

Tete-a-Tete with Arhtiyas

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Informal credit markets, which fall out of the purview of the regulatory jurisdiction, are a striking feature of the rural economy in Pakistan. Their role in promulgation of exogenous and policy shocks due to their pervasiveness and size is hardly debatable. However, little has been done to integrate them in the macroeconomic analyses without which there could be wrong analyses and misleading policy advice.

Moreover, Government has failed to meet the growing demand for credit of farmers through the myriad of alternative institutional lending that it has offered over the years. While bureaucratic hurdles and lack of timely access for small farmers are some of the causes that contribute to the collapse of these institutions, the major reason behind their failure is the inadequate understanding of the way in which informal rural credit operates.

In order to fill this gap and recognize the significance of informal market lending, a group discussion with informal money lenders was organized in Okara. This was a first step towards establishing a contact with them and gaining indepth analyses of the way they run their business. Based on the information provided by surveys conducted in Okara, this paper aims to study the modus operandi of informal credit markets in order to address key policy questions and increase the efficacy of both monetary and fiscal policy.

The informal commercial lenders who we interviewed are locally known as arhtiyas. In general, informal lenders are non-specialized lenders who come in different guises. They could be landlords who finance their labor; or they may be input dealers who lend money on the condition that inputs for cultivation would be purchased only from him; they may be commission agents, who finance the cultivators on the condition that the cultivators sell their crop to lenders alone. This gives rise to interlinked credit market where credit is linked to the output produced or the factors of production. In this paper, we will focus on the commission agents (also known as arhtiyas), who take crop as the collateral.

Survey Profiling:

Focus group of arhtiyas included 17 informal moneylenders from the market town of Okara. This city lies in an irrigated area where multiple cropping is practiced and has yields of maize, rice, wheat, sugarcane and potatoes where maize is the major crop sold in the market.

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According to the respondents, it has one of the biggest “Galla Mandi” (grain markets) in Asia, generating revenue of around Rs. 400 Million annually.

It is important to highlight here that the type of arhtiyas and the way they operate is differentiated according to the type of markets they operate in (namely grain and vegetable markets). Arhtiyas belonging to different markets have different problems and deal with their clients differently. Lack of time and resources constrained us to interviews with only those arhtiyas who were active in the grain market in Okara.

Meeting with arhtiyas was initiated by SBP representatives who introduced themselves and the aims of the project to the twenty arhtiyas present in that room. This was followed by a general discussion where the problems faced by arhtiyas and their partners, mainly the small farmers, were discussed in detail. Out of the twenty, nine arhtiyas stayed behind for individual interviews. The survey focused on the type and size of the market they operated in, the way they conducted their business and the problems they faced while dealing with banks. In addition to that, we received their feedback on the ways in which SBP could possibly collaborate to facilitate their business operation. Since this meeting convened arhtiyas belonging to the same market, the answers for individual surveys were very similar. A report based on their collective response is presented below.

Modus Operandi of Informal Credit Markets

In Okara, just like the rest of the rural economy, cash flow of farmers is characterized by uncertainty and seasonality. There is a wide gap between the time when costs are incurred to finance the inputs and the time when crop is harvested and proceeds are received from the sales of the crop. As a consequence, demand for credit is strongly influenced by seasons. In the absence of the availability and flexibility of institutional lending markets which would cater to such variance in demand for credit, arhtiyas become an important source of credit for these farmers. They take the role of commission agents who provide farmers with credit on the condition that lenders will be given exclusive rights over sale of the cultivators’ crops. Arhtiyas recover the amount of loan from the payment made for crops. This net return is usually in kind and varies according to the crop. The crop received from farmers is then sold on commission in open auctions at their respective “mandis” (markets). Hence, by receiving crop/output as collateral instead of land, arhtiyas interlink the credit market with output market. This proves to be very useful for the arhtiyas who make money not only from interest rates but also the commission which they receive for selling the output. Each arhtiyas caters to around 20-25 farmers.

One of the reasons which explain the pervasiveness of the arhtiyas is that they provide loans for purposes other than farming such as social events. Over the years, farmers’ expenditure on social events/customs has risen beyond their means and therefore there is an increase in demand for credit. This is where arhtiyas help them out by providing loans for weddings/funerals, etc. This information was highlighted in the meeting when arhtiyas discussed their relationships with the clients. They include these loans and support in their non-financial services. In addition to that, the social support that arhtiyas extend includes the advice they provide to the farmers regarding agricultural techniques.

With the exception of a few respondents, the business of informal money lending was passed onto arhtiyas by their forefathers. Hence, the relationships that they have with their clients have been formed and strengthened over the years. This contributes to diminishing the cost for arhtiyas especially with regards to the asymmetrical information costs that exists in credit markets. These information costs include determining the extent of risk associated with the client, giving the clients incentives to encourage repayment or in extreme cases coercing the defaulters into paying back the loan. Their claim that their recovery rate is hundred percent further justifies their nonexistent costs associated with asymmetrical information. In the case of new clients, it is the party interested in need of loans that approaches arhtiyas.

The increase in yield of corn coupled with the claim of arhtiyas that they charge lower interest rates than the banks has contributed to the growth of the grain market in Okara, over the years.

Arhtiyas in Okara provide loans on a need basis and in stages over the year. These stages are determined by the agricultural cycle and seasonality. Most of the loans given are in kind with cash loans accounting for around 10-15 percent only. Inputs such as seeds, pesticides and fertilizers are provided to the farmers according to their needs. The advantage of having information about their clients at this stage is that they can assess the needs and the ability of the farmers to pay back. Moreover, they ensure that farmers do not utilize an agricultural loan for personal purposes. By providing them with exactly the amount they require and that in kind too, lenders are able to reduce their default rate.

The annual net rate of return is estimated to be around 20 percent for each arhtiyas. The return is in kind and varies for each crop. Since most of the return on the investment they make for providing inputs is in kind and varies for each crop, this is just a rough estimate. (For example they receive Rs.10, 000 for a Rs. 100,000 loan for one crop for which the duration of the loan is around six months).

Loans are offered on average for three to four months. Usually there is no fixed time for repayment and it depends mostly on the timing of harvest. As mentioned before, arhtiyas claim to have hundred percent recovery rates. If the farmer is unable to pay back on time, the repayment date is extended to accommodate that farmer. In the case of disputes, arhtiyas committee is convened to resolve issues and disputes are settled within three days. In extreme cases, a farmer is boycotted by the arhtiyas in that area if he refuses to pay back the debt.

A double entry method along with signed piece of paper or a “parchee” is employed to keep track of business transactions. Self-financing is the only method adopted by the arhtiyas to fund this business and banks are used for funds only as the last resort.

The size of the market is difficult to estimate as Arhtiyas are not ready to provide their investment figures. However, from their discussion we can infer that a minimum of Rs. two million in cash is needed for this business in the “grain market” of Okara and that the upper limit is around Rs. ten million.

Problems Faced by Arhtiyas and Their Partners:

The last section of the survey deals with the problems that arhtiyas and farmers face while dealing with banks as well as the hurdles they encounter in the supply management process. Arhtiyas interaction with banks is limited to holding accounts in the banks. They avoid using banks for business purposes. A major predicament which was reiterated during the meeting was the imposition of three percent of withholding tax. This is perceived as an extortive tax that they have to bear unnecessarily. They strongly opposed this withholding tax and suggested to withdraw this tax.

One of the problems that were brought to our notice was the delay in clearing bank cheques and the corruption associated with processing these cheques. It takes three days on average to get the cheques cleared. Arhtiyas also find the minimum balance requirement to be unduly high and the account length set by the government too short. Business transactions sometimes take more than six months and so they would like the government to extend this period and increase the minimum requirement.

Farmers face similar problems. Their problems are compounded by the fact that most of the documents are in English and farmers are unable to comprehend most of the documents as the literacy rate is very low in rural areas. More importantly, these farmers are not familiar with the services that banks offer and find it cumbersome carry out transactions through them. They find bank policies stringent and the fear of getting reprimanded severely in case of default on loans discourages those approaching banks. Farmers, who are already short of cash, have limited access to credit. Their financial conditions deteriorate further when mills withhold their payments.

Arhtiyas suggested that interest loans should be lowered so that loans become more affordable for small farmers. Banks should facilitate arhtiyas and farmers by reducing the formalities involved in carrying out different transactions. Arhtiyas are more flexible with repayment dates and this is how they suggest that banks should operate so the fear of getting harassed by banks in case of late repayment is reduced. Schemes such as loans for cattle, or loan packages designed for machinery specific for agricultural purposes should be introduced. In these schemes, an important feature could be that loans are provided in stages the way arhtiyas offer their loans.

The suggestions provided above pertain to banks. In addition to these problems, arhtiyas pointed out their role as banks from the deposit side as well. This is because people from different occupations in rural economy preferred to keep their cash with arhtiyas rather than banks because of security, flexibility and easy communication. When asked about which financial institute they would like to associate with or be a part of, arhtiyas felt that there was no need for making more banks or other institutions. They want current banks to differentiate them from other customers and have a special desk assigned for their transactions which would cater to their needs.

Lack of SBP's representation in the rural credit market was highlighted by arhtiyas when they pointed out that even though they were aware of the State Bank and its role as a

regulator of all the banks in Pakistan, they never had any direct interaction with the institution itself. It is suggested that partnership should be established between the two so that both gain from each other's experiences and strengths.

According to arhtiyas, an awareness campaign by the government is imperative to educate farmers about dealing with agricultural problems but more importantly informing them about bank procedures and the services they have to offer. This is to encourage farmers to benefit from the services that banks have to offer. They also feel that provincial government should accommodate loans for small farmers.

With regards to pricing, arhtiyas are of the opinion that government should control prices and introduce price floors.

Problems related to supply chain management were asked separately. Lack of storage is one the dire problems faced by both farmers and arhtiyas which constrains both parties in various ways, e.g. it limits their ability to sell their crops abroad. Hence, very few arhtiyas are involved in exporting the crops as well. They are prepared to invest with SBP at 7.5 percent on storage capacity in Okara.

Policy Implications:

From the discussion above, it can be concluded that arhtiyas are not interested in a separate financial institution or bank. However, they are interested in increasing their interaction with the existing banks on the condition that these banks differentiate them from other consumers and offer loan packages tailored to their needs. Several questions have appeared from this dialogue which will determine the course of our future interaction with the arhtiyas. The way we address these questions will define our role in the informal rural credit markets.