

# STATUS OF INFORMAL FINANCE SYSTEMS IN SRI LANKA

**Rauno Zander**

T. University of Berlin, Germany  
Agrarian Research & Training Institute

*Paper presented to the Seminar on the Present Status of Informal Finance Systems in Sri Lanka and their Potential Role in the Development of the Finance Sector November 7, 1990 - A.R.T.I.*

## 1. Introduction

The analysis of informal financial markets has only in the last two decades evolved as a subject of increasing interest among researchers and policy makers alike. Shortly after the general term "informal sector" had been introduced and defined in the early seventies, this concept of segmented markets with a visible and often state controlled formal part and a highly organized, but often illegal informal part was applied to the finance sector.

Early publications on informal finance systems primarily aimed to describe the hitherto unknown systems. Authors with anthropological or sociological backgrounds, who spent extensive periods in the field, provided the first insights into these systems (for Sri Lanka, see: Informal saving and credit arrangements in developing countries: observations from Sri Lanka. F.J.A. Bouman, 1984).

Socio-Economic have subsequently tried to analyze the comparative advantages of informal vs. institutional finance arrangements. This kind of analysis is focussed on certain credit components, especially interest rate levels (for Sri Lanka, see: N.A. Fernando. The interest rate structure and factors affecting interest rate determination in the informal rural credit market in Sri Lanka, 1988). A further step developed by Dale Adams is the transaction cost analysis. Costs and benefits for lenders and borrowers are assessed in this approach by measuring the monetary costs of credit transactions from banks or informal sources. Usually

the definition of transaction costs for credit customers encompasses travelling costs, expenses to deliver required securities and the interest rates of the loan.

## 2. Methodology

The research project currently undertaken between the University of Berlin and the Agrarian Research & Training Institute implements a modified analysis approach, which —

(a) takes into account All relevant credit components, not only the interest rates, maturities and travelling costs:

(b) analyzes a complete finance profile consisting of both the informal and the formal market participants.

The direct comparison between formal and informal market participants is based on the transaction cost analysis; whereas the focus on credit components and their detailed analysis modifies earlier analysis methods described above.

Two survey methods have been used:

(1) *Questionnaire Based Interviews:* in samples comprising 13% to 20% of households in the area.

(2) *Participant Observation:* implemented during two stays in the field of six and three months respectively.

## 3. General Finance Profile of the two Research Locations

The field survey was carried out in two villages—Makkaduwwa in the Kurunegala District and Mabodale in the Gampaha District. The majority of adults in the district are engaged in farming activities. Paddy is the main crop. 37.5% of the

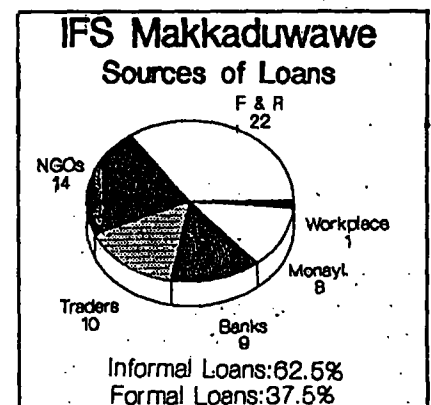
householders are full time farmers and another 55% are part time farmers. The region is severely impoverished. 80.3% of the people in Makkaduwwa are food-stamp recipients.

The banking network of Sri Lanka encompasses Makkaduwwa too. 4 kilometres away from the village boundaries 4 state banks provide their services. Only one savings and credit oriented NGO, Sanasa (Thrift and Credit Co-operative Society), is present in the village and its sources widely used by their members.

Graph 1 shows the importance of formal finance systems (black shaded) for the villagers. In spite of the prominent role of Sanasa in the village, formal loan sources constitute only 37.5% of the total. The 4 banks provide 14% of the total of 64 loans.

Informal Finance Systems (IFS) provide 62.5% of all loans. Parallel to earlier findings by the Central Bank, friends & relatives are identified as the most important source of credits. Traders, in Makkaduwwa above all small shop owners, who also act as produce buyers for rice and paddy, also contribute significantly, whereas money lenders, individuals, who extend loans with interest but not in support of a market linkage or business connection, are the least important informal source of loans. However, the number of loans they have provided almost equals that of the banks.

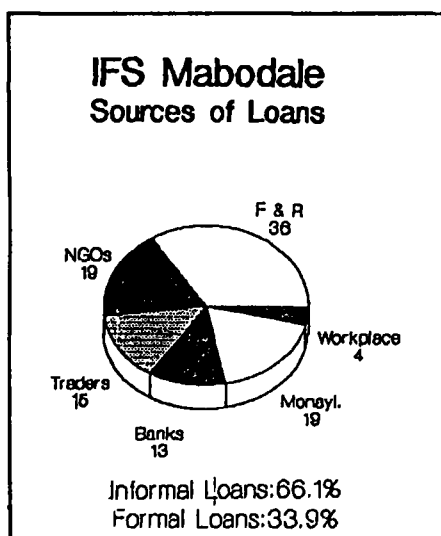
Graph 1a



The village of Mabodale in the low country wet zone is characterized by a diversified cropping pattern, ranging from paddy and coconuts to less common crops like beetle leaves and pineapples. The share of household members with non-agricultural employment is high. The adjoining Free Trade Zone of Katunayake absorbs a considerable amount of low skilled factory labour. Whereas the capital, Colombo provides employment of various sorts. The Gampaha District has traditionally been one of the more prosperous areas in Sri Lanka, with decent average incomes above all for those not employed full time in agriculture. All the same, poverty is also existent in the village of Mabodale. The most vulnerable groups are female householders in low paid occupations and full time farmers with large families on small lands.

The villagers have a wide choice of banks, one of which is located within the village boundaries (Rural Bank), and six other state owned banks less than 10 kilometres away. Yet the general loan profile of the sample resembles that of the Kurunegala sample to a large extent as can be seen from graph 1b.

Graph 1b



Three savings and credit providing NGOs are available in the villages. They contribute more significantly to the provision of credits than the banking institutions. Resulting from the higher share of persons working outside the village, the

scale of loans from the workplace is higher here than in the Kurunegala District.

IFS in Mabodale provide 62.5% of all loans taken from members of the sample in the last two years. Again friends & relatives figure prominently. Traders in Mabodale are largely produce buyers (coconut; paddy on a minor scale), but the village shop owners are an important credit source, too. A few skilled and powerful money-lenders control the large scale moneylending business. Small size loans can, however, be obtained from a variety of money-lenders.

The finance profiles of the savings market turned out to be much more homogeneous than was supposed at the outset of the study. In both districts, household members saved with the banks, which offer a high degree of convenience to their savings customers. Deposits in NGOs are largely maintained to cater for the security requirements of present or future loan applications.

**4. Analysis of the five most Relevant Credit Components**

The analysis approach suggested in this study i.e., the identification and

subsequent examination of credit components of both formal and informal market participants implies a distinction between relevant and less relevant credit components. For future application of this approach it is important to note that the assessment of relevant and less relevant credit components differs

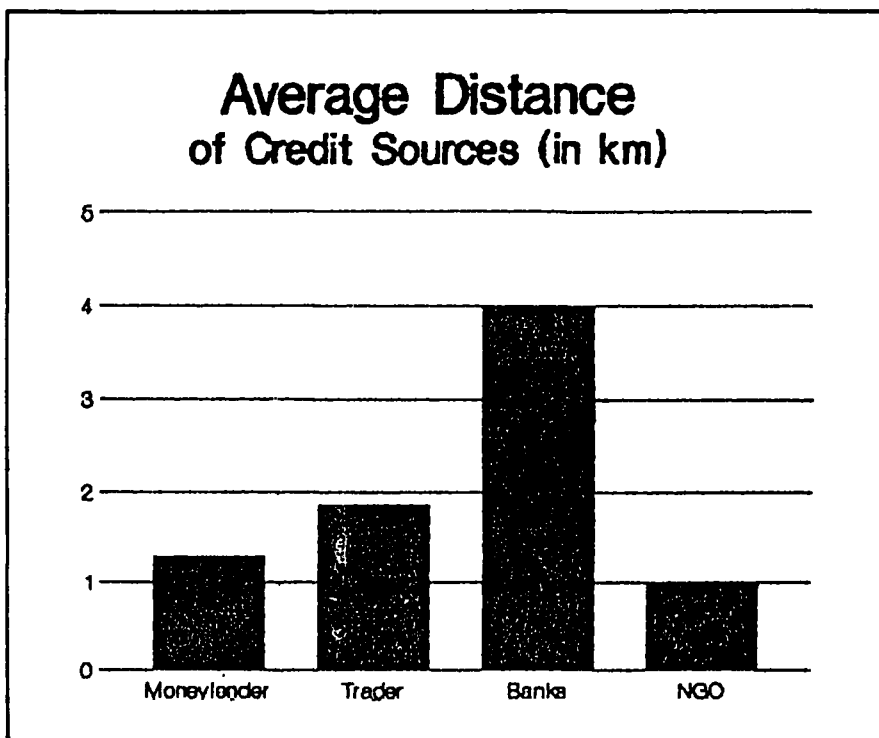
- (a) at different times within the same country;
- (b) in different countries, sometimes regions within the same country, at the same time.

The following credit components have been found to be of minor importance in the Sri Lankan context after their relevance has been analyzed in the field survey:

- (1) *The average distance of informal vs. formal finance systems from the credit customer.*

With a dense network of rural and other state banks they are within reach of the majority of rural households. This holds true esp. for deposits, as post offices accept them on behalf of the National Savings Bank. Graph 2 illustrates the case for Makkaduwwawe, Kurunegala District:

Graph 2



## (2) Sanctions in Case of non-Repayment

The issue of penalties or personal harassment in case of late or non repayment appears not to play a major role in the choice of credit sources of the village population. Banks do not exchange information on defaulters and are generally reluctant to pursue their claims in courts. Serious personal harassment from informal creditors, who demand repayment, might occur in single cases, but generally no debtor is afraid of it. To forgo the possibility to take loans from the same source in the future seems to be the prevailing motive for high repayment rates in the informal sector of rural Sri Lanka.

The following credit components have been found to determine the choice of the prospective creditor in Sri Lanka:

(1) Interest Rates; (2) Timely Provision Loans; (3) Credit Amounts; (4) Securities & Guarantors; (5) Repayment Periods.

### 4.1 Interest Rates

Low interest rates constitute an apparent advantage of institutional credit sources. Banks rates range usually between 9% and 30% p.a. In contrast, the average interest rates of village money-lenders both in Kurunegala and Gampaha amounts to around 160% p.a.

In many cases traders did not ask their credit customers for interest, esp. shop owners. The competition for customers is so strong in the small shops of both villages, that the shop owners are often forced into loan arrangements. The case is different with produce buyers, who sometimes charge high hidden interest rates in form of lower prices for the agricultural produce. But they are in turn indebted to their customers e.g., the coconut mills.

There are also important macro-economic implications to be considered when discussing interest rate levels. The interdependence between interest rate levels and the inflation rate is a crucial factor for the village population. Negative interest rates on their deposits deprive them of purchasing power that is in turn by the institutional investors or the government, which is more often

than not the ultimate beneficiary of high deposit levels coupled with negative real interest rates in developing countries. The fact of imbalanced savings and credit ratios of banks operating in the rural sector aggravates the adverse effects for rural depositors, as scarce capital is channeled away from rural investment projects.

With regard to credit, Von Pischke's publications (see for a general overview of the issue: Von Pischke, J.D. *The Political Economy of Specialised Farm Credit Institutions*. London 1980) have shown the adverse effects of large scale subsidized interest rates for agricultural loan schemes. Banks are reluctant to advance the artificially cheap credit lines to small customers. They rather revert to (or are pressurized from outside to that effect) their well known larger customers, which help to minimize the administrative costs.

The present interest rate policy in Sri Lanka directly influences the informal financial market segment. The intense effort of the banks to attract rural savings has marginalized informal savings arrangements which were popular in earlier days. The low levels of reinvestment in rural areas of the collected deposits in turn increases the general lack of investment capital in the rural areas. Informal credit arrangements—partly at high interest rates—thrive under these conditions.

It is this interest rate induced mechanism which contributes to a high and persevering presence of informal credit arrangements. Informal loan systems exist therefore partly because of the dense banking network in the island and not in spite of it.

### 4.2. Timely Provision of Loans

The performance of banks in this respect differs according to the credit line. Generally it can be said that the lower the interest rate level, the longer the waiting time and the more demanding the requirements that have to be fulfilled. The pioneering effort of the People's Bank, which included advances for pawned jewellery in its credit programme still stands out as a successful innovation. The bank profits, as pawning loans bear high interest rates; as do the customers, who have quick access to bank loans.

The quick advance of loans is a common feature of all informal finance systems and another crucial variable that helps to explain the popularity of IFS in rural areas of Sri Lanka.

### 4.3. Credit Amounts

The transaction volume of credits plays a vital role in the overall success of an investment undertaking or the effectiveness of a consumption loan. The analysis of loan amounts in the Sri Lankan context reveals some interesting insights both in the informal and the formal sector.

The largest average credit volumes of all informal sources are provided by money-lenders. High standard deviation values point to highly variable loan amounts. Loans taken from friends and relatives are the second most important informal source of loans. In both areas the average loan amounts of this source range around two thirds of that of money-lenders. The smallest volumes are provided by traders. Especially the village shop owners usually extend only small size loans. Shop owners often cling to fixed credit ceilings, which vary according to the profession of debtors. Farmers obtain smaller amounts that customers with a regular salary. Salary earners are in turn expected to settle outstanding claims at pay day, whereas farmers are granted longer repayment periods until they have harvested their crops.

All informal loan sources come nowhere near to the average credit amounts extended by Sri Lankan banks in the survey areas. In Kurunegala, banks offered average amounts almost four times higher than those of NGOs and moneylenders, both of which offer roughly the same credit amounts. Data from the semi-urban field survey area in the Gampaha District show an identical ranking of credit sources albeit on a higher overall transaction level. This higher level of credit amounts can mainly be attributed to two facts. Firstly, incomes and therefore repayment potentials in agricultural and non-agricultural professions are higher in this district. In addition, a dynamic economic environment promises higher returns on investment capital.

### 4.4 Securities and Guarantors

Informal loan sources keep securities only to a limited extent. Friends and relatives as well as traders provide loans

without asking for any securities or guarantors at all. In either case the personal relationship between borrower and lender assures a prompt repayment of the loan. But moneylenders have asked for securities sometimes for loans extended to household members of the samples. In the Kurunegala district for 25% of the loans, a security had to be deposited with the moneylender, in 15.8% of the cases in Gampaha. The items range from bicycles to tape recorders, registration papers for motorcycles and cars to jewellery.

Interviews held with moneylenders lead to the conclusion that securities increase the repayment morale of credit customers. The most successful moneylenders in both survey areas were the ones with variable and sometimes sophisticated security arrangements.

NGOs in Sri Lanka follow a different path to secure high repayment rates. Two members have to guarantee the repayment of a loan applicant, securities are not taken. According to the underlying level of cohesion in each particular group, the repayment results differ greatly. Everytime a group is on the verge of disintegration, the guarantor scheme does not help to recover outstanding loans. The opposite applies to active and dynamic associations. Especially the Sanasa movement in both villages achieves high recovery rates relying on guarantors, apart from taking deposits of loan applicants as a security.

Banks resort to a wide mix of security and guarantee arrangements. Provisions differ according to the loan scheme and even for the same credit line different branches of the same bank ask for different securities, pointing to an emphasis on personal judgement of bank staff rather than clinging to rigid rules. The general trend appears to be away from tangible collaterals towards guarantee schemes. In many cases the item financed with the credit remains as a security in possession of the bank until the loan is fully recovered.

But villagers who have been questioned as to why banks are not used more often instead of informal sources, frequently complained about the difficulty of finding guarantors acceptable to the banks. They demand income tax payers or income certificates from higher level public sector

employees. It is almost impossible to find suitable guarantors in Makkaduwwa, the survey village in Kurunegala. But the mere presence of such personalities does not ensure that they are willing to act as guarantors. Poorer sections of the population with no well-to-do relatives in the area are hardest hit by these regulations. Against this background it was surprising to learn from the banks how rarely repayment is actually claimed from guarantors in case of default.

#### 4.5 Repayment Periods

Friends and relatives, moneylenders, produce buyers and shop owners provide the majority of their loans without a fixed repayment date. Whenever the credit is interest free, the understanding between creditor and debtor is that the borrower should repay "as soon as he can". The priority of moneylenders, who collect the interest mostly once per month, is different. As long as the interest is paid regularly, they do not insist on fixed repayment schedules. None of them did in Kurunegala. In Gampaha 16.7% of the moneylenders fixed dates—the reason being that if the interest payment largely exceeds the principal, dissatisfaction of the debtor and subsequent default becomes more likely.

Banks and non government organizations attach clearly defined maturities to their loans. Both sources are open to readjust repayment agreements if events beyond the control of borrowers affect debt servicing schedules. The average repayment periods of bank loans in Kurunegala and Gampaha are 44 months and 40 months respectively, which compares favourably to data from other countries. NGOs with much smaller loan amounts have repayment periods of 12 months on average. Interviews confirmed the approval of credit customers of banks and NGOs of their repayment schedules. In some cases it was even proposed to shorten the repayment periods.

#### 5. Conclusions

(1) The access to credit from banks in rural Sri Lanka is limited. Graphs 1(a), 1(b) show the comparatively small size of bank loans taken from two village samples in Kurunegala and Gampaha. NGOs figure more prominently, they are the most important institutional source of credits. In both areas, more than 60% of

the total of loans were obtained from informal sources.

(2) Interest rates in the informal sector vary from zero to 165% p.m. Banks offer lower rates, partly below levels that assure reasonable profit margins for the transactions. Deposits are in most cases not reinvested in rural areas, which aggravates the scarcity of investment capital in the survey of regions.

(3) The timely provision of loans is paramount in attracting rural loan customers to informal sources. Friends and relatives, shop owners and produce buyers, as well as moneylenders are able to complete loan transactions in a few minutes. The amount of time in the formal sector differs according to the credit scheme, but NGOs generally take less time than banks.

(4) The comparatively small number of credit customers from banks and to a lesser extent from NGOs have high loan amounts available. In this respect, the informal sector can't compete especially with the banks.

(5) In the informal sector only moneylenders ask for securities, that for not always. Personal bonds between creditor and debtor have the same effect as security arrangements. Debtors also need to keep their options for future loans with the same creditor open, which is a further incentive to avoid default.

NGOs also rely on guarantors with generally good results. Banks tend to favour liability arrangements, too, but their high standards for potential guarantors act as a barrier for a considerable amount of villagers, who have no connection with the upper strata of the village population.

(6) A present term structure as part of the credit transaction is in Sri Lanka characteristic only of the formal credit sources. The repayment periods agreed on with banks or NGOs are suitable for the credit customers.

The informal sector largely operates without fixed repayment periods. If loans have to be repaid to moneylenders, a monthly interest payment is usually expected.

(7) Informal savings systems in rural Sri Lanka have largely been marginalized by a highly effective savings mobilization campaign of the state banks.