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5. Author(s)

1. Nimal Sanderatne
2.
3.

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Seminar on Informal Financial Markets in Development

INFORMAL LENDERS IN SRI LANKA: LINKING FORMAL AND INFORMAL MARKETS

Nimal Sanderatne
Institute of Policy Studies
Colombo - Sri Lanka

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ABSTRACT

Paper describes the wide array of informal finance found in Sri Lanka, discusses its relative imponance and provides new perspectives on informal lenders. Several innovative programs in Sri Lanka that link formal and informal lending are also described.

INFORMAL LENDERS IN SRI LANKA:
LINKING FORMAL AND INFORMAL MARKETS

by

Nimal Sanderatne

I. INTRODUCTION

This paper describes the wide array of informal lenders in Sri Lanka, assesses their significance and re-examines their characteristics. It discusses efforts to develop semi-formal credit arrangements and the recent innovations to link formal and informal markets. It attempts to draw out the lessons of informal lender experience which would be useful in formulating credit policies.

Like in many other countries informal lenders in Sri Lanka move in diverse ways to perform their functions. The wide array of informal lenders includes, apart from direct professional money lenders, informal credit arrangements tied to land, labour and marketing, informal groups like voluntary credit societies and informal savings associations. These informal credit arrangements which are a part and parcel of other market relations, include trade credit, credit linked to marketing arrangements for crop disposal and land tenure related credit. With their inclusion, informal credit arrangements become a very wide range of sources, instruments, agreements, understandings and contracts.

Like other countries at an early stage of development of financial markets when institutional credit sources are limited, informal lenders defined to include the multiplicity of such sources, have always played a more important role than institutional sources in the provision of credit for small enterprises and personal needs. Informal sources have provided essential though perhaps limited and inadequate capital for economic activities in the metropolis, large cities, towns and rural areas of the country. Although there has been a progressive expansion in institutional lending, informal lenders still play a significant functional role in the provision of credit in Sri Lanka.

The next section of this paper assesses the significance of informal lenders over time and the factors bearing on the changes in their significance. The third section categorises the wide array of informal credit arrangements and discusses the characteristics which distinguish informal credit arrangements from institutional lending. The fourth section re-examines several stereo-typed characteristics of informal lenders. The fifth section describes several attempts to develop semi-formal institutions such as rural banks to remedy the deficiencies of institutional lending and assesses their success. The sixth section discusses recent innovations to link formal and informal markets by commercial banks, particularly the appointing of credit facilitators known as Praja Naya Niyamakas (PNN). The Conclusion (Section VII) attempts to distil the policy implications of the experience in institutional, informal and semi-formal lending which may have an applicability to other countries as well.

II SIGNIFICANCE OF INFORMAL LENDERS

Informal lenders are sources of finance for a wide range of activities from petti-trading to financing large investments of unincorporated firms. In urban areas and in the heart of the metropolis informal borrowings of both small and large sums of money are a continuous activity which knows no time nor season.

A well-known phenomenon in urban areas is the daily borrowing of funds on condition that the borrower repays an additional sum at the end of the day. Such borrowings are used by retail vendors to purchase the produce they sell and by labourers to hire a cart or wheel barrow. Larger sums are borrowed by proprietary enterprises for purchase of capital items. Traders in particular borrow funds to finance their stocks. A large number, possibly most, small and micro industries are financed by informal sources.

The informal sector by its very nature eludes the collection of information on the nature of its activities. The informal urban money market is particularly secretive for fear that its activities may be disclosed to authorities which may control or tax them. For this reason, lenders as well as borrowers, are averse to giving information and therefore there has not been any systematic collection of data on the activities of the informal urban money market in Sri Lanka.

Unlike in the case of the urban sector, data have been collected on the incidence of borrowing and character of informal lending in micro-studies of particular villages or rural areas and through national sample surveys. However, even in rural credit surveys, especially of a national coverage, there are difficulties in obtaining data as borrowers do not want to be characterised as `poor', `failures', or as `not having means', while lenders do not wish to be tainted as money lenders - a derogatory profession that has been characterised as unsocial and exploitative. Also the data relate mainly to direct money lending. Trade credit and some part of credit given by landlords are included to a limited extent. Therefore, the incidence of informal credit is greater than disclosed by survey data.

Although efforts to increase institutional lending have succeeded to some extent surveys of rural credit and indebtedness disclose the continued importance of non-institutional sources. (See Table I). In 1957, informal lenders were responsible for nearly 92 per cent of rural lending, in 1969, 75 per cent and in 1975/76 less than one - third of the outstanding debt and 45 per cent of the loans taken by paddy farmers during the survey reference period (1st April 1975 to 31st March 1976) were from them.

TABLE I

DISTRIBUTION OF RURAL CREDIT BY SOURCES, SRI LANKA 1957, 1969 & 1975/76

Sources	1957 1/	1969 2/	1975/76 3/
	Percent of Total Borrowing		
I Institutional Sources:	7.8	25.0	54.6
of which			
government	2.6	2.7	7.3
cooperatives	4.1	9.7	5.1
commercial banks	1.1	6.7	36.9
rural banks	-	-	5.3
other financial institutions	-	5.9	-
II Non-Institutional Sources	92.2	75.0	45.4
of which			
money lenders	15.5	11.0	
semi-professinal lenders	-	17.8	
boutique keepers	7.4	14.3	30.3
merchants & commis. agents	4.1	1.5	
landlords	8.0	0.7	
relatives and friends	44.2	25.8	13.4
others	13.0	3.9	1.7
Total	100.0	100.0	100.0

Sources: 1/ Department of Census & Statistics, Survey of Rural Indebtedness 1957; 2/ Central Bank of Ceylon, Survey of Rural Credit and Indebtedness 1969;
3/ Central Bank of Ceylon, Survey of Credit and Indebtedness Among Paddy Farmers 1976

Notes: In the 1975/76 Survey the non-institutional sources were only categorised into three; money lenders, non-interest lenders and others. Therefore, non-interest lenders have been placed under relations and friends.

In 1957 the major proportion of institutional credit was from co-operatives which accounted for 4.1 per cent of total rural credit. As much as 44 per cent of total credit was from relations and friends; 15.5 per cent was from professional money lenders; and 11.5 per cent from boutique keepers, traders and commission agents. Landlords, who as a category of lenders declined in importance subsequently, accounted for 8 per cent of total debts.[1] It is most significant that professional money lenders accounted for only 17 per cent of informal lending.

[1] Department of Census and Statistics, Survey of Rural Indebtedness Ceylon 1957, Monograph No.12, Colombo 1959.

Certain regional differences in the significance of informal sources of credit was also observed in this survey. Relations and friends who accounted for the major proportion of credit in four of the then 22 districts accounted for less than one fourth of credit in four other districts. Landlords were an important source of credit in three districts, while boutique keepers were important credit sources in three others. Professional money lenders accounted for between 23 and 32 per cent of credit in five districts.

By 1969 the quantum of institutional credit to the rural sector had increased substantially under the agricultural credit programmes, and the People's Bank which had been established in 1961 with the specific objective of serving the credit needs of the rural sector had opened branches and established 89 cooperative rural banks. Despite these institutional developments non - institutional credit sources still accounted for 75 per cent of total debts in 1969. Credit from co-operatives and commercial banks increased significantly and the new category "other financial institutions" accounted for nearly 6 per cent of credit. Among informal lenders, relatives and friends continued to dominate but their share of lending had declined significantly from that of 1957. Although professional money lenders had declined in importance in overall lending their share in informal lending had increased from about 17 per cent in 1957 to 25 per cent and semi-professional money lenders and boutique keepers were important lenders accounting for 18 and 14 per cent respectively of total debts. Landlords contributed less than one per cent of total credit.[2]

A more restricted sample survey undertaken between these two surveys in 1961 - 62 by the Department of Agrarian Services disclosed that informal sources provided about two - thirds of total credit.[3]

The Survey of Credit Conditions Among Paddy Farmers conducted by the Central Bank in 1975/76 disclosed for the first time a lesser dependence on informal sources. Only 45 per cent of the amount of loans borrowed during 1975/76 and about 32 per cent of the loans outstanding on 1st April 1975 was from non - institutional lenders. Money lenders were the most important informal source and were responsible for 30 per cent of the total amount borrowed. Non - interest lenders accounted for 13 per cent of the amount of loans taken during the year.

Even if allowance is made for the fact that the sample of this last survey consisted of only paddy farmers, yet the overall change is indicative of institutional sources becoming more significant in the rural credit market. In the last decade prior to the survey, a fairly large amount of credit had been given to paddy farmers and a lesser amount of credit for other food crops. By the end of 1975 there were 338

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[2] Central Bank of Ceylon, Report on the Survey of Rural Credit and Indebtedness 1969. Colombo 1971.

[3] Department of Agrarian Services, Administration Report 1962/63. Colombo 1965.

rural banks which had mobilized more savings than lent to their members. The bank branch network had also expanded to 562 branches.

The significance of informal lenders has decreased in importance as institutional lending increased. Since institutional credit volumes have tended to fluctuate quite markedly, it is likely that the importance of informal lenders would vary from year - to year. In an average year of government agricultural lending, it is likely that informal lenders are about as important as institutional sources but when a large amount of institutional credit is pumped into the rural sector as in 1967 and 1977/78, the relative importance of informal sources may decline. Conversely when there is a contraction of institutional credit, informal sources are likely to be predominant. For instance in 1978/79 institutional credit for paddy cultivation increased substantially from Rs.107 million in the previous year to Rs.448 million but declined in subsequent years. The importance of informal lenders is likely to have shrunk in 1978/79 but would have reasserted their importance later.

The preceding analysis of several national surveys of rural credit suggest that though the share of institutional credit in the rural sector has increased, informal lenders narrowly defined, accounts for a very significant proportion of credit. If the more comprehensive definition of informal lenders suggested in the paper is accepted, there is little doubt that informal sources predominate. One serious limitation in coming to conclusions on the current situation is that the latest available national data is of 1975/76 and that too of a segment of the rural sector, albeit an important one.

III THE RANGE OF INFORMAL CREDIT SOURCES AND THEIR CHARACTER

The wide array of informal credit arrangements and sources could be grouped into three main categories and sub-groups as indicated below:

Informal Credit Market

1. Direct Money Lending	2. Indirect Money Lending	3. Voluntary Credit Groups
a. Professional Money Lenders	a. Trade Credit (boutique keepers and shops)	a. Single purpose credit societies (e.g. funeral societies)
b. Semi-professional Money Lenders	b. Marketing Credit (commission agents, purchasers of farm produce)	b. Multi - purpose savings and credit societies.
c. Non-professional personal sources	c. Landlord credit	c. Rotating Savings and Credit Associations (ROSCRAS)
d. Pawning	d. Crop related lending (crop mortgages)	

a. Direct Money Lending

Direct sources of credit could be sub-divided into three broad categories: professional money lenders, semi-professional money lenders and personal (non-professional) sources of finance. Professional money lenders are those whose primary occupation is money lending. High rates of interest, the entirety of the transaction being in cash and their resourcefulness at all times characterise money lenders. Since professional money lenders combine their money lending with other services like petty trading, wholesale procuring of produce or are landlords, it is sometimes difficult to distinguish them from semi - professional money lenders. Semi professional money lenders include a whole array of persons generally resident in the village or in close proximity to it, who are mainly involved in other activities but who may lend money when called upon by known parties. Their money lending activity is often secretive, clandestine and often restricted to a known range of persons. The interest rate charged by this category, as well as their conditions of repayment, could vary significantly but are generally considered to be more flexible and less exacting.

The disadvantage of dependence on these two categories of lenders, who may be landlords and merchants themselves or be allied to them, is that apart from high interest rates, borrowing from them may prevent farmers obtaining the advantages of government measures such as guaranteed prices, rental control provisions and crop insurance. They are also often able to secure the repayment of their monies as a first charge and therefore institutional sources could suffer defaults.

The third category of money lenders includes friends, relatives and landlords who assist persons at times of need. The distinguishing characteristic of this group of lenders is that they may lend free of interest or at a low rate of interest. Money lending could be a reciprocal transaction where the borrower would turn lender at other times or the reciprocity may be in non - financial terms such as assistance in farming operations or help in the domestic chores of the creditor. It may also have no reciprocity but merely be a part of the social and kinship relations in the village.

A form of credit arrangement associated with money lending is pawning which is popular in both rural and urban societies. Under this arrangement a loan is obtained by pledging gold or jewellery. The loan is only a small proportion of the value of the pledged item. The availability of gold and jewellery and other valuable possessions provide good security for credit. While many transactions may be with professional pawn brokers, yet the good security provided could persuade persons who are not regular money lenders to lend on such security. Pawning has been institutionalised in Sri Lanka and since 1963 the People's Bank - a state commercial bank - does pawning business.

b. Indirect Money Lending

A very common phenomenon in both urban and rural society in Sri Lanka is that a large number of poor households obtain their daily provisions for consumption on credit from boutiques and shops. Often the arrangement is a very flexible system of revolving credit. When the consumer obtains provisions, the cost is added to his account by the shop keeper and when the consumer is able to advance a sum of money this is set off against his debt. The consumer has a great degree of trust in the boutique keeper and the accounting is entirely left in his hand. Though trade credit of this nature has no apparent interest charge, in fact concealed interest costs are likely through higher prices for purchases. Though a very significant amount of credit is in this form difficulties of recall by respondents results in inadequate estimates of trade credit.

Credit linked to marketing of produce is a well known phenomenon in Sri Lanka, especially in vegetable cultivation. It is also prevalent in the purchase of paddy. In these arrangements the farmer sells his produce to `commission agents' who have already given him credit during the cultivation cycle. Such credit may be for production or consumption needs. The ample flexibility of these commission agents in the manner in which they give credit and the convenience they provide in purchasing the output are among the reasons for preferring to sell produce to and secure credit from them. There is no explicit interest charge for credit but the prices paid for the produce would be lower than when the purchase is a direct cash payment.

The third source of this type of credit is landlords who provide inputs such as seed or draught power for cultivation. Here too there is often no apparent interest charge and the provision of these inputs is part of the land tenure relationship. An implied interest rate is often borne by the tenant as the share rent arrangement is adjusted to a higher rental. The share rent of a tenant who obtains such inputs would be higher than from one who is not dependent on the landlord for resources other than land. In addition to the provision of inputs, landlords often provide finance which is repaid in kind at harvest time and the valuation of the produce often includes an interest cost.

Pledging of standing crops provide another means by which cultivators obtain credit. This is most prevalent in the case of seasonal crops where the standing crop may be pledged in advance for a sum borrowed. In perennial crops the debtor may agree to give the entire produce of the land till such time as he repays the capital. In such arrangements the crop becomes the interest payment and the period of loan may not necessarily be stipulated. Such pledging of crops could involve long periods of time where the capital sum borrowed is large. There could also be arrangements where the amortization of the loan is included in the produce payment and the loan is liquidated in a stipulated period of time. These arrangements are not generally in the form of legal instruments but informal agreements.

c. Voluntary Credit Groups

Voluntary credit societies are formed for specific needs such as meeting expenses for funerals as well as for diverse purposes. These mobilise savings in small sums and lend for agreed purposes. Thrift and Credit Societies and rotating credit societies or cheetus are informal savings mobilization forms widely prevalent in the country.

Cheetus take different forms but their essential characteristic is that participants contribute at regular intervals and the pooled sum is distributed as a lump sum on the lottery principle, auction bidding or a predetermined order of payment. Some Cheetus have as their objective the purchase of a "luxury" item. These voluntary credit associations create a motivation and psychological impetus among low income participants to save significant amounts.[4]

These many types of informal lending underscores the fact that informal credit arrangements are not solely money lending transactions. Their nature and character are diverse. Credit forms the basis of many transactions linked to trade, land tenure and produce marketing. Informal credit groups too form a significant share of this market. Informal lenders have several advantages to the small farmer. Little or no collateral is asked for; repayments can be adjusted to times convenient to the borrower who does not need to go through elaborate procedures; credit could be obtained for "non - productive" purposes like consumer expenditure especially at times of personal contingencies and borrowers do not have other transaction costs. It is the convenience, flexibility and accessibility of informal credit sources which account for small farmers' and small entrepreneurs' greater dependence on them even when institutional sources are available.

IV. NEW PERSPECTIVES ON INFORMAL LENDERS[5]

The money lender is generally characterised as one who lends small sums of money at very high interest rates for short periods without security and mostly for consumption purposes. Among these features, the usurious and exploitative nature of interest rates has received the greatest publicity. There is also the inference that the money lender's role is parasitic, rather than functional and that society would be better off without them. In fact the role, function and character of informal lenders vary with changes in the rural financial market over time and the diversity of financial conditions in the country.[6]

It is generally assumed that interest rates charged by informal lenders are exorbitant. In fact a very wide spectrum of interest rates prevail. Interest rates ranged from interest free loans to 250 per cent or more per annum. Of the total volume of informal lending about one - third (31%) was interest free, about one -

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[4] See F.J.A. Bouman, "Informal Saving and Credit Arrangements in Developing Countries: Observations from Sri Lanka", in Dale Adams, Douglas H. Graham and J.P. Von Pischke (Eds.) Undermining Rural Development with Cheap Credit Westview Press Colorado 1984 pp.232-247.

[5] This section is based on data collected in the nation - wide Survey of Credit and Indebtedness Among Paddy Farmers conducted by the Central Bank in 1976. Although the sample selected for this survey was primarily of paddy (rice) farmers, the general characteristics of informal lenders cannot be expected to be different as paddy farming predominates in the rural sector:

[6] For a more detailed analysis, see Nimal Sanderatne, "A Profile of the Informal Rural Credit Market in the Mid Seventies", Central Bank of Ceylon, Staff Studies Vol.11 Nos.1 & 2, Colombo 1981.

third (33.5%) was at interest rates of below 25 per cent and about one - third (36%) was lent at interest rates of over 25 per cent per annum (about 30 per cent was between 25 and 100 per cent and about 6 per cent above 100 per cent per annum). The modal interest rate was 26 - 50 per cent per annum (Table 2). Two - thirds of informal lending was below 25 per cent per annum which cannot be considered an exorbitant interest rate. When interest free loans are excluded, 29 per cent was at 20 per cent or less, about 53 per cent between 21 - 50 per cent and 18 per cent at higher than 50 per cent per annum.

Many surveys and village studies have disclosed that a significant proportion of informal loans are interest free. For instance the 1969 Survey of Rural Credit and Indebtedness disclosed that 34 per cent of the amount borrowed was interest free. Kinship, friendship, patron - client relationships and reciprocity are important factors in meeting credit needs especially at times of emergency such as illnesses and death or for ceremonies. The fact that 46 per cent of loans for ceremonial purposes was obtained interest free lends support to this hypothesis.

Interest free lending should be cautiously interpreted as some interest free loans could in fact have a built-in cost. Loans obtained from traders may be nominally free of interest but farmer's obligation and commitment to sell his produce to the lender could result in lower prices. Similarly, boutique keepers may give credit on purchases and charge higher prices. A more subtle and disguised cost of interest free loans are loans given to ensure existing tenancy and labour arrangements which are highly beneficial to the landlord. Also some loans reported as obtained without an interest charge may be loans in kind and the timing of repayment in kind and the different measure used could include an interest component. Therefore, while it must be recognised that a significant proportion of informal loans are interest free, yet the actual proportion could be over - estimated owing to these reasons.

The volume of credit at very high interest rates was modest, but the number of loans transacted was large. About 19 per cent of loan transactions (197,120 loans) was estimated to be at interest rates above 25 per cent and 4.4 per cent of the total number of loans (46,535 loans) transacted was at rates of interest above 100 per cent. The large number of high interest rate loans creates the impression of very high interest rates. A balanced view of informal lenders must take into account the fact that a very significant proportion of amounts lent is nominally interest free and a sizeable proportion is at rates comparable with institutional interest rates (not subsidised interest rates).[7]

[7] See Nimal Fernando, "The Interest Rate Structure and Factors Affecting Interest Rate Determination in the Informal Rural Credit Market in Sri Lanka", Savings and Development No.3 1988 XII, Milan 1989.

TABLE 2

INTEREST RATES OF INFORMAL SECTOR
1976, 1978/79 & 1981/82

Interest Rate per Annum	1976 1/	1978/79 2/	1981/82 3/
		per cent of total	
0	31.19	72.1	54.1
1-10	4.16	4.1	1.6
11-20	15.82	3.5	13.0
21-50	36.81	3.0	3.0
51-100	6.19	5.4	4.0
Over 100	5.83	11.9	24.3
Total	100.00	100.0	100.0

Sources: 1/ Department of Census & Statistics, Survey of Rural Indebtedness 1957; 2/ Central Bank of Ceylon, Survey of Rural Credit and Indebtedness 1969; 3/ Central Bank of Ceylon, Survey of Credit and Indebtedness Among Paddy Farmers 1979.

The general impression is that informal lending is mainly for non-productive purposes such as ceremonies, household consumption and fortuitous needs such as sicknesses and deaths and not for the cultivation of crops, business purposes and capital expenditure. In fact the Survey data disclosed that informal lenders gave credit for a variety of purposes. About 50 per cent of informal lending was for cultivation, about 10 per cent for trade and 4 per cent for house construction. Informal lending for agricultural production was about 65 per cent of the amount lent by institutions and informal lenders lent about five times that of the institutions for industry and trade.

There is an interesting difference in the purposes of lending of money lenders and non - interest lenders. While money lenders gave 58 per cent of their credit for cultivation purposes, non-interest lenders gave only 32 per cent. While about 20 per cent of money lender's credit was for consumption and ceremonial expenditures, as much as 38 per cent of credit of interest free lenders was for these purposes. Therefore among informal lenders, money lenders lent more for production purposes than interest free lenders such as friends and relatives.

The impression of informal lending being consumption - oriented, is based on the fact that about 55 per cent of total consumption loans was from informal sources and about 25 per cent of informal lending was for consumption purposes (consumption, ceremonies, debt redemption and others). Nearly all the borrowing for ceremonial purposes was from informal sources.

Since most informal lenders do not require the usual procedures of institutional lending, such as the filling of forms, it is generally believed that most such lending is without security. In fact about one third of all informal loans was secured. As far as non - interest lenders are concerned, only about 7 per cent of their loans was secured but money lenders secured a fairly large proportion (47 per cent) of their loans with several forms of security. Money lenders secured their loans with immovable assets (19 per cent), jewellery and durable consumer goods (16 per cent) and machinery and equipment (9 per cent). Since the number of secured loans was small, the large number of unsecured transactions gives the impression that security is not a consideration in informal lending. In fact a significant proportion of the larger loans are secured.

Informal loans were in a wide range of sizes. Although the average size of loan was not small, the median and modal sizes were small. The modal size group of informal loan was below Rs.250. There was a significant difference in the size of loans of money lenders and non - interest lenders. While money lenders extended nearly 9 per cent of their credit in big loans (between Rs.16,001. and Rs.25,000.), non - interest lenders lent mostly small sums though they had given loans over Rs.10,000. While money lenders did give larger loans, yet over half of the sums lent by them was in loans of less than Rs.2,000. and over 70 per cent of their lendings was below Rs.3,000. Therefore, money lenders too were essentially lenders of small loans though some of their loans were larger. In contrast, interest free loans were mostly small. As much as three fourths of the number of loans and about 39 per cent of their lending were below Rs.500. Only 2 per cent of their loaned amount was in loans of over Rs.5,000.

Contrary to the conventional view that informal lenders achieve high rates of recovery, this survey disclosed that only a small proportion of high interest loans is recovered. Therefore the interest rate may include an amount of implied capital repayment. High interest lenders may be reconciled to the non repayment of loans after a certain length of time and borrowers themselves may feel justified in not repaying high interest loans once they have paid interest for a length of time.

Many ideas about informal lending have been derived from conditions prevailing during a period when institutional credit was very limited and informal lenders exercised their monopoly power to impose high interest rates and other exacting conditions. The preceding discussion leads us to derive some new perspectives on informal lending. Contrary to popular notions, interest rates of informal lenders may not be as high as it is supposed to be, informal lenders do lend significantly for production purposes and informal lenders secure their larger loans. Informal loans are very varied in size but generally small though money lenders lend a proportion of their portfolio in larger loans.

There are several reasons why informal lenders are characterised as exploitative and usurious. In the assessment of informal lending the role of the non - interest lender is not recognised. Admittedly some of these interest free loans have hidden costs such as high retail prices or lower producer prices to the borrower or payments in kind or other arrangements which are of benefit to the lender. Yet, it is undeniable that a significant proportion of informal lending, even though not entirely interest free, are not at exorbitant interest rates. It is the high interest loan component that has created the image of exorbitant interest rates in the informal market. Even though high interest loans do not constitute a majority of the amounts lent, they are a very large number of transactions. Since large numbers of small loans of short duration are transacted at high interest rates, it is these loans which have moulded the view that informal lenders are nearly always high interest lenders. In an assessment of informal lending it should be borne in mind that informal lenders charge interest on a monthly basis and lend small sums for a short duration. Therefore such loans do not necessarily constitute a high cost to the borrower. This is especially so as such lending has no transactions costs or other costs. But when such costs of borrowings are converted to annual interest rates, they yield a high rate of interest.

The impression that informal sources lend mainly for consumption appears to have arisen out of the fact that institutional sources lend very insignificant amounts for such purposes. The non - availability of loans for consumption from the institutional sector implies that informal lenders have to fill the lacunae. The lack of consumption oriented institutional lending has led to a misconception that informal lenders, who lend for consumption purposes, do so mainly for such purposes and not for production needs. In fact, over 70 per cent of informal lending was for production purposes. Over half of the volume of informal loans was for cultivation purposes and exceeded the amount lent by institutional sources for cultivation. Informal loans were also responsible for the bulk of lending for trade.

The hypothesis that is advanced here, is that the purposes of informal lending are demand determined. There is no reason why informal sources should be reluctant to lend for production purposes, if they are willing to lend for consumption. The overall considerations of the informal lender are the rate of return for his capital and the recoverability of his loans. If these two conditions are satisfactorily met, there is no reason for informal lenders to prefer lending for consumption purposes rather than production. In fact, the informal lender's transactions unlike many institutional loan schemes which restrict loans for specified purposes are based on the realistic acceptance of the fungibility of money and credit. Therefore, the purpose - wise distribution of informal loans is a significant reflection of the rural credit demand which is not met by institutional sources.

In summary, informal lenders transact at very wide ranging rates of interest, they lend for a wide array of purposes and their sizes of lending are more varied than is generally presumed. In fact, these characteristics of informal lending are suggested to be the outcome of the demand for credit rather than characteristics which emerge from the lenders' attitudes.

V SEMI FORMAL LENDING

The recognition that institutional lending has many limitations resulted in several efforts to service the small borrower through adaptations in institutional lending. The foremost experiment has been the establishment of Cooperative Rural Banks (CRBs) in 1964 under the auspices of the People's Bank. CRBs are not banks but departments of co-operatives which mobilize savings and lend funds for limited purposes. They are small in size, less impressive than bank branches and established within the co-operatives which are a familiar institution in the village. Unsophisticated village clientele find it more comfortable to transact business with their village co-operative society rather than fully fledged banks, whose impressive structures and procedures intimidate them. They are a device for extending limited banking facilities to areas where economic conditions do not justify the establishment of a branch bank. The limited facilities could be adequate and even preferable to fuller banking services through sophisticated and less familiar institutions. CRBs also operate at times more convenient to the local clientele and could be more flexible in the provision of credit owing to their familiarity and knowledge of credit worthiness of borrowers.[8]

After the first five years of CRBs operations their deposits exceeded advances and in most years since then there have been substantial surpluses. At the end of 1988, CRBs had a surplus of Rs.1068 million with deposits being over twice the quantum of advances. In the 25 years of their operation nearly one thousand CRBs and special branches of the People's Bank, which were again on innovation to perform the same functions as CRBs, were established.

While the expansion of CRBs, their distribution in the country and the amount of savings mobilized by them could be considered a success, they have had only a limited impact on lending for developmental purposes. The surplus of deposits over total advances including pawning implies that they have been mobilizing rural resources for transmission to other areas rather than been a provider of funds for rural and small scale development. The funds lent have been for limited purposes. More than one half of short term loans has been for housing, electrification and water supply and about 20% for agricultural production and cottage industry. Credit obtained by pawning, which constituted as much as 30%, is likely to have been used for a variety of purposes including productive employment.[9]

It is likely that the limitation in lending was due to an excessive prudence with depositor's funds by the co-operative staff. The popularity of pawning perhaps vindicates this hypothesis. Lending based on the viability of projects would have been

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[8] S. Kahagalle and Nimal Sanderatne, "The Role and Performance of Cooperative Rural Banks in Sri Lanka 1964-1976", Central Bank of Sri Lanka, Staff Studies Vol.7 No.2, September 1977, pp.1-44.

[9] Nimal Sanderatne, "Cooperative Rural Banks - A Success Story?" Economic Review Vol.14 Nos.8 & 9 Nov - Dec 1988 pp. 15-17.

difficult as most staff would not have had the capability to appraise projects. Therefore, CRBs have turned out to be a limited source of funds for small borrowers. The greater flexibility in the lending procedures have not led to easy access to credit. The inability to increase their lending is not entirely due to deficiencies of these banks themselves, but also due to the local communities not having viable economic enterprises which require various skills and marketing possibilities.

The other more recent innovation is the establishment of Regional Rural Development Banks (RRDBs) in 1985. These unit banks are expected to meet the gap in credit which other commercial banks do not provide and which are provided by informal lenders. In order to perform this function RRDBs were given guidelines that they should not compete with the existing financial institutions but supplement them by providing credit to small farmers, rural artisans, peti traders, small entrepreneurs and for personal needs which are not adequately serviced by banks. RRDBs were expected to be a new species of banks which would bring about a new culture in banking. The area of operation of each bank was also limited to make these objectives effective.

In the 3 1/2 years since the commencement of the scheme, 11 RRDBs were established with 80 branches (including their head offices). The security situation has hampered the expansion of the scheme to 14 other districts as well as reduced the pace of branch expansion within each district.
RRDBs had mobilised over Rs.100 million in savings at the end of 1988. Unlike CRBs they had lent more than their deposits. About 40 per cent of their loans was for agriculture, 21 per cent for small industry and 18 per cent for trade and business. There is evidence that they have lent for a wide variety of purposes and that many micro - enterprises have obtained funds from them. Although it is somewhat too early to come to any definite conclusion the author's inquiries have revealed a somewhat high rate of defaults in certain RRDBs. Though some of the defaults are due to agricultural failures, others are wilful defaults created by an attitude that RRDB lending is government lending. There is also evidence that owing to officers in banks being pushed to provide credit they may not have been as prudent as they should have been with depositors' funds.

RRDBs have a high cost structure owing to the tendency for the staff being paid fairly high salaries, the staff numbers being high for the small turnover in branches and costs of servicing large numbers of small loans. The financial margins are also inadequate and consequently most RRDBs are probably running at a loss. This would be a unsustainable condition in the long run. Although it was intended to transfer the ownership of these banks gradually to share-holders in the community itself this has not happened.

VI LINKING FORMAL AND INFORMAL MARKETS: The Praja Naya Niyamakas (PNNs)

The Praja Naya Niyamaka (PNN) scheme inaugurated by the two state banks in October 1988 is an attempt to link informal credit sources to the institutional banking system. The basic features of the scheme are that the two state banks lend funds to persons of proven credit worthiness, often on the basis of collateral, at an interest rate of 1 1/2 per cent per month (18% per annum) and expect the PNNs to lend at an interest rate not exceeding 2 1/2 per cent per month (30% per annum). The banks give the PNNs guidelines on how to lend but do not require them to provide documentation and other proof of their lending. Since this scheme is meant to assist the small borrower, loans are not expected to exceed Rs.5,000.

Under this scheme the financial resources of the banks are expected to supplement the resources of the informal sector to meet the small borrower's credit needs. The increased supply of funds from the PNNs and the consequent increased competition among informal lenders are expected to bring down the cost of borrowing, make credit more readily available for the needs of the small borrower and improve the conditions of borrowing. Since the two banks are expected to appoint about 14,000 PNNs throughout the country, the competition among them and with other informal sources is expected to bring down informal interest rates. It is by increasing the supply of funds and the availability of options to the small borrower that the rural financial market could be expected to bring down the cost of borrowing to the small man. The flexibility and convenience in lending, which the banks as institutions could never provide, could be provided by the PNNs with the resources of the banks.

The success of the scheme would partly depend on the choice of the PNNs. Therefore, the banks are making an effort to choose persons who are not motivated by profit alone, but also have a social purpose and view the implementation of the scheme as one having a significant impact in improving the productive capacity of the economy, alleviating poverty and increasing incomes.

In the first ten months of implementing this scheme the two state banks appointed over 4000 PNNs and lent about Rs.160 million to them. It would have been possible to appoint a larger number of PNNs had the security situation in the country been better. In several areas affected by security conditions, the appointment of PNNs has been slow. They have also been reluctant to exhibit the display board as required by the banks. They have lent for a wide spectrum of purposes, including very small loans for self employment, petty trade and various services. However, some of the PNNs have tended to concentrate on larger lending and not lent to very small enterprises as required under the scheme.

Among the difficulties PNNs have themselves highlighted is that the upper limit of credit given by the banks (Rs.200,000) or the limit imposed within this maximum on the basis of their credit worthiness was inadequate. They contend that they are unable to explain to borrowers that they have exhausted their resources when they are appointed as "agents" by the banks. Many PNNs have said that the margin of 1% per month was inadequate as they bore the entire credit risk and the total income derived by on-lending Rs.100,000 was around Rs.1,000 per month. The maximum loan limit of Rs.5000 was also considered inadequate and PNNs have in fact often lent higher amounts.

It is somewhat too early to evaluate this scheme, which is undoubtedly a useful experiment in linking the informal lender to the institutional system. One of difficulties in its successful implementation is the need for the banks to ensure that the informal lender continues to lend unfettered in an informal manner. The banks should lend to credit worthy PNNs and ensure recovery of funds lent to them and give PNNs freedom in the manner they on-lend. The linking with the banks should not result in the introduction of formal procedures. Since the PNN bears the risk and the money he lends is `his' money, the PNN should be free to lend in any manner he likes. Banks should only use some `moral suasion' to achieve the objectives of the scheme. Otherwise this linking could be a kiss of death.

Apart from the PNN scheme several other attempts have been made to link formal and informal finance. One model which was used by banks even prior to the appointment of PNNs and continues is that of lending to non-government organizations (NGO) which in turn lend to groups and individuals on their own terms. The NGO takes the responsibility for monitoring the loans and ensuring recovery. The two state banks have made special efforts to expand this model within the last year as part of the government's programme for poverty alleviation.

Some NGOs borrow at market rates and lend at rates which give them a margin to cover risks and build up their own reserves. Such borrowings are used for on-lending for agricultural inputs as well as for strengthening marketing. While the cost of the credit is higher than the direct borrowing rates from the bank, the NGO offers the borrower great flexibility, immediate access to credit and a minimum of transactions costs. This model of granting credit has in effect reduced the costs of inputs and noticeably improved the prices fetched for the borrower's produce. The latter has been achieved in several ways. Since the marketing is not linked to credit, the grower is not restricted to selling his produce to the bulk purchaser of the produce ("commission agent") who gave him credit and therefore able to obtain the market rate for his produce. The NGO itself has used funds borrowed to provide transport facilities and for some of its members to be employed in marketing. Further the NGO has linked up with outlets in the metropolis to sell the produce of its members and to participate in regular or week-end markets. New economic enterprises arising out of the possibility of marketing their produce has also been organised. Since the borrowers are themselves members of the NGO they have a sense of responsibility to repay the loans.

There has been an interesting development in the above model which has enabled its implementation in a more extensive manner. A foreign organization has given guarantees on the bank's lending to the NGO. This has enabled the bank to be more flexible in the granting of the loan as the repayment of the loans are guaranteed. Further on the basis of this guarantee the bank is also in a position to lend more than the sum guaranteed on the basis of its own assessment of the recovery rate. It is useful to indicate that the guarantee is not publicised among the members so as to ensure their sense of responsibility in repaying loans.

The role of the NGO also varies in the above model. Members of the NGO borrow certain loans direct from the bank and the NGO gives its `approval' to the bank, supervises the use of the funds and helps in the recovery, but the bank uses its own criteria as it takes the full risks of the lending. In other loans the Bank lends to the NGO which in turn lends to its members and the NGO takes full responsibility. A third type is where the NGO provides a guarantee but the bank uses its criteria in deciding to give the loan. The fact that the guarantee operates is not known to the borrower.

There are however several difficulties in expanding this model. Many NGOs receive grants from foreign sources for their activities and lend free of interest or at very low rates of interest. Consequently such NGOs cannot simultaneously implement a programme at market interest rates. In fact many NGOs are not motivated to borrow at market rates even when banks are willing to lend at minimum market rates owing to their view that if banks are really interested in poverty alleviation that they should charge very low rates of interest-rates much below deposit rates.

The state banks have also used a government organization - the National Youth Services Council (NYSCO) to lend for a number of small enterprises employing youth. NYSCO plays the roles of preparing the projects, assisting the youth to obtain skills and inputs, lends part of the needed funds, monitors the projects and helps resolve any difficulties the youth may have, assists in marketing the produce and in ensuring recovery of the funds. This has been one of the most successful schemes both in terms of the extent of the implementation and the recovery of funds. About 3500 small scale projects have been financed with bank lending of about Rs. 25 million. NYSCO has played its role as if it were a NGO. It must also be mentioned that NYSCO has a larger number of projects of their own without bank financing.

VII LESSONS OF THE EXPERIENCE

There have been many efforts to increase lending to small borrowers. The expansion of the branch banking network has resulted in a bank for every 22,000 of the population. Banks have been involved in concessionary credit for agricultural crops for over two decades. About 1000 Cooperative Rural Banks and 80 Regional Rural Development Banks have been established. The two state Banks in particular have implemented through their 600 branches a number of special credit schemes to reach the poor and hitherto unserviced sectors, craftsmen and self-employed enterprises. More recently there have been several attempts to link the formal and informal markets.

Despite all these efforts the small man is ineffectively reached and informal sources meet most needs of small borrowers whether they be self employed entrepreneurs, peti traders, farmers or craftsmen. The reasons for this is manifold. Small customers find it difficult to complete the necessary forms, get guarantors, provide documentary evidence and convince the banks of the viability of their projects. Past experience of high rates of default discourage managers to lend to small borrowers. The work load of lending to a large number of small borrowers is greater than in lending to a fewer larger borrowers and the supervision of lent funds is difficult. Managers take a risk of their loan portfolio having a larger rate of default, their cost structures being higher and their branch profits being lower. Since the performance of a branch is judged by its profits these factors discourage managers from increasing their lending to small customers. It is much easier to lend to bigger customers who may also reciprocate the assistance they have received with gifts and other favours. To be effective in this type of lending bank staff would require to be specially commited to this type of lending.

More recent efforts to increase lending to small borrowers have met with some success though it is still limited in coverage. The reasons for the success lies in the fact that the political leadership has laid down the need to extend such credit. In the two state banks the transformation is like a change of ownership where the `new owners' have stipulated new priorities. This has given a new impetus to developing credit schemes for craftsmen, self-employment projects and particular enterprises. To some extent these schemes are likely to meet the needs of the small borrower but whether they would themselves have high rates of default and consequently flounder without making a dent on the problem is yet to be seen. The adoptations of formal institutions to meet the needs of the small borrower has met with limited success. The CRBs have been successful in mobilising savings but failed to have a real impact in lending for reasons discussed earlier. The RRDBs on the other hand have lent more liberally and for a variety of purposes, yet there are indications that their rates of recovery may be low.

A lesson that can be learnt from the experience of institutions adapted to serve small borrowers is that they have proved more successful in mobilizing savings than lending to small enterprises. Therefore institutions should have means by which they could reach as large a number of persons as possible so as to mobilize savings. Semi-formal institutions and agents should be commissioned to muster small savings. Banks can then use these savings through the linkages they adopt to lend to small enterprises. It appears that institutions have a strength in mobilizing savings while informal lenders are more adapted to lending to the small sector. Therefore the two strengths could be combined with resources of the informal lender being significantly supplemented with institutional finances.

It is also part of the experience that when institutions, particularly government sponsored or state institutions, attempt to lend to small farmers and small enterprises they run the risk of high rates of default. This is largely due to an attitudinal problem of borrowers from such institutions thinking that they need not repay their loans from state institutions. Therefore attempts to provide institutional finance through grass roots level institutions sponsored by the government tend to attract high rates of defaults. It is therefore preferable for the on-lending to be by non institutional sources and certainly non governmental organizations.

What are the lessons of these experiences? Can formal institutions learn from the way informal lenders operate and use those methods in their lending? If so what are those lessons which require to be implemented by formal institutions?

The essence of informal finance is the complete flexibility the lender has in his decision making. He is responsible only to himself. Whatever conditions he lays down are requirements he considers necessary. None are mandatory. He can vary his interest rates and requirements of collateral depending on the nature of each risk. His is a personal relationship with the lender which itself ensures a minimum of wilful defaults. These and many other features of informal finance discussed earlier are inherent features of informal and personal sources of finance. In contrast institutions by their very nature require internally consistent rules to their customers, rates of interest can only vary within certain margins. For instance a bank cannot give interest free loans nor charge 120-300 per cent interest per annum. Even if some discretion is used if the rates are much higher, say double that of the high interest rates, then there would be criticism that banks are charging exorbitant rates to the poorer customers. So interest rates cannot reflect risk or administration costs of loans as informal loans do. Documentation is a necessary part of institutional lending even if such documentation is reduced and simplified. Complete discretion to bank officials is also not realistic, they would have to operate within laid down parameters.

The gist of the above argument is that institutions like banks can adapt themselves to suit the clientele to some extent but cannot possibly be like informal lenders. Banks could be more flexible in their criteria, simplify procedures, reduce form filling and motivate their officers to lend to small borrowers. Yet they will still retain procedures and require documentation. They will not be able to charge interest rates which reflect the true cost of such lending. Since there are limits to the extent to which banks and institutional sources of finance could be like informal lenders it is not realistic to expect institutions, however adapted they may be, to perform the functions of informal lenders extensively. Therefore it is suggested that one of several methods be adopted to meet the requirements of the small borrower and non corporate borrower. One method is to use an intermediary, preferably NGO, to perform some of the functions of the bank so as to assist the borrowers and the bank. The NGO could help in formulating the projects, filling in the forms and negotiating on behalf of the borrower, supervising the projects and helping in making the investments a success. Another method which is preferable is for the banks to lend to NGOs which would perform the functions of on-lending in much the same way as informal lenders. The NGOs could price the credit on the basis of risks and the return to capital. A third method is to lend funds to persons who will take the risks of on-lending to small borrowers. The PNN scheme discussed in this paper is such an attempt and provides an effective means of making available adequate finances and increasing competition among informal lenders. The thrust of such a programme should be to increase the number of such lenders and amounts rather than control interest rates, purposes of lending or loan amounts. In fact conditions should not be laid down on how the funds should be lent. By adopting such a strategy the cost of informal finance could be reduced over time.