencies of the variables.

As per findings shown in Table 2, out of the total respondents having bank accounts, only 19 % in the T-group and 6% in the C-group applied for a bank loan. Out of those who did apply for a bank loan, 72% in the T-group and 50% in the C-group could not get it sanctioned. Various reasons have been cited by the respondents for their bank loans being rejected. In the T-group, the major reason cited was the demand for collateral by banks as a guarantee (14 respondents), followed by incomplete paperwork (06 respondents) and "other" reasons (08 respondents). Among "other" major reasons were the absence of a guarantor followed by a demand for bribes in some cases and ineligibility for a loan due to being in low-paid private jobs. In the C-group, the reason cited was the demand for collateral by banks as a guarantee (by one respondent) and "other" reasons (by one respondent). Here "other" reason included the absence of a guarantor. These results validate the findings obtained in several studies. Microfinance India (2006), Nandhi (2011), and KC et.al. (2011), found that their respondents were largely dependent on informal sources of credit.

Almost 81% of respondents in the T-group and 94% of respondents in the C-group never applied for a bank loan. The reasons cited by the respondents for not applying for a bank loan are given in Table 3 below.

Table 3: Reasons for not applying for a bank loan by treatment (T-group) and control groups (C-group)

	T-group (frequency)	C-group (frequency)
Too much paperwork	89	26
High opportunity cost	30	06
Fear entering bank	40	05
No collateral to offer	44	11
Unaware of products and services	45	25
Other reasons	50	22
Too much paperwork and High opportunity cost	21	06
Too much paperwork and Fear entering bank	22	05
Too much paperwork and No collateral to offer	30	10
Too much paperwork and other reasons	16	08

Fear entering the bank and No collateral to offer	08	02
Total number of observations	166	64

Source: Author's estimates based on primary data

As Table 3 suggests, the major reasons why people didn't prefer bank credit are lengthy and tedious paper works (as reported by 89 respondents in T-group and 26 respondents in C-group), other reasons (50 respondents in T-group and 22 respondents in C-group), ignorance or no proper knowledge of bank loan facilities (45 respondents in T-group and 25 respondents in C-group), lack of collateral to offer as security (44 respondents in T-group and 11 respondents in C-group), fear of entering banks (40 respondents in T-group and 05 respondents in C-group), wastage of time and energy and consequent loss of work resulting in high opportunity cost (30 respondents in T-group and 06 respondents in C-group). For T-group, among the "other reasons," the major reason was MFI's group loan schemes under which it is easier for the poor to get loans from MFI and the benefits that they derive from group loans such as group-liability, doorstep delivery, easy repayments, etc. This was followed by unawareness among people about bank loan procedures, and in some cases, respondents reported that they did not require loans. For the C-group, among the "other reasons," the major reason was unawareness among people about bank loan procedures, some respondents reported that they do not require bank loans followed by the fear of rejection.

Some of the respondents reported multiple reasons for not applying for a bank loan. These are - too much paperwork and no collateral to offer (30 respondents in T-group and 10 respondents in C-group), too much paperwork and fear entering the bank (22 respondents and 05 respondents in C-group), too much paperwork and high opportunity cost (21 respondents and 06 respondents in C-group), too much paperwork and other reasons (16 respondents and 08 respondents in C-group) and fear entering bank and no collateral to offer (08 respondents and 02 respondents in C-group). The results are consistent with the findings of Microfinance India (2006), (KC et.al. (2011)), and Addo et al. (2017) which cited similar reasons for not applying for bank loans. Thus, it conforms to the hypothesis that the poor are hesitant to apply for bank loans due to the strict procedures involved.

It is therefore concluded that despite the expansion of banking facilities, the poor have not been either attracted by the loan facilities offered by the bank or those having applied for a loan were not favourably considered by the banks. This gap has been filled to a large extent by MFIs that are gaining rapid growth and wider popularity. One of the major reasons for its popularity is MFI's group loan schemes which makes it easier for the poor to get loans with joint liability and without any physical collateral.

5. CONCLUSIONS

An attempt has been made in this paper to understand the households' demand for bank credit. The analysis is based on primary data collected from 368MFI clients, mainly women in Delhi Slums in 2016. The study reveals a substantial increase in the percentage of households having bank accounts in the treatment group compared to those in the control group between the "before" and "current" periods. To a large extent, the MFI's staff by facilitating the opening of bank accounts for their clients, help in achieving the goal of financial inclusion. Majority of respondents who have bank accounts have not availed of loans from the banks. Those who applied for the loan were not favourably considered by the banks due to various reasons. Also, the majority of respondents never applied for a bank loan due to multiple reasons, thus, highlighting the bank's failure to reach the target group. This gap has been filled to a large extent by MFIs that are gaining rapid growth and wider popularity as their group loan schemes make it easier for the poor to get loans with joint liability and without any physical collateral. These results accept the postulated hypotheses and substantiate the existing literature that the poor are hesitant to apply for bank loans due to the strict procedures involved.

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