

Informal Finance for Private Sector Development in Sub-Saharan Africa

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Abstract: What can be done to make informal finance and microfinance suitable for financing growing small to medium size enterprises (SMEs) in Sub-Saharan Africa? First, I present the characteristics of informal finance, focusing on size, structure, and scope of activities. Informal finance has not been very attractive for the private sector. Indeed, the informal sector has considerable experience and knowledge about dealing with small borrowers, but there are significant limitations to what it can lend to growing microbusinesses. Second, I discuss some recent trends in microfinance. While externally driven microfinance projects have surfaced in Africa, their performance relative to small business finance has not been as positive as in Asia and Latin America. Third, I introduce some possible steps toward a new reform agenda that will make informal and microfinance relevant to private sector development, including focusing on links among formal, semi-formal and informal finance and how these links can be developed.

In this section I explore the characteristics of informal finance that make it difficult for it to be accessed by Sub-Saharan African enterprises. “Informal finance” might be defined as embracing all financial transactions taking place beyond various countries’ regulations on banking and other financial sectors. This

definition includes a wide range of financial activity whose operational scope differs across countries. Indeed, there is a wide variety of informal savings and lending in the region.

The definition of informal finance includes such schemes as the operations of Savings and Credit Associations (SCA), known all over Africa; professional moneylenders; part-time moneylenders (estate owners, traders, grain millers, smallholder farmers, employers, relations and friends); mobile bankers, known as *susu* or *esusu* collectors in West Africa; credit unions; and cooperative societies. These exist in both urban and rural areas. While savings collectors fall under the first category of deposit mobilizers, moneylenders—including relations and friends—do not generally accept deposits and may be assigned to a second category. SCAs (credit unions and credit cooperatives) take in deposits and also lend in varied forms. Most informal units deal with specific groups of people, ensuring that only those satisfy distinct selection criteria are able to either deposit with them or borrow from them.

Who Can Borrow from Whom?

There is extreme segmentation in Sub-Saharan financial markets, “fragmented” because the various segments serve distinct groups of clients with similar characteristics and needs, and there is hardly any interaction among different institutions. The negative effects of weak linkages among segments far outweigh benefits of any specialization they could make available through the existence of segments. Fragmentation is indicated by wide differences in interest rates, as well as insignificant flows of funds between segments, limiting access to funds by potential clients. Because funds of different lenders can hardly be substituted for one another, fragmented markets have difficulty intermediating between savers and investors. In not being able to allocate financial resources, they cannot always transform and distribute risks and maturities efficiently. As a consequence, deposits mobilized, as well as credit facilities, differ in structure, associating demand and usage with distinct socioeconomic groups.

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Credit from moneylenders is often the most expensive credit available, hence demand comes from persons with no other options. Such credit remains, nevertheless, the only source of informal credit that does not require borrowers to satisfy specific membership obligations. Despite the relatively high probability of loan requests being granted, short maturity periods and high interest rates do not make this credit attractive for those seeking working capital and fixed investment loans. In most of rural West Africa, for instance, clientele is wide ranging—farmers, market women, other traders, nonfarm entrepreneurs, and other self-employed craftsmen. Farmers sometimes borrow money from moneylenders during the planting season to maintain their households until the next harvest. They may also borrow for funerals and other social events. While rural households usually borrow from their own communities, they sometimes travel far to borrow from a moneylender.

SCAs' credit facilities are used mainly for consumption, even though they sometimes provide working capital. In Malawi, however, the use of cooperative loans for financing farm working capital outweighs use for consumption, as these are mainly for fertilizer purchase and payment for farm labor (Chipeta & Mkandawire, 1991). A small loan for a short period has to be used for an activity that has a quick turnover, such as cereal production. Group membership is an essential tool for screening loan applications and for ensuring that contracts can be enforced. For many associations, limitations to growth in size are imposed by expected increased risk and increased probability of losing homogeneity as the group expands. Homogeneity provides them with a sense of familiarity, engendering mutual trust. Some rotating savings and credit associations (ROSCAs) intentionally do not put together people with too different backgrounds and interests. Size limitation restricts capital to those borrowers whose demand for loans is not regular—e.g., those requiring loans to purchase a relatively expensive consumption item.

Savings (*susu*) collectors grant “advances” to some trusted clients. Other loan recipients might be traders at local markets in need of short-term credit. When collectors lend to non-deposit clients, terms

are often different from those of their deposit clients; they tend to behave as moneylenders.

How Does Informal Sector Lending to the Private Sector Work?

A number of recent studies reveal adequately that there has been substantial growth in the activities of the informal financial sector since reforms began in many Sub-Saharan African countries (e.g., Steel, Aryeetey, Hettige, & Nissanke, 1996; World Bank, 1994).¹ Unfortunately, while the informal sector has grown and is willing to increase lending, its products are not necessarily what the growing small private sector demands.

There appears to be greater diversification in activity among some informal institutions in attempts to reach out to more borrowers than is observed among formal institutions even after reforms. Lending by SCAs has become part of a wide and growing range of informal financial activities that are increasing clientele, as well as growth in institutional goals and scope, including a diversification of clientele. Even though SCA activities have broadened, socioeconomic principles underlying their operations have not. Change in the scope of SCA activities, as with other informal financial units, has been induced by changing socioeconomic circumstances of clientele or membership, and also by changes in national economies.

Significant growth in lending by SCAs and rural cooperatives has been observed in a number of countries. But the growth of lending by commercial moneylenders has been slower than that of the SCAs and cooperatives in West Africa. Loan applications to moneylenders in Ghana and Nigeria rose significantly in the 1990s but rural moneylenders received more applications in a year than did urban lenders. They granted loans to over 80% of their loan applicants in the period. Similar experiences have been reported in Malawi.

Urban informal commercial loan sizes in Sub-Saharan Africa generally lie between \$50 and \$1000, with a median value of about \$250, and have only grown marginally in many cases. In general, loans from moneylenders tend to be the largest in the informal sector.

Urban loans are also significantly larger than rural loans. Loan sizes for moneylenders tend to be similar across countries.

Interest rates and maturities of informal lenders often make their loans unattractive for business. Interest rates vary widely, from zero to more than 100% per annum, even though they often have similarly short maturities, seldom going beyond six months. Also, rates do not seem to change significantly with time for a large number of informal lenders. Interest rates of Malawian moneylenders (*Katapila*), for example, appear to be much higher than in most parts of Africa. They sometimes go as high as 100% per month. This rate has been applied for many years in Malawi. In all countries, moneylenders have the highest lending rates.

Interest rates of moneylenders in some countries have come down, since financial sector and economy-wide reforms in the 1990s began in Africa. It is not obvious if this is a result of competition with other existing lenders, leading to declining demand, or of a change in their own supply. This has more to do with general economy-wide alterations in economic structures. Moneylenders are changing the scope of lending in response to the changes in the financing needs of traditional clientele. There is increasing pressure on lenders to provide more credit for working capital for longer periods than they have done in the past. While this change has been observed, moneylenders' rates remain far above other segments.

When other group-based schemes lend to nonmembers, their rates are often comparable to those of moneylenders. This holds for both savings collectors and SCAs in many countries. Their rates remain far less when dealing with their members or traditional clients. In general, loans with the above characteristics are not attractive for growing small borrowers, leading to the development of a gap in the credit market as discussed below.

What Credit Gap Exists in African Financial Markets?

As a result of fragmentation, and because each lending unit cannot alter the structure of its operations and products in the short to medium term without additional flows of resources, there are few lenders in Sub-Saharan Africa that meet the needs of borrowers

interested in credit with the following characteristics: small loan amounts up to \$1,000, interest rates far below 30% per annum, and a maturity of up to 18 months. That is what many small businesses, often in countries with inflation rates well over 20%, ask for. The most affected are microenterprises wanting to expand in small towns.

Credit gaps in various countries capture borrowers who cannot access informal lenders, because they do not find the packages or contracts of those lenders attractive for their purposes, and yet cannot gain access to the formal circles, because they are considered ineligible. This does not mean small borrowers who want loans that informal lenders provide are adequately taken care of. But if they have not received credit, it is mainly because the nearest informal lenders—for whom they are eligible—do not have enough resources to provide them with loans. Their inability to obtain credit is seldom because informal lenders do not want to lend to them. For the others, no one can meet their demand cost effectively without significant revision of institutional structures.

How Do Informal Operators Select Clients?

A characteristic of African financial markets is the weakness of modern contract enforcement mechanisms. Lenders lend small amounts and have maturity periods that minimize costs, often in a way that make their loans less attractive to businesses. In the absence of sound formal contract enforcement, both formal and informal lending institutions face the problem of managing risk with loan administration practices that suggest greater emphasis on loan screening than on monitoring the use of loans and contract enforcement. Their approaches might suggest a greater concern, the fear of selecting noncreditworthy clients (adverse selection), even though clients' changing their minds about loan use later (moral hazard) remains a problem in the information asymmetry that lenders confront (Nissanke & Aryeetey, 1996).

Screening in the informal sector relies extensively on personal knowledge about borrowers. The development of personal ties and the use of borrower proximity in decision-making are mechanisms for countering adverse selection and moral hazard. The more rural

the environment, the greater the need to personalize ties in confronting information asymmetry. Familiarity with borrowers often reduces the significance of repeat borrowing. This explains why, in such places as northern Nigeria, agricultural lending among relatives, acquaintances, and neighbors is the norm. *Susu* collectors in Ghana can take a decision on a loan request within one minute simply by looking on the card on which deposits are entered to ensure that borrower is a regular depositor. For a moneylender, new borrowers are often introduced by persons a lender knows quite well and who are prepared to guarantee payment with their word. This confines their locus of operation to small areas.

In SCAs, as in cooperatives, loan screening is done at the time of admission to membership. It assumes that a person requesting to join the group is interested in a loan and will be admitted to the group if he or she has characteristics similar to those of the other members, including occupation and ethnicity in many cases. In screening applicants therefore, emphasis is not necessarily on whether members can pay back loans they have taken, but on the commitment of members to the group's goals. Because group members invariably have similar incomes and similar credit requirements, knowing the individual's character and how reliable they are is important.

The suggestion often made that informal lenders have a better record on repayments than the formal sector mainly because of constant monitoring of the uses to which loans are put does not appear substantiated from a number of African studies (Nissanke & Aryeetey, 1996). The form of monitoring often considered is regular visits to project sites, but there is relatively little monitoring by informal lenders after loans have been given out. Moneylenders and other informal groups seldom visit the project sites of their borrowers. Obviously, when lending is localized, the need for project visits is reduced. For moneylenders who are more likely to have borrowers in other localities, monitoring is minimized because they always know very well the persons who introduced borrowers to them.

Loan repayment rates generally tend to be much higher for informal lenders than they are for formal lenders. Higher repayment rates for informal lenders are not necessarily the result of more

“aggressive” contract enforcement procedures. There is indeed little evidence of litigation in courts. Collateral confiscation, in the absence of proper ownership documentation and malfunctioning legal systems, is very difficult. Informal lenders go to clients’ homes to deliver verbal warnings and threats. In membership arrangements, dismissal of borrowers from groups is the most significant sanction.

The higher repayment rates of informal lenders are simply a consequence of more efficient procedures for the retrieval of loans and the borrowers’ knowledge that the informal lender has a higher capability of actualizing threats to foreclose on collateral. For example, when farmland is used as collateral, a bank is less likely to foreclose on this without extra costs than a moneylender would. The borrower knows that the moneylender can always find a relation to farm on the land until a loan is repaid in full—an action that a bank cannot take without incurring additional costs. Hence, for borrowers facing the two lenders, collateral has different meanings which condition their attitudes towards repayment. They would not treat the threat of collateral confiscation by an informal lender lightly. This gives reason for risky SMEs to be cautious about dealing with the informal financial sector.

What Are Direct and Indirect Linkages between Formal and Informal Segments?

It is obvious that informal lenders could boost their business considerably if they could expand their lending base with resources from the formal sector, and increasing loan sizes would be attractive for SMEs. Direct or institutional linkages are expected to be shown in actual flows of funds between segments. By indirect or market linkages, it is anticipated that activities in various segments will be affected by activities in other segments through the influence of financial markets. Both links are actually weak in most countries. Thus, there is little evidence of informal lenders obtaining bank loans for their lending businesses (Popiel, 1994; Nisanke & Aryeetey, 1996; Bell, 1990).

With respect to indirect interaction between formal and informal lenders, this remains less important. Expected competition between an

institutional lender and an informal lender presents possibilities for price interaction to occur, but this is based on the assumption of an availability of “low-cost institutional credit” to informal lenders. This seldom holds for Sub-Saharan African financial markets. In view of deep market segmentation, informal lenders are hardly ever persuaded by changes in formal sector loan interest rates to alter their own rates. The fact that many informal rates have not been altered in the face of significant increases in formal interest rates, since financial sector reforms in the 1990s began in many countries, indicates how “unrelated” pricing in the two sectors might be.

Recent Developments with Microfinance in Sub-Saharan Africa

To counter credit market failures that result in the fragmentation and exclusion of many potential borrowers from markets, a variety of credit schemes have been introduced into many Sub-Saharan African countries. But innovative credit schemes and microfinance activities are far better known and more successful in Asia and Latin America than in Sub-Saharan Africa. Apart from fewer programs, their occurrence among countries varies considerably also. There are countries with a good number of microfinance programs, including Mali, Guinea, Burkina Faso, The Gambia, and Guinea Bissau, and others with very few, including Sao Tome, Chad, Mauritania, and Sierra Leone. K-REP in Kenya is probably the best known microfinance scheme in Africa (Rosengard, 2000; SODECON, 1990).

Objectives and Strategies of Innovative Schemes

Innovative credit-retailing schemes are usually community-managed credit and savings schemes established to improve members' access to financial services, build a community self-help group, and help members accumulate savings. Microfinance programs, generally derived from innovative schemes, are more likely to be born out of donor projects, and are not necessarily community-based. Indeed, over 80% of enterprise development programs sponsored by donors

have a microfinance component. More than half of such projects focus solely on microcredit. For many innovative schemes, however, credit provision may not be the only operational objective. Even for those that perceive credit provision as the ultimate assignment, the extent to which a direct supply of credit is present in their programs depends on whether they adopt “minimalist” or “integrated” approaches.²

Most of the acclaimed innovative schemes have been based on the minimalist procedures. A recent trend emphasizes market principles. Through donor participation, many microfinance arrangements have benefited from the best practices developed in other developing regions. They have drawn some ideas from more successful projects elsewhere, including the following: (1) issuing short-term loans; (2) starting with small initial loans; (3) concentrating on providing small working capital to firms with proven track records; (4) providing specialized services without targeting; (5) simplifying services; (6) providing localized services; (7) shortening turn-around time for loan applications; (8) motivating repayment through group solidarity or joint liability; (9) mobilizing savings from the poor; and (10) charging full-cost interest rates.

Village banks, for example, emphasize making loans to finance income-generating activities and savings. In establishing mechanisms to lend to joint liability groups, these banks expect group members to overcome collateral requirements. They lend on unsecured bases, using five-person group guarantees whereby each individual is responsible for the others and future access to credit is determined by all members repaying loans. This is a principle borrowed from the Grameen Bank.³ There are a number of microfinance projects in Africa, however, that provide credit to individuals and projects. K-REP has both group lending (through *Watanos*) and individual arrangements with nongovernmental organizations (NGOs) that on-lend K-REP loans. A number of the schemes in Francophone African countries have a mixture of group and individual arrangements.

The loan characteristics of microfinance schemes indicate that their loans are comparable to those of most existing informal arrangements. Loan maturities are generally short. Groups that borrow

on-lending are expected to repay within a year. Members of the small groups must repay their first loans within a few weeks, with assurance that they can take a further loan from the revolving fund established by the group. While interest rates are higher than most formal lending rates in Africa, they tend to be lower than the rates of moneylenders. Rates seem comparable to those of some of the best known schemes in Asia and Latin America. Characteristics of these loans suggest that a large part of Africa's private sector cannot use such facilities to finance investments. They are useful for the very poor microbusinesses, similar to those financed by the informal sector.

Performance of Microfinance Programs

The assessments of the achievements of credit programs are centered on repayment rates, loan sizes, savings levels, program costs, and income from interest. Evaluations of repayment in *Village Banking* programs have been high, averaging 90% in many places (Holt, 1991). Projects with high repayment rates often include the following characteristics:

- training programs for participants
- interest rates not subsidized
- integrated formal written membership requirements and screening measures in their bylaws to ensure discipline among members
- a savings program accompanies lending
- an appropriate sociocultural environment, e.g., population not transient, which helps to reduce default as social sanctions are strongest in a stable population.

A number of recent evaluations of microfinance projects have examined the extent of their outreach activities and their drive towards self-sustainability (Christen, Rhyne, & Vogel, 1994). Financial self-sustainability is achieved when the return on equity, net of any subsidy received, equals or exceeds the opportunity costs. Outreach is measured on the basis of the types of clientele served and the variety of financial services offered, including the value and number of loans extended, value and number of savings accounts, type of financial services offered, number of branches and village

subbranches, percentage of the total rural population served, real annual growth of the institution's assets over recent years, and participation of women as clients. Many such evaluations have questioned the sustainability of projects, as well as their outreach (e.g., Webster & Fidler, 1995; Kiiru, Pederson, & Nzioka, 1995).

It is important not to compare the achievements of African microfinance programs only to those of other regions. It is possible to explain further the backgrounds of these programs and to compare their achievements with other institutional arrangements within the region. Comparing innovative schemes and ascertaining their compatibility with known practices and attitudes in African countries, reflected in informal systems, introduces a better understanding of their difficulties. Various evaluations suggest that while innovative, other microfinance projects are performing in making credit available, local environments often constrain their ability to bring costs down much lower than they presently are. They cannot go where the informal sector can with their present set-up, hence providing a justification for a link between them. Evidently both microfinance and informal finance try to reach the same target group, but with different structures. The African Development Bank (AfDB) has developed a program in microfinance (see Appendix). But it is important that care is taken to ensure a complementarity in the services provided by informal finance with a view to reaching those that are currently not reached by either.

Increased Informal Finance and Microfinance for Private Sector Development

The central problem for financial development in most Sub-Saharan African countries remains how to ensure that institutional development and innovation leads to filling of the "credit gap" facing SMEs. While they lack access to bank credit, their requirements exceed limits of informal agents, as well as of many microfinance programs. There is currently limited scope for enhancing the allocation of credit equitably and efficiently outside of a closer relationship between the formal and informal sectors. As seen earlier, financial system fragmentation can be wasteful. Closer linkages between dif-

ferent segments can improve system efficiency by enabling different agents to specialize for different market niches and by facilitating flow of savings and credit up and down the system. Filling the credit gap may require incentives to the formal financial sector to establish conditions and support for informal and semiformal institutions to move up to this market following an integration of the financial markets. The approach to a greater role for informal finance and microfinance focuses on the achievement of integrated financial markets: how such integration might come about, and operational approaches for bringing microfinance closer to small African entrepreneurs.

The proposal for integrated financial markets is based on a number of recent studies applying concepts from the “new” institutional economics, stressing information asymmetry, transaction costs, and risks. These studies have provided useful analytical tools to understand constraints that explain the persistence of fragmentation in Sub-Saharan African financial markets, even when financially repressive policies have been reformed (Chipeta & Mkandawire, 1996; Nissanke & Aryeetey, 1996; Popiel, 1994). In an integrated financial market, direct and indirect linkages between the formal and informal sectors are evident and significant. The flow of funds among them is dictated by awareness of their respective specializations, allowing each segment to utilize information and the structural advantages of others to enhance their own activities. The flow of information is a major component of market integration.

There is an obvious need for national policy frameworks that have appropriate levels of incentive and regulatory policies as a context for achieving integrated financial development. In addition to using such frameworks to provide a developmental platform for financial institutions by helping them reduce and share risk with an acceptable incentive structure, the framework should draw in broader economic relationships by ensuring that the approach is truly demand-driven by the real sector. Hence, while avoiding a crowding-out of the private sector, maintaining steady growth of the real economy is essential. A strong revival of informal finance in a number of countries after reforms provides a good testimony to the influence of a vibrant real sector on financial sector developments.

Forging Links in Deposit Mobilization

Banks should be encouraged—and given incentives—to enter into closer relationships with such informal agents as SCAs and NGOs. These agents have the potential of becoming effective mechanisms to mobilize deposits from and deliver credit to the household and microbusiness sector. They can bulk up small savings at relatively low cost and can retail more credit to the informal sector if backed up by access to bank credit.

Indeed, taking a cue from what *susu* collectors in Ghana have demanded of Ghanaian banks, banks in Sub-Saharan Africa could be encouraged to offer informal deposit mobilizers preferential deposit rates—higher than the rates of return on their other opportunity sets—that encourage them not only to use the facility more and more in view of financial gain, but also to discern recognition of their role in savings mobilization by banks. In many West African cities where transactions at bank branches take unusually long periods, “special” clerks or tellers could be assigned to such frequent depositors as savings collectors at large branches they patronize in order to reduce the length of time they spend at bank counters. Waivers of charges and fees on demand deposits of informal deposit mobilizers by banks would be seen as encouraging an institutional link between the two.

While direct contact between banks and informal deposit mobilizers will be very useful, semiformal institutions—savings and loan companies—well-functioning finance houses, and credit unions also hold considerable potential as shown by the review of the role of such semiformal institutions. When markets are fragmented, it is best to develop new institutions to integrate markets, and only then to regulate. In a satisfactorily operating market-based economy, the development of such new institutions is likely to take place if demand for additional financial services exists. Governments only need to be supportive.

Forging Links in Credit Allocation

The optimal way for banks and informal lenders to link up for purposes of credit allocation is to develop an agency relationship in which

bank-loanable funds are channeled through semiformal (microfinance) lenders and informal lenders for on-lending to small borrowers. Here also, operations of *susu* collectors⁴ in West Africa provide some valuable insight into how such an arrangement could be pursued.

The realization of the full potential of informal finance units lies in the identification of similar strong links between formal and informal units. This relation should be oriented toward a two-way flow of deposits and credits to enhance financial intermediation in the region. While potential is much stronger in some countries than in others, it must be developed wherever possible to ensure that the benefits arising are for mutual growth. In eastern and southern African countries as well as francophone countries—where cooperatives are relatively well-developed—they could be the informal institutions for developing such linkages.

Special incentives could be particularly useful in encouraging banks to develop twinning arrangements with semiformal or nonbank financial institutions, to provide these institutions with management support as well as funds. For example, funds on-lent to microfinance intermediaries could be rediscounted at a concessional rate to increase profitability to banks, or tax incentives could be provided to compensate for the costs and risks of developing small borrower portfolios. This would lead to the layering of credit supply through different intermediary steps that involve a number of “shock absorbers.” This is a principle well-known in informal finance in those arrangements involving links with traders.

While the principle of channeling credit through informal sources is acceptable, there is a need for caution with regard to which informal agents can serve as good conduits for such lending. It is important to rely more on well-established agents operating from within recognizable bodies—associations, cooperatives, companies, unions, etc. These have greater credibility than individuals. In a number of countries, also, individual moneylenders with good long-standing relationships with banks could be useful. Channeling formal credit to informal lenders can be defended on the grounds of efficiency and increased financial integration, especially among small farmers. Informal lenders can build a personal relationship with their borrowers

that can ensure an extremely low loan default rate. The encouragement of more subcontracting in the real sector would also generate more financial linkages in parallel. For example, if leasing companies could pass on tax benefits to banks to obtain better credit terms, they could in turn pass on more financial services to their clients.

Government Policies for Enhancing Linkage Development

If banks have not linked up with informal finance and microfinance institutions already, it is because of considerable distrust, inadequate knowledge about the latter, and prejudice in some cases, all of which create a risky environment for banks. Policy should be designed to overcome this. There should be an approach to developing financial systems that focuses on building institutions that serve identified segments. There are two possible ways for policy to be used to enhance the development of linkages between the various segments, including the informal sector and such semiformal lenders as NGOs—that is, the use of the fiscal system and of regulatory and supervisory systems to provide incentives for formal institutions to provide wholesale credit through informal agents.

Tax relief on profits granted to banks that allocate credit through informal and semiformal agents could be recovered by imposing higher taxes on banks that do not channel credit through the informal sector. Some banks—such as merchant banks—will have no need to use informal agents for allocating credit and, therefore, will be the actual financiers of the subsidy. Because the higher tax is on bank profits, it should not be transferred to the users of those banks.

Regulatory and supervisory systems could be of considerable importance in providing incentives to banks. If banks perceived that risk was considerably reduced by dealing with credible semiformal and informal agents, they would be encouraged to use them. Effective regulation and supervision of semiformal and informal institutions might tend to be problematic, in some cases, however. Governments would require a proactive approach. This would embrace a legal, regulatory, and prudential framework that fosters, and when possible, accelerates financial market development. This framework supports the setting up of mechanisms, institutions, and

instruments that promote and facilitate this development as the economy grows and as market functions expand. Regulation should steer away from restrictive laws and focus on removing the obstacles to financial market development. Restrictions on what assets banks may hold could be modified to encourage them to invest in semi-formal financial institutions. This requires diversification of formal sector instruments. Commercial bills and bankers' acceptances based on cooperative or "mutualistic" guarantees should be developed to establish a link between semiformal and formal financial institutions.

In sum, the development of a three-tier approach for lending to marginal borrowers, mainly SMEs, would be very useful because it provides an appropriate framework for regulation and supervision. Banks would lend in the first instance to credible semiformal agents⁵ who would then link with such informal lenders as *susu* collectors, cooperatives, and SCAs. Rural borrowers would receive loans directly from informal agents. Where banks have good relations with easily identifiable informal agents—e.g., the Association of *Susu* Collectors in Ghana—there is no reason why the chain cannot be shortened by directly dealing with that informal institution. Semiformal institutions would in general be agencies for regulating smaller informal units as they can identify operators much better than any other external body.

Reducing Lender Risk for Microfinance Projects in Africa

Principles for reducing lender risk in integrated financial systems will necessarily involve restructuring internal management leading to improved appraisal of risk, the development of other tools for containing risk, and some risk-sharing procedures. Formal and informal lenders and deposit-takers will have to learn to share risks with each other while developing better techniques for dealing with borrowers at the margin for whichever market niche they have adopted. Techniques for lending to small borrowers minimize risk, and these have seen significant improvement in the last decade throughout the world. It is possible to reach small borrowers cost-effectively, taking into account existing risk profiles of such borrowers.

At the margin, financial institutions want to know whether it is cost-effective to take deposits from and lend to small businesses. Internally, they will have to adjust the credit-delivery methodology, focusing on the way in which borrowers are identified, approved, and supervised. Financial institutions that have been more successful in extending and recovering credits to small enterprises have often based their lending operations on an in-depth market assessment at the design stage, allowing them to determine actual patterns of demand and to identify and address the relative levels of risk involved.

Financial institutions lending to small borrowers must be profitable. They must earn enough to cover the cost of funds and recurrent operational and administrative costs. This requires the use of interest rates freely to assure profits, considering the negative impact too high rates will have by way of incentive effects and the effects of adverse selection. They must therefore strike a proper balance between risk management and low transaction costs as a percentage of average earning assets.

There are a number of innovative financial institutions that have been successful in maintaining this balance. They have employed a variety of measures to effectively reduce SME lending risk, basing their risk reduction strategies on the fundamental principles of:

- minimizing poor judgments on character and capability, through careful credit analysis
- using intensified follow-up methods to track projects and loan repayments
- applying “get tough” policies on repayment

It is interesting that many institutions are increasingly emphasizing nontangible aspects of creditworthiness—character, repayment history, motivation to succeed—to reduce the likelihood of poor credit judgment and the resulting need for intensive collection efforts. One of the more successful microfinance institutions in Africa has been the Senegalese Private Enterprise Credit Agency (PECA) (USAID, 1989). It addresses the intangibles by carrying out rigorous risk analysis of the potential borrower and business operation,

including on-site observation of the business operation and interviews with employees and key informants in the community about the business operator's character and debt repayment records. Personal knowledge of the borrower or the person introducing the borrower is generally accepted to be a crucial first step.

Indeed the principle of knowing the borrower is highly regarded by the Malian Bank of Africa (BOAM)—an “alternative” commercial bank—which bases risk management largely on “character lending.” They require that each borrower be known by and receive the moral guarantee of a member of the loan committee or a shareholder. In Kenya, the project “Promotion of Rural Initiatives and Development Enterprises” (PRIDE) also requires that all potential borrowers be vetted by the executive committee governing their community level market enterprise committee, and their immediate enterprise group must agree to cross-guarantee the loan given. (See also, Morris & Barnes, herein.)

Some institutions approach project-related risk with rigorous analysis of project viability on the business site. If well done, with the appropriate methodology, significant gains in risk reduction could be achieved. PECA has tried this approach quite successfully. PECA field officers develop business plans with enterprise owners and conduct careful analysis of all risk factors—market, market share, cost, and pricing structure—followed by similar independent evaluations of the proposed projects by PECA management.

Also, the principle of lending to borrowers with a record of good payments is generally applied by a number of successful institutions lending to borrowers at the margin. Most of the loans undertaken by PRIDE and PECA are made out to existing businesses with an established business history and reputation. Initial loan sizes are limited and maturities are short-term. These conditions remain until the borrower establishes creditworthiness. PECA negotiates subsequent loans according to business needs. PRIDE provides loans in steps, building up loan size to prepare good repayers to graduate into the banking system. PECA tailors the loan size and repayment schedules to cash flow.

PRIDE uses a computerized accounting system to track savings and loan performance. It has developed a credit reference system for borrowers to be used as a centralized credit reference bureau with banks and NGOs as partners. BOAM has introduced mobile field officers to track SME loans in areas without branches.

In view of the high dependence of a large number of economic activities in Africa on the agricultural sector—itsself highly dependent on uncertain weather conditions—it is advisable for entrepreneurs to seek ways of reducing dependence. As entrepreneurs move away from strong dependence on one sector, it becomes important for the financial system to complement that move with its own diversification. Where feasible, financial institutions need to diversify their loan portfolios to reduce their dependence on high-risk activities. While this could be done through loan pricing arrangements, there is often no guarantee that the desired results will be achieved in poorly functioning market systems. PECA has taken direct actions to diversify their portfolios as a risk reduction measure, to avoid sectoral concentration or overemphasis on lending in areas vulnerable to natural calamities or external shocks.

An approach that seems to be catching on with some successful financial institutions and which has been used quite effectively by a few informal lenders when necessary has been the adoption of a tough stance on contract enforcement. It has been shown that while collateral confiscation in the informal sector does not happen everyday, knowledge that the lender could actually do it has often put some fear into borrowers and encouraged them to make repayments on time. Some nonbank financial intermediaries have begun a “get-tough” policy on repayment. PECA ensures that any client not paying within 10 days of the scheduled payment date is visited by a legal officer. If loans are nonperforming for more than 60 days, action is initiated to seize security.

Appendix: African Development Bank Microfinance Initiative for Africa (AMINA): A Case Study

Microfinance institutions, which often represent the only access to some form of financial services for microentrepreneurs and other

disadvantaged groups, often lack professionalism and institution capabilities. In an attempt to encourage and strengthen these institutions, the primary objective of ADB Microfinance Initiative for Africa (AMINA) is to increase the access of the poor to financial services through capacity-building of microfinance institutions. The economic and institutional viability of microfinance institutions is key to their long-term sustainability. By developing permanent institutional capacity to serve microentrepreneurs, both outreach and sustainability are fostered, which is more effective over time than simply giving grants, disbursing loans, or providing one-time training to microentrepreneurs.

The weaknesses of microfinance institutions include the lack of suitably trained and qualified personnel, appropriate operational policies and procedures, and management information systems. AMINA shall focus on long term capacity-building of these microfinance institutions through a coordinated program of technical assistance, creating linkages between microfinance institutions and commercial banks and strengthening information dissemination among microfinance networks.

AMINA will seek to assist microentrepreneurs, women, and other disadvantaged groups in their development of productive activities. The proposed model for the initial implementation of the AMINA program has at its core technical and other assistance designed to increase the professional capacity of microfinance institutions to respond to the financial service needs of the target groups. AMINA will also attempt to establish and enhance linkages between microfinance institutions and formal financial sectors, primarily commercial banks. Finally, AMINA will coordinate its activities closely with existing and programmed ADB activities and with the activities of other donors, especially those that pertain to the financial and private sectors. AMINA will serve as a mechanism to increase horizontal linkages between microfinance practitioners and to engage governments, regulatory agencies, and donors in a policy dialogue on issues of concern to microfinance institutions.

AMINA Program Objectives

The overall objectives of AMINA include:

- Providing technical and other assistance to nontraditional financial intermediaries, such as nongovernment organizations (NGOs) and others who provide financial services to the poorest sections of the population in low-income African countries. This capacity-building sponsored by AMINA will strengthen the ability of microfinance institutions to reach large numbers of the target groups on a sustainable basis.
- Encouraging commercial banks and other formal financial sector actors to play a more active role in providing financial resources for the target populations. AMINA will seek to create linkages and greater intermediation between the formal financial sector as wholesale providers of funds for distribution on a local or retail level by microfinance institutions. It will also encourage microfinance institutions to place savings deposits gathered from the target populations with the formal banking sector. Enhancing these linkages between the formal financial sector and retail microfinance institutions will result in increased monetization and financial deepening of the economy as a whole.
- Facilitating cooperation and coordination among aid donors, private sector actors, and others involved in providing financial services to target groups. AMINA will play an important role in encouraging and facilitating information dissemination among microfinance practitioners themselves. AMINA will also serve to facilitate policy dialogue among donors, relevant government agencies, and other interested parties on subjects relevant to the provision of microfinance services, such as interest rate policies, reserve requirements, and the like.

AMINA-sponsored activities seek to contribute to the economic and social welfare of the program's target populations through improved access to appropriate financial services.

- Microenterprise development: employment opportunities are created and incomes are increased among the rural and urban

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poor through improved access to a range of financial services, including the provision of credit and savings mechanisms. This leads to the economic empowerment of the marginalized and disadvantaged members of society.

- Increased economic output, employment, and incomes: The increase of economic opportunities among the poor and other disadvantaged groups such as women yields more balanced economic growth for the economy as a whole, and more equitable distribution of its rewards.
- A growing and dynamic private sector: microfinance expands the ranks of new stakeholders in the economy through the empowerment of previously disadvantaged groups—women, landless rural poor, and urban unemployed—by providing them a means of attaining economic advancement. In addition to jobs and income created, more broadly-based economic empowerment advances the development of a more pluralistic society.
- Transformation of the private sector: as microentrepreneurs are assisted by microfinance institutions and there is an increased level of economic empowerment among previously disenfranchised societal groups, the private sector is transformed from being reactive and poorly organized into a more cohesive and effective force for political stability. A more broadly-based private sector in turn leads to a more accountable and transparent economic, regulatory, and political system.

AMINA Program Components

In order to attain these program goals, objectives, and anticipated outcomes, AMINA will engage in a coordinated range of activities. These include technical assistance for microfinance institutions, the issuance of financial guarantees to commercial banks who establish refinancing facilities for microfinance institutions, and service as a forum for policy dialogue and an information dissemination mechanism. An important undertaking of the AMINA program will be to sensitize ADB professional staff to microfinance issues and techniques through training sessions and participation in technical assistance

activities for microfinance institutions. Their participation will likewise develop a heightened appreciation for the role of the private sector and women in the overall economic development process. AMINA will also support existing and planned ADB activities in countries selected for implementation of the pilot phase of the program. Finally, AMINA will closely coordinate its technical assistance and policy dialogue activities with other donors and initiatives active in the pilot program countries. (Source: African Development Bank, retrieved from http://www.afdb.org/about_adb/AMINA.htm)

Notes

1. See, for example, <http://www.microcreditsummit.org/pubs/reports/socrt/2004/SOCR04.pdf>

2. With the “minimalist approach,” the organization concentrates only on lending. All activities that it engages in are designed to facilitate lending. These include the training of staff and also beneficiaries to the extent that they can comprehend how the loan program works. Under the “integrated approach,” training and other forms of technical assistance are regarded as integral components of a whole scheme for assistance.

3. See website at <http://www.gfusa.org>

4. Susu collectors (usually male) visit shops, workplaces, market stalls, and homes at agreed times on each day and collect funds towards a savings plan. Following this plan, a saver agrees to deposit a specific amount determined by himself or herself in consultation with the collector for an agreed period of time—usually a month—after which period, his or her deposits are returned less a day’s deposit.

5. These agents would include the numerous modern nonbank financial institutions (savings and loan companies, finance houses, credit unions, etc.) that are currently observed in a number of countries.

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