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DETERMINANTS OF FAILURE IN INFORMAL AGRO-FINANCE- A STUDY OF RURAL AREA OF KHYBER PAKHTUNKHWA, PAKISTAN

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ABSTRACT

Being a developing country, Pakistan finds most of its farmers facing very meager economic conditions. Owing to this, they are incapable to manage expenses of their various agricultural requirements and provisions; including basic agricultural inputs and machinery. In order to overcome these issues, through the most simple and conceivable means, they opt to secure financing from numerous resources, the most important of which are informal financing sources. However, there are some drawbacks related to informal finance that makes its usage less appealing. These include the practice of charging an exorbitant interest rate, the lack of appropriate legal documentation, the provision of insufficient funds, and reliance on trust. The empirical data was collected from farmers who, frequently avail informal finances, and have similar publicized shortcomings. The present study was conducted to critically analyze - theoretically as well as practically, through empirical research, the downsides of informal financing.

Keywords: *Informal sources, formal sources, agricultural finance, financial institutions, farmers, agriculture, rural areas, local farming.*

INTRODUCTION

For human survival and nourishment, food is an indispensable component. Among the many sources of food, agriculture is likely to be the most crucial one; as it provides variant and numerous selections (i.e., wheat, paddy, sugarcane, cotton, potato, mustard, tobacco, etc.). The importance of this sector is of paramount importance for the survival of man. So, the continued growth and development of this sector is the foremost duty of every civilized society.

Because of its importance, all classes of the society (i.e., upper class, middle class and the lower class) are associated with the agricultural sector in one way or another. Timmer, Falcon, and Pearson (1983) explain the phenomenon as, “Farmers are a remarkably diverse community, ranging from near-subsistence peasants in India and Guatemala to those in corporate business in California and Sao Paulo.” However, a worm view of the world’s farmer community makes public that majority of farmers belongs to the lower class of society. The case of Pakistan is not different in this regard where the majority of farmers have meager economic conditions (Malik & Nazli, 1999). A substantial number of such farmers live in rural parts of the country where their financial status drastically varies. With a conducive environmental condition, they can earn from their seasonal crop yield. However, catastrophes (which are not unusual here in the Subcontinent) jeopardize their agricultural yields and consequently their existence. Having such poor and unpredictable economic conditions, they constantly remain in dire need of financial resources for the purchase of basic agricultural inputs like seeds, fertilizers, weedicides, herbicides, and insecticides. For harvesting, they also need prerequisite tools, and sometimes heavy agricultural machinery of their own like tractors, thrashers, and harvesters.

For fulfilling their financial needs, farmers always seek and opt for various financing sources. Literature defined these as ‘formal’ and ‘informal’ sources. Formal sources include banks – both conventional and Islamic – non-governmental organizations, various regulatory bodies, and conventional financial institutions. Nevertheless, most of these sources are available in urban areas. The availability of formal sources in rural areas is scarce. Field experts associate it with many reasons. However, the most critical reason, being considered by experts, is inadequate infrastructure, natural calamities, human-made disasters and political instability in urban areas. So, the ease of accessibility, which is the essence of formal financing, is a hindrance for these urban areas farmers. They are left with the only option of informal modes of financing to secure and fulfill their agricultural needs, both for crop and non-crop activities. The providers of such intimate finances in Pakistan are mostly relatives, friends, neighbors, local money-lenders, village shopkeepers, traders, and commission agents (Bashir & Azeem, 2008). The attractive features of such financing, such as low-interest rates, low transactional costs, straightforward procedures and ease in approachability, persuade farmers to avail this mode of funding. However, with the changed pace in economy and multiple sources for investors to invest, this mode of financing has primarily been restructured. This restructuring and re-mechanization have distorted the fundamental essence of informal methods of financing. These factors create, as a result, hurdles in obtaining informal loans by farmers for their crop and non-crop activities.

Previously studied literature shows limited evidence of relationships between financial stability of farmers and informal financial system. Like the work of Schaefer-Kehnert and Von Pischke (1986); Tilakaratna (1996); Yehuala (2008); Bhattacharjee and Rajeev (2010), give indications about the shortcomings of informal sources of finances. However, their work has been limited only to few traits of informal financing. Majority of structural factors and the phases of mechanism seemed missing. Likewise, being qualitative in nature, their study cannot be contextualized and generalized. So, this study is aimed to explain the authentic prevailing situation of informal financing in the agriculturally dominant province of Pakistan, Khyber Pakhtunkhwa (KP). This study is also intended, additionally, to explain the multi-dimensional nature of the informal financial sector. For explaining multi-dimensional nature, two types of respondents have been interviewed. The first group consists of those experts or practitioners who have contributed to or worked in the area of agri-financing by one way or another. The second group comprises of the beneficiaries or farmers who are directly being affected by the alterations in the perceptions or mechanisms of informal financing. From the views of experts and farmers, this study has tried to propose measures for making the existing informal financial system more efficient and beneficial.

This study has certain inbuilt limitations. First and the most important one is its high degree of contextualization. Since this study has been designed keeping in view the informal financial sector of KP. So, the results apply to the same region, only. This research cannot be, therefore, generalized to other areas of the country due to the ethnographic and geographical preferences and variations in the contextual nature of individual regions. Similarly, some areas of the KP province, including Bajaur, Waziristan, Orakzai, and Mohmand, are facing severe political instability and, therefore, the data has not been collected from these areas. However, this factor does not affect the findings and results, owing to the fact that all rural areas in the province have similar agricultural climate and geography.

LITERATURE REVIEW

Quartey, Udry, Al-hassan, and Seshie (2012); Lawal and Abdullahi (2011); Owuor and Shem (2012); Turvey and Kong (2010); Guirkinger (2005), have contributed valuable insights on the constructive nature of informal agricultural financing. Each of these scholars has thoroughly discussed the merits of informal agricultural financing. In their views, such sorts of typical informal financing have a very critical role in the development of the agricultural sector, both for crop and non-crop activities.

Other scholars present a different approach towards informal sources of agricultural finance; pointing out the inadequacies that exist. Among these is the work of Schaefer-Kehnert and Von Pischke (1986), a brilliant academic work that reveals that informal loans usually involve small amounts of funding that are not enough and, therefore, do not fulfill all the agricultural requirements of a farmer. Tilakaratna (1996), also commented,

> "Loans from informal sources are in general inadequate in scope for development purposes, being often only for short-term purposes and rarely for capital assets, usually for traditional rather than new or innovative activities, and mostly for survival needs rather than for developmental needs."

Other researchers like Yehuala (2008), have the same opinion vis-à-vis the informal credit system. Due to its inadequacies, the informal credit system loses its foundation when applied in the agriculture sector.

There are also objections to the repayment mechanism of informal loans. "The conditions of repayment are often not specified at all or so imprecise that the line between loans and gifts is blurred (Schaefer-Kehnert & Von Pischke, 1986)." It is clear that if the repayment issues are not addressed adequately at the initial stages of the contract, then such a situation may lead to severe consequences, mainly, where the farmer intentionally defaults, and the lender has knowledge of the same. The state of affairs may lead to more severe consequences in the case where the creditor and debtor belong to the same family (as often the informal credit loan is secured between relatives and friends).

Some researchers have devoted their work on the issue of high-interest rates; charged by the moneylenders in these informal credit transactions. In their understanding, the skilled moneylenders charge high-interest rates resulting in problems, above all, for the small farmers in the rural areas of developing countries. In the case where the formal credit facility is not easy to get to, such interest rates become prime tools for the exploitation of the situation (Elhiraika & Ahmed, 1998). Some empirical research shows that the case of Pakistan is not different in the same connection (Shah, Khan, & Khan, 2008). The intellectual work of Rakesh Mohan indicates the matching observation after studying the agriculture credit system in India (Mohan, 2006). He has proposed that appropriate legislation should be carried out to combat such malpractice of money lenders.

Other writers like Bhattacharjee and Rajeev (2010), advocate that such rates of interest do not exist, homogeneously, across the informal markets, but, instead, vary from lender to lender and from developed to less developed regions. They argue that in less developed informal credit markets, there are few moneylenders who have full information about the borrowers. They, in these circumstances, have no other alternative but to resort to such moneylenders for the provision of loans at high-interest rates. In other words, the lack of competition among the moneylenders naturally builds monopolized environments. The case of a more developed informal credit market, however, is not possible due to the existence of many money lenders which increases the options for availing credit from multiple sources.

Some experts explain the exploitive nature of informal credit from a different perspective. In their view, generally, moneylenders provide loan capability to the farmers on the condition that they will sell their outputs at the end of the harvesting cycle (Shah, Khan, & Khan, 2008). In most cases, such a price is comparatively less than the price for the same commodity in the local market. In these experts' view, the lenders of informal credit enjoy, by this way, two benefits from a single transaction, i.e., by charging higher interest rates and by purchasing the farmers' yield at a price lower than the actual market price. These experts strappingly recommend that the governments concerned of these regions should provide institutional agricultural financing through commercial banks, specialized agrarian banks, and other financial institutions under the supervision of respective central banks in order to give farmers more reasonable funding options. Tilakaratna, an expert on the rural credit system, concurs,

> "Credit provision by moneylenders often involves other obligations such as to buy inputs or consumer goods or to sell the produce or labor thereby creating opportunities for the lender to impose unfavorable terms of exchange on the borrower. There is often an overlapping of personae of money-lenders, landlords, employers, produce dealers and traders; and in such situations, it would be possible to tie credit supply to operations in produce and labour markets so that all major economic transactions of the borrower operate in favor of the lender" (Tilakaratna, 1996).

Due to these reasons and others, money lending is sometimes considered an anti-social institution (Jeromi, 2007). It seemingly does not contribute towards society via constructive lines rather it, on the contrary, exploits the compelling situation faced by the farmers due to the shortage of liquidity, especially in the beginning of a season. Researchers from India have a comparative analysis regarding the moneylenders in the rural areas of their country (Reddy, 1999). An insightful study of various research works on informal agricultural finance exposes that such exploitation is due to the lack of proper education and the low literacy ratio in the farmers' community. Most of the farmers, predominantly, those who live in rural areas remain illiterate and uninformed and are, consequently, not in a position to negotiate the loan transaction with the moneylenders in such a way as to acquire the best possible benefits. This situation may continue to grow for another generation until all require education in the country. It is because of this reason the exploitive nature of informal markets has found to be more prevalent in tribal or less developed areas (ibid) in comparison to those villages where the education rate increases to a reasonable figure.

RESEARCH METHODOLOGY

The qualitative research method is adopted to conduct this study. Content analysis is always of greater value in the evaluation of the phenomenon under consideration from multiple angles. Content analysis has been given primal importance because a significant theoretical portion of this research has been taken from books, online and printed journals, web resources, and newspapers. However, the online and printed journals are cited and quoted more for the collection of relevant information as compared to other secondary sources; as most of the current materials, related to the present work are available in the esteemed journals of the same field. Content analysis, since very vital for the confirmability and transferability of qualitative research, has been done with primal importance in the first phase of the study. For achieving integrity and clarifying and authenticating the picture of informal finance, more similar researches have been searched, evaluated and cited. After content analysis, a semi-structured interview has been developed and tested for confirmability and dependability. Through this interview, data was collected from 13 respondents who have been selected through purposive or judgmental sampling technique. Nine (9) out of 13 were farmers/ beneficiaries of the informal financial system while 4 were practitioners.

DATA ANALYSIS

A Realistic Approach to The Demerits of Informal Sources of Agricultural Credit

Informal financing has played a significant role in the development of agricultural sector, both for crop and non-crop activities. This fact has been recognized and acknowledged by many renowned scholars in their scholarly works including Quartey, Udry, Al Hassan, and Seshie (2012); Lawal and Abdullahi (2011); Owuor and Shem (2012); Turvey and Kong (2010). However, over the years, the informal nature of such financing has been turned to more formal in terms of its basic structure and mechanism. For instance, in the beginning, informal financing was mostly provided by friends, relatives, and neighbors without charging any interest. Later, the professional money lenders started the same financing facility but charged high-interest rates. Additionally, they follow strict procedures for creditworthiness and also demand high collaterals and securities at the same time. In its current state, informal financing is not meeting the objectives that were intended from its inception. The following discussion will further elucidate the same and other negative aspects of informal financing with minute details.

Higher Interest Rates

A major critique of informal finance is that some lenders charge high-interest rates on the principal amount of their loans. Notwithstanding, contributing 70% of agricultural credit in Pakistan, informal lenders also charge farmers a high mark up (Kaleem, 2007). In countries like Sudan,

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[1]*Agricultural Finance Program*, Department of Agricultural Economics and Rural Sociology, The Ohio State University, Annotated Bibliography on Agricultural Credit and Rural Savings: Xiii (A Special Issue on Informal Finance), October 1989, p.3, accessed June 21, 2014, http:// pdf.usaid.gov/pdf_docs/PNABJ788.pdf.

moneylenders follow similar agrarian financing practices.[1] Some scholars contend that moneylenders in most developing countries charge exploitive interest rates (Schaefer-Kehnert & Von Pischke, 1986). This tendency for charging high-interest rates fashions more problems for the farmers than solving them. The State Bank of Pakistan has also sturdily criticized this behavior of money lenders by stating,

> "The fact that 70% of agriculture credit requirements not being met had resulted in charging of extremely high (50% to 100%) interest rates by the informal agricultural credit providers from the needy farmers in every province of Pakistan"
>
> *(Executive Summary SBP: 2014).*

Alarmingly, this reveals that some informal finance providers charge interest rates of 50% to 100%, exorbitantly high and almost unimaginable for farmers who mostly belong to the lower class. Schaefer-Kehnert and Von Pischke (1986), report that money lenders are charging farmers enormous interest rates. How, then, is it possible for a lower-class farmer, who is not able to buy the essential agricultural input and requirements, to repay such a high-interest rate? It is, therefore, the duty of the state to protect these borrowers with suitable legislation where rules and regulations for money lenders are strictly imposed and monitored so that they cannot take advantage of the compelling situation of farmers. Further, moneylenders in Pakistan do not charge interest rates according to a specific criterion, as the amount financed and the length of time for repayment. Instead, payment plans are random and haphazard. Qadir (2005), said that,

> "Informal markets are generally characterized by high-interest rates and a sizeable gap between lending and deposit rates. There is extreme variability in the interest rate charged by lenders for similar loan transactions".

The lack of specific methods for the measurement of interest rates is apparent. Additionally, there is no exact scale for the determination of a repayment schedule. These complications can be easily solved through a positive and active intervention of the state under the philosophy of 'Public or General Interest.' Laws pertaining to the violation of rules and regulations (by money lenders or any other provider of informal finance) can also be considered under the same philosophy. However, such laws should not be one-sided, i.e. only to focus and check activities of money lenders, but should regulate, at the same time, activities of the farmers related to loan transaction as well (for example, verifying repayment of an advanced loan within the given time, punishment for defaulters, etc).

Inappropriateness for Pakistani Farmers

Pakistan is predominantly a Muslim country with a population of 174 million (the second largest Muslim population country after Indonesia). According to the Islamic belief, Muslims are strictly prohibited by the Holy *Qur'ān* and *Sunnah* of the Holy Prophet (SAW) to secure any loan on an interest basis. *Sharī'ah* strictly bans interest-based loans. There are many verses of the Holy *Qur'ān* and *Hadith* of the Holy Prophet (SAW) that confirm this prohibition. For instance, in the Holy *Qur'ān, Allāh,* the Exalted, says,

> "O Ye Who Believe! Fear *Allāh and* give up what remains of your demand for usury, if ye are indeed believers. If ye do it not, take notice of war from Allah and His Apostle. But if ye turn back, ye shall have your capital sums: deal not unjustly, and ye shall not be dealt unjustly." (*Qur'ān* 2:278-279).

In another verse, the Lord of the Universe says,

> "That they took *Ribā* (usury), though they were forbidden and that they devoured men's substance wrongfully. We have prepared for those among men who reject faith a grievous punishment." (*Qur'ān* 4:161)

> From Jābir, may *Allāh* be pleased with him, said: "The Messenger of *Allāh* (SAW) has cursed one who charges *Ribā*, he who gives it, one who records it, and the two witnesses; and he said, "They are equal" (*Muslim Sahīh*, Chapter on *Ribā, Hadīth* no.1598).

In addition to the religious prohibition, the law of Pakistan does not agree to any interest-based transaction in any form. Taking an interest-based loan is, therefore, not a preferred choice for Muslim farmers in the country. Owing to such facts, informal sources of financing, particularly when a money lender provides the money on an interest basis, is also not an appropriate choice for them. Considering the religious prohibitions, it is difficult to understand the claim by the State Bank of Pakistan, and other sectors, that 70% of the agricultural credit is provided by informal sources. The only possible explanation is that friends, relatives, and neighbors also serve as informal source providers and usually lend money without interest. Germidis (1990), states that in the case of Bangladesh, 63% of the credit is provided by informal sources whereas 77% of such credit is given to farmers. He further supplements that out of the 77% of the agricultural credit, 50% is provided by relatives and friends, 13% by the "well to do," and 13% by professional money lenders. The case of Pakistan is not different where the prime portion of informal financing is provided by relatives and friends of the farmers without charging any interest. It is also significant to mention that these free interest loans are not only based on religious principles but also on social norms. For example, Turvey and Kong (2010), highlight the case of China, "In modern day China, the evidence suggests, and quite overwhelmingly, that friends and relatives no longer charge interest on loans." In China, where religion (particularly Islam) has no concern, of course, in economic matters, friends and relatives of the borrower provide free interest loans purely based on social considerations.

Lack of Legal Documentation

A legal drawback in informal finance associates with the fact that the loan transaction is not accurately documented as required by the law of the land. This generates a severe problem for both parties when they have a dispute or differences over various terms of the transaction, such as the amount borrowed, time of repayment, etc. Another drawback of this system is that the aggrieved party cannot go to the courts to seek a solution or compensation; since informal finance's transactions are social and cannot, therefore, be enforced through the court of law.[2] However, it does not mean that in the case of a dispute there is no solution. The social values, norms, and customs are sufficient for the enforcement of the contract. Qadir explains,

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[2] According to the Law of Contract, those promises are not enforceable in the court of law where the parties have no intention to create any legal obligation. Such intention is sometimes derived from the explicit words used by the agreed parties or it can also be inferred from the circumstantial evidence in which the agreement is signed. In short, the main difference between the social and legal agreements is the intention of the parties to create any legal obligation or not. If they do not want to create any legal obligation then their relation is deemed as a social one and technically called social agreements. Such agreements do not give rise to any legal consequences whereby it means that none of the parties can go to court in case of breach. For further details please visit The Law Handbook, http://www.lawhandbook.org.au/handbook/ch12s01s02.php (accessed June 21, 2014).

> "Social sanction and market limitations are the most common instruments for the enforcement of contracts as well as the recovery of loans. Resorting to the legal system of the country is fairly uncommon. Money lenders usually take various precautionary measures before taking on a new client. These include the practice of dealing with the potential client in other markets, extensive scrutiny of new clients and through small "testing loans" (Qadir, 2005).

Social pressure runs the contractual relationship smoothly and, in the case of a dispute, a mediator is selected by both the parties for the resolution of the matter. The main reason for non-documentation of the loan transaction in informal financing is that both parties are familiar with one another and, therefore, do not feel the need for documentation. However, the social pressure is not enough for the solution of some disputes; particularly when the disagreement is of a severe nature. It is, therefore, necessary in this day and the responsibility of the state to bring some technical changes to the structure of informal financing and to regulate all the involved issues therein with a proper legal process. Some developed countries, like the Philippines, have felt this need and their researchers have suggested changes to the existing structure of informal finance. Floro (1987), makes a remarkable connection with his work where he has endorsed numerous alterations in the existing informal finance structure in the Philippines.

Insufficient Funding

The amount of funding advanced to a farmer is not sufficient to fulfill his basic agricultural requirement; both for crop and non-crop activities, such as seeds, fertilizers, herbicides, weedicides, herbicides, insecticides, sprays, and basic agricultural machinery. The reason for this defect is that informal financing is mostly provided by neighbors, friends, relatives, and moneylenders (Germidis, 1990), who do not have substantial funds for allocation to agriculture. They tend to lend small amounts to farmers at the beginning of a season. The moneylenders provide, comparatively, a more considerable amount, but that too is insufficient due to the investment of a small amount of capital in their personal businesses. Jan, Munir, Usman, and Idress (2012), have concurred,

> "The poor easily access the informal credit markets such as friends, relatives, neighbors, commission agents or professional moneylenders. These lenders advance small amounts for short periods".

These advanced loans are not only small but are furnished, too, for a short period, for example, one harvesting cycle. It is quite possible that a farmer may not be in a position to repay the amount because of natural calamities and mishaps, such as droughts, floods, hail storms, earthquakes, and mudslides (Gulaid, 1995). Moneylenders, as a rule, do not provide any relief to the affected farmers, and by doing so, only add to their miseries.

In the past, informal financing was ample to bear out the basic agricultural requirements of a farmer. However, over the years, predominantly in the last two decades, agrarian expenditures have increased swiftly due to various factors like expensive seeds, new types of artificial fertilizers, modern agricultural machinery, etc. The demand for agricultural credit has correspondingly increased due to these augmented demands over those of the past. Even in a developed country like China, informal finance is insufficient for farmers' agricultural requirements, both for crop and non-crop activities. Tang, Guang, and Jin, (2010), comprehensibly discuss the issue in their wide-ranging research,

> "With the rapid economic growth, informal credit supply may not be sufficient to meet the increased demand for a relatively larger amount of credit as farmers start to engage in more diversified or more capital intensive economic activities like high valued crops and non-farm business activities."

Overdependence on Trust

It is a common practice that credit is always backed by various security measures so that a creditor may receive the principal amount along with interest, where the repayment is not made within the prescribed time. Security includes both movable and immovable properties[3]; the former is

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[3] The Term "Immovable Property" occurs in various Central Acts. However, none of those Acts conclusively define this term. The most important act which deals with immovable property is the Transfer of Property Act (T. P. Act).i. According to Section 3 of that Act, "Immovable Property" does not include standing timber, growing crops or grass. Thus, the term is defined in the Act by excluding certain things. "Buildings" constitute immovable property and machinery, if embedded in the building for the beneficial use thereof, must be deemed to be a part of the building and the land on which the building is situated;

ii. As per Section 3(26) of the General Clauses Act 1897, "immovable property" "shall include land, benefits to arise out of land and things attached to the earth, or permanently fastened to anything attached to the earth". This definition of immovable property is also not exhaustive;

iii. Section 2(6) of The Registration Act,1908 defines "Immovable Property" as under: "Immovable Property includes land, building, hereditary allowances, rights to ways, lights, ferries, fisheries or any other benefit to arise out of land, and things attached to the earth or permanently fastened to anything which is attached to the earth but not standing timber, growing crops nor grass". The above definition, implies that building is included in the definition of immovable property.

iv. The following have been held as immovable property: A right to collect rent, life interest in the income of the immovable property, right of way, a ferry, fishery, a lease of land……………Read more at Law Teacher: http://www.lawteacher.net/free-law-essays/property-trusts/the-difference-between-movable-and-immovable-property-with-reference-to-case-law.php#ixzz41XqdQyci, accessed June 24th, 2014 identified as a ‘pledge’ while the latter is known as ‘mortgage’ in commercial law. The security indicates the creditworthiness of a borrower and plays a central role in the smooth dealing between a creditor and debtor. Nonetheless, in informal finance, the creditor does not demand any security from the farmer. Zeller (2003), an expert of rural finance, confirms this by stating,

> “Borrowing from socially close lenders within the moral economy is often the first recourse that poor households have in financing expenses, especially those related to essential consumption expenditures. Transactions are collateral-free, and in most cases, interest is not charged. These are essentially informal mutual aid schemes that have the principle of reciprocity at the core of transactions”.

The trust and confidence the credit provider has over the debtor eliminate the need for security for the loan. This approach engenders problems, and things go awry only when a farmer is not able to repay the amount or is unwilling to reciprocate. Due to lack of collaterals and other securities, the creditor then finds himself on horns of a dilemma because there is no option to retrieve the loan amount nor file a legal action suit. This causes an uncomfortable situation as the creditor and debtor are, more often than not, socially connected with each other and the dispute may lead the situation to a point where their social relationship is jeopardized. The creditor can turn, in such circumstances, to friends and other social members for the resolution of the dispute. This mechanism is the most fruitful one and, therefore, many of the scholars, who are familiar with informal financing techniques, recommend the same by stating,

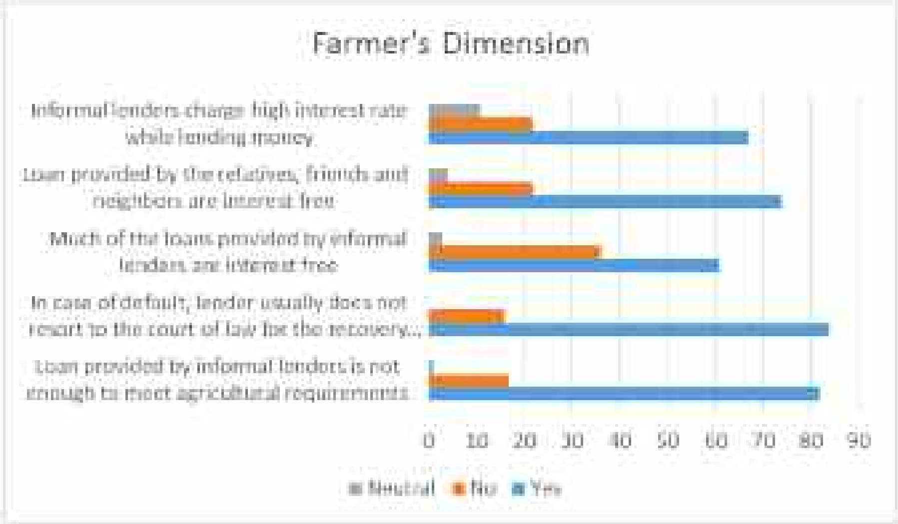
> “Social sanction and market limitations are the most common instruments for enforcement of contracts as well as the recovery of loans. Resorting to the legal system of the country is fairly uncommon. Money lenders usually take various precautionary measures before taking on a new client. These include the practice of dealing with the potential client in other markets, extensive scrutiny of new clients and through small “testing loans” (Qadir, 2005).

Social forces play a vital role in the solution of such disputes. Moreover, small testing creditworthiness techniques should be used by a creditor before advancing a loan facility.

RESEARCH FINDINGS

The research population for this study comprised of three districts of Khyber Pakhtunkhwa (K.P) province, namely Swat, Dir, and Malakand. While conducting research in the region, these three districts were selected owing to their major contribution in the provincial agricultural sector; above all local farming. Both the farmers and lenders were questioned about the different dimensions of informal finance; focusing more on its drawbacks mentioned in the theoretical framework of the present study.

Farmers' Dimensions



a) Insufficient Funding

One of the drawbacks of informal finance is its insufficient volume. Typically, informal lenders do not have unlimited resources from which they can offer to the farmers as compared to formal financial institutions that have stable financial health. While 82% of farmers were in the opinion that informal finance is not sufficient to meet their agricultural requirements, and, consequently, they often find themselves having to seek out formal financing possibilities; which are mostly out of their reach.

b) Lack of Legal Documentation

One of the major defects in informal finance is the absence of legal documentation. A very high percentage of respondents (84%) agreed that lenders do not resort to the court of law in case of a borrower's default owing to the lack of appropriate legal documentation. This lack of legal documentation not only engenders distress between lender and borrower but also becomes a significant obstacle in documenting the country's economic management.

c) Inappropriateness for Muslim Farmers

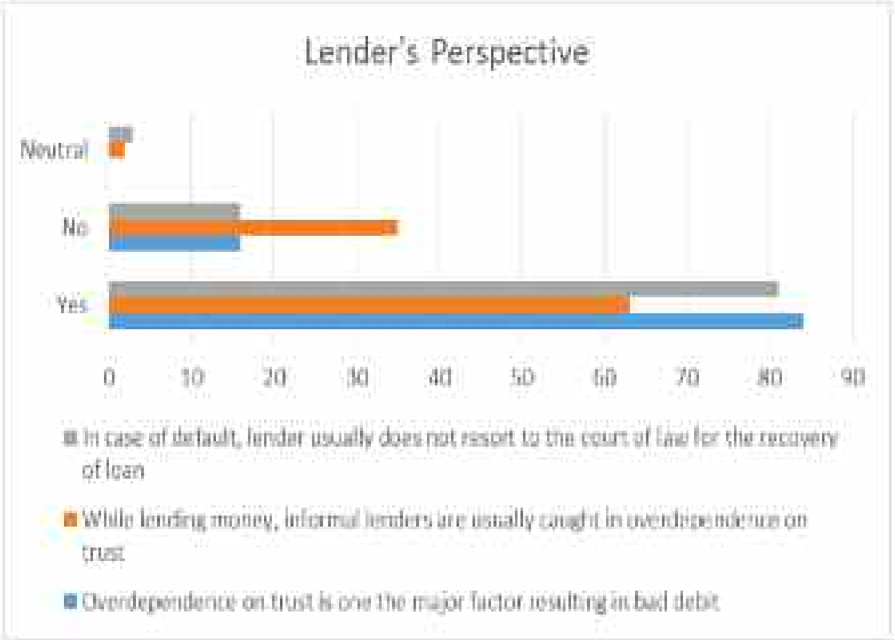
Pakistan is a Muslim country and interest on loans is prohibited in Islam. Therefore, it is understood that, by following Islamic values, farmers prefer interest-free loans. Almost 74% of the farmers interviewed avowed that relatives, friends, and neighbors are the primary source of interest-free loans but that loans are negligible in volume and insufficient in an amount so, nevertheless, they still are compelled to borrow money from commission agents and money lenders.

d) Charging High-Interest Rates

Exploitation is a major issue in rural informal agricultural finance. During interviews with Pakistani farmers, 67% of respondents commented that informal lenders exploited the lending situation due to the absence of any other mode of funding and, consequently, charging high-interest rates. Twenty-two percent of farmers disagreed with this description of their informal finance experience, and 11% were neutral regarding the question. Furthermore, it is noticeable that in the second question almost 74% of the respondents acknowledged that informal finance provided by relatives, friends, and neighbors is nearly interest-free. It is evident from the findings that not all the informal lenders charge high-interest rates. Nonetheless, this harmful practice does occur during transactions with commission agents and money lenders.

Lenders' Dimensions

Lenders from the three districts of K.P (Swat, Deer, and Malakand) were interviewed from two dimensions.



a) ***Over Dependence on Trust***

Payment and repayment of loans in informal finance revolves around the relationship of trust between lender and borrower. In answer to how often informal lenders find themselves trapped in an overdependence on trust in the informal finance process, 63% of participating lenders noted that they often found themselves in this situation. In contrast, 35% believed that such a possibility involving overdependence on trust was not likely to occur. Moreover, in response to whether over dependence on trust is one of the major contributors of the bad debt significant proportion of lenders (almost 84%) believed it was. Only 16% believed otherwise regarding the same issue.

b) ***Lack of Legal Documentation***

To understand the effects of the lack of legal documentation on lenders, participants were asked how often they resorted to the court of law in the case of a borrower's default. The overwhelming 81% of the lenders reported that they could not resort to the court of law due to the lack of legal documentation; but instead, they employed social pressure for the repayment of loans. Just 16% responded that they neither resort to the court of law nor employ social pressure in the case of borrower's default.

CONCLUSION

The agriculture sector is considered to be the most important sector for the development and stability of any economy. The case of Pakistani agricultural sector is not different in this regard. It is not only a source of food but also contributes positively to curb the threat of unemployment. However, being a developing country, most local farmers in Pakistan, particularly in the rural areas of KP, belongs to the lower class of the society. They are endlessly in need of financial resources to fulfill their basic agricultural requirements, both for crop and non-crop activities. To procure financial assistance, they turn to their neighbors, friends, relatives, and professional money lenders for help. Such financing is technically known as informal financing. The farmers opt for such financing because of its various favorable features like simple procedures, less documentation (sometimes there is no documentation at all), flexible schedules for repayment, and ease in accessibility. However, with the passage of time, such characteristics have faded from the scene and the social nature of informal financing has changed into a commercial one. The money lenders and commission agents have played a key role in this transition. Due to the commercial approach, the beneficial nature of informal financing has come to an end. The critical analysis shows that such types of informal financing now contain many shortcomings. For instance, some of the informal loan providers in Pakistan, like moneylenders and commission agents, provide interest-based loans which are strictly prohibited by the Holy *Qur'ān* and *Sunnah* of the Holy Prophet (SAW). Therefore, this later configuration of informal financing is contrary to the religious values of Muslim farmers, particularly those who are typical Muslims and living in rural areas of KP. Being strictly prohibited by the religion, many farmers avoid securing interest based agricultural credit. This research study's data shows 67% of the responding farmers agreeing that commission agent and money lenders charge high interest rates on loans. In addition, the loans that are provided are mostly insufficient for fulfilling farmers' basic agricultural requirements, both for crop and non-crop activities. Correspondingly, 82% farmers responded that informal finance is insufficient to meet their agricultural requirements. Similarly, the lenders provide loans through a simple offer and acceptance (usually an oral contract and no appropriate or legal documentation of a loan transactions is made which is usually a prerequisite required by the law of the land). In other words, no legal cover and/or protection is provided to the deal. This sometimes leads to difficult situations where the parties concerned have differences over various terms of the transaction; such as, the amount borrowed, time of repayment, etc. Due to the absence of legal documentation, 84% of farmers interviewed claimed that in case of payment default, the lender could not file a lawsuit against them and did not resort to the court of law. Almost with the same proportion, 81% of lenders also agreed that they had no ability to file any lawsuit against such malpractices. Moreover, collaterals and securities always play a vital role in loan transactions in order to measure the creditworthiness of a debtor. However, the phenomenon in informal financing was found to be quite different, and the relationship of payment and repayment of a loan between lender and borrower was exclusively dependent upon a relationship of trust. Results depicted that 63% of lenders reported their overdependence on trust during lending decisions and 84% of these respondents agreed that overdependence on trust was the eminent cause of bad debt. Legal documentation is an undertaking that could secure the creditors' debt in the future. However, this process is not followed in informal finance. This leads to a disappointing situation if the debtor fails to repay the amount at the time prescribed in the oral contract. In such a situation, the creditor is neither in a position to have the loan repaid (as there is no type of security to sell it and get the loan amount returned) nor is there an option to go to the court of law to sue the farmer. Because most informal finance contracts are usually social in nature, therefore, cannot be enforced through the court of law.

POLICY RECOMMENDATIONS

While having a compelling character in the development of agricultural finance, predominant in local farming of rural areas, it is the responsibility of the state to work out some reformation in the prevailing configuration of informal agrarian financing. This change can be brought through proper legislation after consultation with the experts in the field and other stakeholders. For instance, a legal nature should be given to some of its aspects. While following this, the basic structure and mechanism of such financing should be changed from more social to more legal. The money lenders should be registered upon accomplishing of some prerequisite. They should be legally obliged to charge a reasonable interest rate, and, in case of violation, their registration should be canceled. Some pecuniary punishment can also be considered for the same purpose. Additionally, the parties should be obliged to reduce the loan transaction into writing. By this way, any future dispute regarding various facets of loan transaction can be settled down and ultimately avoided through the proper legal mechanism.

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