

# Comparison of Cost Factor in Formal and Informal Credit Market

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## Abstract

*The informal credit sources, though their share in the total credit market is declining, can still be reckoned as the main providers of agricultural credit mostly in developing countries of the world. The study is based on primary data; a questionnaire was designed to collect the data from the District Peshawar. It was observed that, on average 51 days were spent in the formal sector on the assessment of loan application. The transaction and total cost decreased with the increase of land ownership of the borrowers.*

**Keywords:** Cost factor, Credit market, Informal Credit Market

## Introduction

Informal credit market having no explicit rules and regulations and owner managed, unhelpful and required no collaterals. Recently, most of the formal financial sectors are trying to adopt the four main characteristics of the informal credit market, that is, to minimize cost on the transaction, creating relationship between borrowers and lenders, access of small income holders to formal sector and finally, transaction regularity and its promotion. The use of informal credit decreases with the passage of time and spread of education (shiyani and Bhatt, 1990). Loans were categorized on the basis of groups such as crops loan, minor irrigation, livestock, and other agricultural loans, reveal transaction costs in the form of laborious efforts and transportation when borrowing from formal institutions such as banks. On the other hand, these transaction costs were almost absent when the credit is obtained from non-institutional sources like money lenders and relatives (shiyani and Bhatt, 1990).

Khan (1991) found that agricultural sector in Pakistan consisted predominantly of small farmers (74 percent of the holding were below 5 acres). However, it was a misconception to view small farmers as inefficient and unresponsive to economic opportunities or unwilling to adopt innovations. The study also examines the constraints that small

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farmers faced in obtaining credit facilities; strict social values, lack of publicity, inadequate infrastructure and so on. The reasons for non-use of credit were; lack of information, non-availability, complex procedure, sufficient own funds, high transport cost and illegal gratification. Whereas in India, to raise the living standards of poor rural households, there is still a need for institutional credit services and other facilities within village communities (Sharma and Ram, 1991). Khan (1991) further sheds light on the credit scenario prevailing at Saharanpur district during 1987 indicating that only 18 percent of the milkmen/women were clients of institutions and the rest were relying on informal sources of credit.

Cost of the services provided by formal institutions is relatively high and replacing process of informal credit mechanisms require a strategic stance which could be enabled through infrastructure improvement. The importance of the informal lenders will not disappear altogether with the improvement and development of the institutional sources of credit (Schrader, 1994). sufficient credit is no longer available to the actual target groups because funds are scarce, as a consequence informal rural credit market is very heterogeneous and is always a component of the prevailing socio-economic and political network, involving relatively low additional transaction costs and high interest cost for credit supply (Manig, 1996). According to Bell (1990) and cited afterwards in Kochar (1997) both argue that the constraints of the credit rationing that formal lenders a high rate of cost charged from households specially from risky households because of the high cost on the screening of the borrowers and on maintaining such a high cost lead to reduce the role of formal credit in the development and investment in rural sector of the economy as well as demand for formal credit also reduced.

Jain (1999) revealed in the model that the cost on lending in the informal credit markets was cheaper than the formal credit market. This advantage of the informal lenders was against formal sectors. Formal institutions of credit aimed to maximize profit and provided partial loan for business to screened borrowers and the remaining portion of loan for their project relay on the informal credit market. In order to reduce the interest rate of the institutional sources of credit by the intervention of the government may lead to reduce the profit of formal lenders and lead the society as a whole may suffer loss and lead formal lenders redistribution the excess funds provided as loan to specific borrowers. In some cases, the formal lenders may drive out of the market completely. Conversely, the intervention of government in the activities of the informal lenders may lead to raise the lending cost on credit, will lead to improve the welfare of society and importance of formal credit market in bringing the effectiveness in screening of the borrowers.

In Nepal, out of 3064 households, 2481 were informal borrowers and 385 were formal. In urban areas, about 24 percent of loans were advanced by informal lenders for production purposes and 75 percent for personal consumption. On the other hand, a same ratio was manifested in the rural areas as 81.8 percent of loans were sanctioned for production and 18.2 percent for consumption purposes. The researchers suggest that the net cost on the informal loan such as transportation cost was lower than formal sources of loan with the unique characteristics like convenience, flexibility, availability and time duration in the informal sector (Besley et al, 2001). In Nepal the reason of taking informal loan was the illiteracy of the households, high transaction costs of the bank and no collateral requirement. This conclusion was drawn from a study where out of the total 144 respondents, 60 were informal borrowers and the remaining were formal and/or informal borrowers (Haugen, 2005).

### *Objectives*

On the base of the above literature and also in the light of the importance of the informal credit market, the main objective of the present study is to compare the transaction cost incurring credit with formal sources of credit as well as the number of days required on the assessment of loan application in the institutional sources of credit.

### **Method**

The present research is based on primary data; the data were obtained from District Peshawar through personally administered questionnaire. Two hundred respondents were selected by convenience sampling techniques. The method of tabulation, percentage and average have been used for data analysis

### **Results**

#### *Number of Days and Transaction Cost in Formal Credit*

The institutional sources of credit charged nominal interest at the rate of 8 percent which varied from bank to bank and amount to amount and for different duration of loan but it is assumed that the interest rate has been kept fixed as 8 percent for all the borrowers irrespective of their land ownership. Table 1 indicates an average amount of loan taken from the formal sector at the rate of 8 percent on the respective loan. Borrowers having no or less than one acre of land ownership, taking loan from formal sector was Rs. 12580 and were to pay Rs. 1006.8 interest at the rate of 8 percent. Table 1 also indicates that formal borrowers face transaction cost which is to be low if the bank branch is situated in village and high if the bank branch was in the city or in town. It is very

interesting that there is no bank branch in the selected 7 union council from rural areas of district Peshawar. The borrowers, taking formal loans, were required to visit city or town.

Table-1: Transaction Cost in the Formal Sector of Credit (in Rs.)

Land Ownership (in acre)	Borrowed Amount from Formal Sector	Interest rate 8 Percent (per year)	Transaction Cost (In Average)	Total Cost of Loan (in Average)	Transaction Cost (In %)	Total Cost (In %)
Less than 1	12580	1006.4	752	1758.4	6	14
1-4	14650	1172	836	2008	5.7	13.7
5-8	18820	1505.6	910	2415.5	4.8	12.8
9 & Above	21850	1748	985	2733	4.5	12.5

Source: Field Survey

The transaction cost includes first, the transportation cost of the borrowers at least 4 or 5 visits and in some cases more than 5 visits to the bank branch and to the department of land revenue spending one day per visit which is equivalent to one day wage so the wage on each visit day was also included in the transaction cost as shown in table 1. There were some other cost which were also included in the transaction cost that are food and tea and the cost on other relevant documents like photocopies of CNIC (Computerized National Identity Card), qualification documents, land ownership papers and photographic. For formal borrowers, having one or less acre of land ownership, the transaction cost on average was Rs. 752 and for those having 1 to 4 acres of land ownership, the average transaction cost was Rs. 836. Thus, the transaction cost increases as the land ownership increases. On average, the total cost on formal loan which includes the interest and transaction cost for farmers who have one or less than one acres of land ownership was Rs. 1758 for taking Rs. 12580 amount of loan. For farmers, having one to four acres of land ownership, Rs. 2008 was the total cost for seeking a loan of Rs. 14650. Transaction and total cost decreases with the increase of land ownership as shown in the table 1.

Table-2: Number of Days and Transaction Cost Incurred in the Formal Credit

Land Ownership (In Acres)	No. of days required in the Sanction of Loan	No. of days required between Sanction and Receipt of Loan	No. of days required between Application and Receipts of Loan
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Less than 1	29.12	21.32	50.44
1-4	32.83	20.54	53.37
5-8	35.32	18.55	53.87
9 & Above	29.50	19.25	48.75
Average	31.7	20	51.6

*Source: Field Survey*

On average, 31 days are required for the sanction of loan from formal sector although the number of days varies with the changes in the land ownership of the borrowers. On average 20 days are consumed between the sanction of loan and receipts of the loan. About 51 days are required for taking loan from formal sector from the day of application to the receipts of loan. Borrowers who had no land or less than one acre of land ownership had to wait for 50 days for the assessment of their loan application in formal sector as shown in table 2. Likewise, about 48 days are taken for the scrutiny of loan application of those borrowers who have 9 or more than 9 acres of land ownership.

#### *Collaterals Required from the Borrowers in Informal Credit Market*

About 70 percent of loan was disbursed by informal lenders without any collateral and 21 percent on personal guarantee (as shown in table 3) and this was the main advantage of the informal credit market over formal sector where as the formal sector was advancing loan on security basis not on personal or productivity of the farmer. About 2 percent of lenders were advancing loans against gold and 2.8 percent on fixed assets like plot, house and building.

Table-3: Collaterals Possession by Households (in Percent)

Kinds of Collateral	In Percentage
Cultivated Land	1.4
House/ Plot/ Building/Property	2.8
Gold/ Silver	2
Personal Guarantee	21.4
No Collateral Required	69.8
Other	2.6
Total	100

*Source: Field Survey*

An average lender spends two days on processing a loan application in case of previous satisfactory dealings and may give a small amount of loan to test the borrower for running finances in emergencies or any urgent matters. In addition, the lender may spend 5 or more days in other

activities. In case of personal relationship, the loan process time is compressed to a greater extent in many cases as shown in table 4.

Table-4: Average Time Spent by Informal Lenders on Loan Assessment (In Days)

Types of Loan Assessment	Time Spent by Informal Lenders (In Average)
On the basis of past dealing	2
Testing him by giving small Initial loan	2
Enquiry in applicant's village	4
Personal Relations	1
Assess through other activities	5
No screening	0

*Source: Field Survey*

### Discussion

In the institutional credit market, borrowers having less than one acre of land ownership, obtained loan and faced on average Rs. 752 or 6 percent transaction cost and the total cost (including interest) was 14 percent on a loan amounting to Rs.12580. The transaction and total cost decreased with the increase of land ownership of the borrowers. In institutional credit market, on average 51 days were spent in the formal sector on the assessment of loan application. However, on average, 31 days were taken by banks on the loan applications to the sanction of loan and, on average, 20 days between sanction of loan to the receipts of loan. The balance between formal and informal credit can be stuck by enhancing the number of branches of government bodies in rural areas which inwardly would have multi-pronged and multi-layered ramifications by reducing the transaction costs and above all the cash strapped widows and their dependents would benefit from such initiatives.

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