

What are the advantages of borrowing through formal channels rather than local moneylenders?

Borrowing from formal channels like banks and non-banking financial companies is safer when compared to private moneylenders.

Loan can be a serious liability for an individual and the correct management of the same is a crucial aspect of business, and even life. The most common form of loan taken by individuals is a personal loan. However, selecting the right mode of borrowing is crucial for your future years.

When it comes to loans, there are two types of lenders in the market today: formal channels like banks, non-banking financial companies (NBFCs), etc., and private moneylenders. Before applying for a loan, it is important that you understand the pros and cons of borrowing from organized and unorganized lenders.

Risk factor

Availing of a loan from banks, licensed NBFCs and microfinance institutions (MFIs) requires a significant amount of paperwork, which may seem cumbersome. However, the level of security in loans from such institutions is higher than that from unorganized lenders. There is little chance that a licensed lender will overcharge or cheat you. In case of an unorganized lender, the process may be simple and the paperwork may be minimal; however, the risk associated with such loans is higher, as the lending process may not be transparent.

Rate of interest

The working of organized lenders is usually regulated by the central bank. In case of India, it is the Reserve Bank of India (RBI) that puts in place policies to avoid unfair practices and take corrective measures. Hence, the rate of interest charged by these players cannot exceed a certain level. However, there is no such governing body when it comes to private money lenders. Consequently, they charge a rate of interest that is usually much higher than that of banks and NBFCs.

Recovery process

Another key factor that you need to keep in mind while availing a loan is the recovery process. In case of late payment, organized players such as banks and NBFCs may charge a penalty. However, a similar situation with an unorganized lender may result in personal visits from the lender or selling of the collateral.

Benefits

Borrowing from a financial institution like a bank provides a number of tax benefits and improves the credit rating of an individual or organization, if the debt is managed well. Such benefits are not available in case of unorganized money lenders, as there is no documented record of the transaction.