Informal Financial Markets and Financial Intermediation

in Four African Countries

What role can informal financial institutions play in financial development in African countries? A study of both informal and formal financial markets in Ghana, Malawi, Nigeria and Tanzania, Financial Market Fragmentation and Reform in Sub-Saharan Africa, shows that informal institutions use specialized methods to serve broad segments of the population that lack access to banks. Although they have responded positively in a liberalized environment, fragmentation into isolated market segments persists. Greater efforts are needed to integrate informal institutions into financial development strategies.

Framework

Costs and risks vary in serving different categories of clients, which constitute different segments of any financial system. Specialization of financial institutions for different segments can be efficient if they are well integrated through flows of funds between them and through access of clients to alternative sources of finance. In such a situation, interest rates differences across segments are determined by differences in cost and risk profiles.

Financial systems can be described as fragmented when linkages between segments are weak and wide differences occur in risk-adjusted returns. African financial systems have historically been fragmented into dualistic markets, with little connection between formal banks and informal agents and little overlap in clientele. The resulting inefficiencies inhibit development, as potential household savings go untapped and profitable investments cannot be financed.

The study investigated structural problems such as imperfect information and costly contract enforcement and institutional weaknesses in banking systems and the legal framework that
cause wide differences across lenders in the costs of screening, monitoring and enforcing loans. Poor information systems in low-income countries raise the cost to formal institutions of acquiring information on any but the largest clients. In contrast, informal agents utilize personal relationships, social sanctions and various collateral substitutes to serve market segments that remain beyond the reach of formal banks.

**Background**

Data were collected on informal financial institutions in Ghana (90 observations), Malawi (70), Nigeria (64) and Tanzania (59) during 1992 and 1993. Questionnaires sought information on the agents themselves, portfolio characteristics, interest rates, risk management, transaction costs, delinquency, and linkages to other institutions. Comparable data were obtained from formal financial institutions, including the major commercial and development banks and a representative sample of rural and community banks.

Pre-reform policies in all four countries shared repressive characteristics such as: restriction on market entry, often coupled with public ownership; interest rate ceilings, quantitative controls on credit allocation; and restrictions on capital transactions with the rest of the world. Financial sector reforms emphasized liberalization of these policies along with balance sheet restructuring and strengthened regulatory and supervisory frameworks. Ghana and Malawi pursued reforms more systematically than Nigeria or Tanzania. All of the countries initiated reforms during the period 1985-87, although implementation in Tanzania was slow before 1991.

**Characteristics of Informal Institutions**

Informal financial transactions can be defined as financial activities that are not regulated by central bank supervisory authorities. Unlike formal institutions, such transactions rarely use legal documentation or the legal system to enforce contracts. One category of informal agents specializes for either the credit or the savings side of the market. Another bases the financial transaction on personal or business relationships. A third category provides full financial intermediation between savers and borrowers. Organizations that are registered under non-financial legislation, for example as cooperatives, businesses or non-governmental organizations (NGOs), are sometimes referred to as 'semi-formal.'

Informal financial agents in the sample tended to be well-educated relative to real informal sector workers and were generally in their mid-40s. Overall, about 60% of those sampled had attended secondary or other post-primary school. In Nigeria, savings collectors averaged 7.2 years of school, moneylenders 10.5, leaders of savings and credit cooperatives or associations (SCCs) 14.0, and organizers of rotating savings and credit associations (ROSCAs) 16.8. Individual lenders and savings collectors were predominantly men, while women were more likely to be leading ROSCAs (46% in Ghana, 57% in Tanzania, 80% in Nigeria).

**Operating on One Side of the Market**

'Moneylending' covers a wide range of financial arrangements with interest rates varying from
0-100% a month. The most common source of informal finance (usually interest-free) is from relatives and friends. This type was not covered in the survey because of its non-commercial character. While a few registered, professional moneylenders exist, most of the commercial moneymaking is undertaken as a part-time activity, using surplus funds from other sources such as a trading business.

Individuals who operate primarily on the savings side were found only in West Africa. These savings collectors take regular deposits (often daily or weekly) of an amount determined by each client and return the accumulated sum at the end of a stipulated period (usually a month), minus 1 day's deposit as commission. These 'mobile bankers' form a symbiotic relationship with market traders, protecting their daily earnings from competing claims and ensuring working capital to restock supplies at the end of the month. They sometimes extend 'advances' to their clients before the end of the month and occasionally lend to non-clients, though lending is constrained by their lack of a capital base other than monthly collections.

**Relationship-based**

ROSCAs were pervasive in all the countries studied. These are known variously as susu in Ghana, esusu or ato in Nigeria, chilemba or chiperegani in Malawi, upatu or mchezo in Tanzania, and tontiniers in francophone countries. ROSCAs are closed membership groups where all members pay set amounts at regular intervals (monthly, weekly, daily) to a common pool, which is handed over to each member in turn (randomly or by bidding). All recipients but the last receive the pooled sum sooner that if they had saved the same amounts alone. Some continue over long periods and develop supplementary insurance, loan and welfare funds or save toward a common objective.

Traders often supply inputs or cash advances to farmers, linked to purchase of produce at a discounted price. In Malawi and Tanzania, landlords and estate owners often lend to their tenants.

**Intermediaries**

SCCs raise savings from and make loans to members. A variety of membership organizations come under this heading, sometimes raising money from shares as well as deposits. Unlike ROSCAs, they are relatively large and open to new members. They may be legally registered as a cooperative or the savings and credit arm of a cooperative formed for other purposes. Credit unions are registered as such and represent a more formal form of SCCs based on share capital. They are increasingly coming under the regulation of central bank authorities under non-bank financial institution legislation.

Other semi-formal institutions have emerged that both mobilize and lend funds to the general public. In Ghana, susu companies were registered businesses that utilized susu collector techniques to mobilize savings by promising credit to those who accumulated over a period of 6 months or more. Nigeria's finance houses-private investment companies registered under the Companies Act-were sometimes used to take advantage of exchange rate controls. In both cases, questionable management practices and pyramid-like schemes led to the collapse of
many of these institutions. In Ghana, a new savings and loan variant has emerged under the 1993 Non-Bank Financial Institutions Law.

Most NGOs with credit programs in the sample countries have historically had a welfare orientation with heavy external subsidies, and were excluded from the survey's focus on indigenous commercially-oriented informal finance. A growing number, however, are attempting to operate on a commercial and financially sustainable basis, often using informal techniques such as group-based lending. They may be able to play a growing role in financial intermediation for lower-income households and microenterprises.

**Informal Methodologies**

Informal lenders succeed through information based on personal and social networks. They use bilateral, character-based relationships to achieve high repayment rates without relying on formal collateral and project appraisals. They pre-screen clients by focusing on specific groups. By focusing on a narrow niche of known clients, they avoid the high processing and monitoring costs that deter banks.

Informal methods yield loan administration costs that are, surprisingly, below those of banks operating much larger loans. Whereas banks reported operating costs on the order of 12% to 19% of amounts lent, informal moneylenders and associations were generally under 3% (partly because they carried little overhead costs). Furthermore, repayment rates tended to be higher for informal lenders. At least 80% of informal agents in Ghana and Nigeria reported no delinquent borrowers, and all expected virtually 100% repayment within three months of the due date. Thus, the data indicated that informal agents bore lower relative costs and losses on their small loans than banks did on larger ones, contrary to the common perception that small loans are costly and risky. With appropriate methods, it is possible to efficiently serve market niches that are excluded by the methods of commercial banks.

The principal limitation is that informal agents tend to operate on only one side of the market or within a circumscribed group. Savings collectors' funds come entirely from their clients, while moneylenders use their own funds and do not borrow to increase their loanable funds, even though many are creditworthy. ROSCAs have access only to their own savings.

Very little intermediation occurs in terms of mobilizing funds from savers and transmitting them to borrowers in other groups. The isolated, personalized nature of informal relationships can provide substantial monopoly power (especially when the legal framework restricts moneylending), resulting in wide differences in interest rates across different segments within the formal sector.

**Impact of Financial Sector Reforms**

The countries studied undertook financial sector liberalization in the late 1980s and early 1990s to introduce market forces, reduce public sector domination of banking assets and liabilities, increase competition, and raise efficiency. These measures were often accompanied by restructuring, recapitalization, and improved regulation to rehabilitate banking systems in
crisis.

While banking systems are being strengthened through better supervision, they have so far tended to focus on their best clients to improve portfolio performance, rather than reach out to new, smaller clients. Banks continue to have difficulty with small transactions because of high costs, perceived risks, collateral-based methodologies, and strong incentives to lend to the public sector. Any efficiency gains have not yet been reflected in lower interest spreads, and interest rates often remain high under the pressure of public budget deficit financing.

Informal financial institutions have responded more positively, with increases in the number of approvals, as well as applications, in many cases. The assets of informal lenders and savings collectors increased following liberalization because of their linkages with expanding real sectors. For example, moneylenders are often traders with excess short-term liquidity. Nevertheless, many informal agents reported being unable to satisfy demand for loans by clients they considered creditworthy.

A financial gap remains for small businesses, which generally need larger loans at lower rates than informal agents can provide but lack the track record and collateral necessary to access bank loans. However, some new financial institutions are beginning to emerge with the potential to respond to excess demand for credit that is being satisfied by neither formal nor informal sectors. In Ghana and Nigeria, in particular, there has been a steady emergence of formal non-bank financial intermediaries—discount houses, leasing companies, finance companies, etc.

**Conclusion**

Informal institutions use specialized techniques to address the problems of information, transaction costs and risks in serving households and micro businesses that prevent banks from serving these market segments in African countries. But the high localization of informal agents and lack of access to formal finance limits the extent of financial intermediation by informal agents. Hence it is important both to include informal institutions in financial development strategies and to link them more closely with the formal financial system in order to both increase savings mobilization and make more funds available to high-return investments in informal activities.


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