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Credit for the Informal Sector:

An Experiment With Informal Sector Lending in Senegal

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CREDIT FOR THE INFORMAL SECTOR: AN EXPERIMENT WITH INFORMAL SECTOR LENDING, AND THE PROBLEMS FOR ITS INSTITUTIONALIZATION IN SENEGAL

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SENEGAL: AN ECONOMIC OVERVIEW

Senegal's economic situation is difficult at present. This is due to an over dependence on agriculture of which groundnut production occupies 70 percent of the cultivated acreage. Alongside groundnuts, millet is the only food crop of importance. Agriculture employs 70 percent of the active population and is highly dependent on external factors, particularly rainfall and world market prices. The implications of such dependence were evident in 1984 when drought reduced farmers' gross incomes (i.e., those of 70 percent of the population) by 35 percent.

The industrial sector has been relatively long established since colonial times when Senegal was the principal country in French West Africa, but infrastructure is now old and firms are relatively uncompetitive. The average age of a registered Senegalese company is 24 years, which is ancient by developing country standards. The formal private sector is dominated by the French and the Lebanese. The French own most of the big businesses, while the Lebanese tend to dominate the medium and small companies. There are, however, large Senegalese businesses that are prominent in activities such as real estate and tourism, and many smaller ones that undertake all types of activities that are formally incorporated but fringe on the informal sector.

Power in the country is officially with the Government administration. The administration has maintained basically the same structure as was left by the French at the end of colonial rule in 1960. The administrative class tends to be hostile and distrustful of the private sector.

Because the colonial administration never incorporated traditional power structures, and the national administration is a very recent phenomenon, unofficial or traditional power still remains in the hands of the Muslim religious brotherhoods, of which Mourides and Tidianes are the most important and embrace 80 percent of the population. The brotherhoods are governed by marabouts (leaders) who grew economically strong with the development of the groundnut industry and are now active at all levels of the national economy.

Another influential group in the economy is the foreign donor community, since the country is dependent on outside aid. The administration is often influenced in its policy decisions by these outside agencies, particularly the International Monetary Fund.

From independence in 1960 to 1980 the government was the dominant force in the economy. After it took over foreign companies in the groundnut industry, it held a monopoly over gathering, marketing, and processing. The government created a number of regional public companies and soon became the largest employer in the country at exorbitant cost, to the detriment of profits.

In 1980 the Government of Senegal adopted an Economic Reform Plan to reduce balance of payments and budgetary deficits by limiting public expenditures and removing constraints on private sector development. In 1984 this plan developed into a program of medium and long term modernization. The two policies that form the adjustment program are the New Agricultural

Policy (NPA) and the New Industrial Policy (NPI). The NPA caused all the regional public companies dominating the agricultural sector to be dissolved. The NPI's targets are industrial diversification, opening to the world market, making optimum use of Senegalese workers, and giving priority to activities of high added value. Both of these policies rely on the private sector taking a high level of initiative. To date, the private sector has responded sluggishly.

SENEGAL'S INFORMAL SECTOR

Informal sector businesses may be classified, in one sense, as those not definable as formal sector. In Senegal, formal businesses are legally incorporated, are employers in compliance with the labor code, produce regular accounts, and are taxed on the basis of these accounts.

Dakar has 34 percent of Senegal's population and is the center of modern industrial activity. Dakar's economically active population was estimated at 570,000 in 1980, and at 700,000 in 1983.

Government statistics show that 195,000 people were employed in the modern sector in 1980, and 140,000 in 1983. Assuming that the economically active population outside this sector was not unemployed, in 1983, 80 percent of Dakar's active labor force was working in the informal sector.

Senegal's labor legislation can be partly blamed for these figures. The code governing conditions of employment, particularly procedures for hiring and dismissal, are onerous and complex. It is virtually impossible to dismiss a permanent employee. Employers therefore keep permanent staff to a minimum. Temporary labor is changed every three months, or work is contracted out to the informal sector at piece rates.

For probably more than 90 percent of the population, the informal sector provides all immediate needs for retail goods, transport, services, and an important proportion of food and locally manufactured goods.

A large proportion of informal sector business people, who do not consider themselves informal at all, are permanently occupied. The rest are transient, such as farmers engaged in off season activities, and rural/urban migrants who take informal sector jobs while trying to find employment in the modern sector.

Some informal sector businesses fringe upon illegality, but most are in conformity with the law. Depending on type and size of business, there are annual registration taxes (patents), monthly municipal taxes on business premises, and daily rates on market stalls.

In Senegal, the difference between the formal and informal sectors is not one of legality, it is one of culture. The formal sector in Senegal is Modern and Western, the informal sector is Traditional and African.

In the traditional enterprise there is little division between the business and the family or between professional and private life. The businesses are open every day of the week and the employees and apprentices work long hours for minimal wages. Just as the family can be an asset, it can also be a liability as the business and family cash box are often one, and family needs and obligations (baptisms, weddings, etc.) can place a strain on cash flow. Family obligations cannot be ignored, however, for the extended family is the businessman's primary source of influence.

The informal sector is well adapted to the Senegalese socioeconomic environment. The modern sector is less so. In traditional life, the group is more important than its individual members. Within the group, individual merit or initiative is not rewarded by leadership. Rather, authority is based on age. In the context of the modern organization, traditional attitudes lead to promotion based on length of service rather than hard work or ability. These same attitudes are at the heart of Senegal's labor code, which serves the modern sector poorly.

The traditional concept of time, which focuses on the present moment without immediate concern for the future, is quite different from the western concept. In Senegal, for example, a truck owner normally consumes all profits from his activities without putting any funds aside for depreciation or repairs. This is contrary to the Western concept of a business venture capitalized expressly with the objective of longterm profitability. This is not to say, however, that the Senegalese owner is wrong; he manages to get many years of service from his vehicle, dealing with problems as they arise.

The formal sector in Senegal is presently shrinking. Modern companies based on Western systems have difficulty in changing their basic principles when adapting to African habits. This means that as the older French companies close down, and the Lebanese move into lower profile activities, the traditional sector moves in. Road transport of freight and passengers, for example, used to be owned and formally run by the Lebanese. More recently the road transport industry has been "informalized" by the Mourides.

THE BANKING SYSTEM

The banking system in Senegal is divided between commercial banks, which incorporate the interests of foreign banks, and Government financial institutions.

Banking is heavily concentrated in Dakar where 60 percent of the country's bank tellers are located. Branch banks are located in four major towns (86 percent of tellers are located in Dakar and the major towns) but decision making is highly centralized. All loan proposals of a value above CFA 500.000 ($1,600) are sent to Dakar for approval.

Most Senegalese banks are in severe liquidity crisis with outstanding bad debts dating since successive agricultural campaigns were financed through the regional public companies during the 1970's. The liquidity crisis has made the commercial banks orient themselves more and more towards formal sector activities that they understand well such as trade financing, and to concentrate on large loans where their transaction costs are low.

Presently the only credit that commercial banks are providing to small businesses are overdraft facilities to longstanding clients.

There are two government financial institutions, La Societe Nationale de Garantie d'Assurance et de Credit (SONAGA), and la Societe Financiere Senegalaise pour le Developpement de l'Industrie et le Tourisme (SOFISEDIT), that provide development finance to the private sector. Both are based in Dakar, without branches. These institutions manage a number of different programs which are active according to the availability of funds. They are by no means a constant or sure source of credit for small businesses and deal only with the formal sector.

At present the banks and other financial institutions are reluctant lenders to small businesses for a variety of reasons. Interest rate spread fixed by the central bank (3 percent) is considered insufficient to cover administrative fees for such lending, not to mention provision for bad debts for such loans which banks assess at 18 to 45 percent.

Small businesses in the formal sector produce regular accounts, which banks use for credit risk analysis. Banks find, however, that these accounts are usually inaccurate.

All bank lending is collateral based, but small businesses cannot easily provide the sort of loan securities that are easy to value and to sell, which banks prefer.

From the borrower's point of view, bank loans are long and costly to obtain. The potential borrower must produce published accounts and an investment plan, which means hiring an accountant. Banks may take up to six months to approve a dossier (more particularly in the case of development banks where administrative procedures are more complex). Once a proposal has been accepted, the client will pay collateral registration and other fees before the loan is disbursed.

COMMUNITY AND ENTERPRISE DEVELOPMENT PROJECT SMALL BUSINESS PROGRAM

The Community and Enterprise Development Project was financed by USAID in 1985 to strengthen the Government of Senegal's New Agricultural Policy. The project was managed by the New

Transcentury Foundation with Management Systems International, the latter being responsible for the Small Business Program. The Small Business Program's aim was to support the private sector in the economic readjustment process. The program was intended to offer advisory services and loans, and to test innovative approaches to small business promotion on a pilot basis in the regions of Kaolack and Fatick, Senegal's peanut basin.

There was flexibility in the program design to allow for local research into small business needs, before a strategy was designed and then approved by the Government of Senegal's committee responsible for overseeing project policy. The research and design phase took six months.

The Research Phase

Apart from six factories, the banks, some hotels, and Lebanese companies, all of the businesses in the Kaolack and Fatick regions could be categorized as being informal.

A survey of 310 businesses in towns and villages was carried out. Evidence of formal business skills were lacking; less than one-fifth of people interviewed used a cash book or any more detailed accounts, however, three-quarters of the sample indicated, that they did not need, or were too busy to receive instruction in bookkeeping. Most of the businesses were active and three-quarters of the town-based business owners had ideas for future development. Craft and commercial skills appeared well developed through the local system of apprenticeship.

The survey revealed that sources of credit to small businesses were extremely limited. Less than 5 percent of the business people interviewed had access to bank credit in the form of overdraft facilities. Otherwise supplier credit, savings societies (tontines) and loans from family members were the limited alternatives. Bank credit was said to be expensive although none of those interviewed could say by how much, as banks apparently applied interest and fees without any clear policy. Ninety day supplier credit was an average of 20 percent more expensive than for the equivalent cash purchase.

Simple financial analysis showed that the businesses surveyed were profitable and had very high rates of return on the modest amounts of capital that were invested in them.

There was no evidence of direct government repression of informal businesses. Businessmen paid a flat municipal tax on their premises on a monthly basis. They competed for local government contracts through the Chamber of Commerce or Chamber of Handcrafts (Chambre de Metiers) although the government was reputed to be notoriously late in setting its bills. Bureaucratic "red tape" was relatively light. Only the police and the customs service were active controllers of road transport and contraband.

A Minimalist Approach:

Results of the survey showed that access to credit was the major constraint to small businesses development in the region. The strategy was therefore to provide a credit service that would respond to the needs of the informal sector client. Training and advisory services were to be kept to a minimum because:

- Former small business promotion projects had emphasized technical assistance and used training programs as a qualifying mechanism for loans, with poor results.
- The potential clients seemed capable of managing their businesses in their own way.
- The program was funded by USAID for 5 years. At the end of this period the portfolio of investments would be handed over to a local financial institution. This meant that the small business program would have to be able to cover all its costs out of loan interest, on the basis that no local institution could take over a losing venture. Because training was costly, its role was minimized.

A minimalist approach was therefore adopted, where credit was made available on demand to people with existing businesses who wished to expand their activities.

THE STRATEGY

Elements of the operating strategy which was defined, approved by the Government of Senegal and is currently in use, are as follows:

Field Based Personnel

The program has a network of seven field offices in the most important centers of the region. These are simply store front premises which are easily accessible to the clients. Each office is manned by a single field officer who is responsible for a geographical zone. All loan applications originate from the field offices, so field officers have a high degree of decision making authority, but are closely supervised by the Head Office. Field Officers come from the same milieu as the clients and have modest, but adequate, educational qualifications. They receive intensive, field-based training in loan proposal analysis and loan tracking for six months before becoming operational.

The Loan Approval Process

A businessperson needing a loan to develop his activities first discusses his idea with the field officer. If the field officer judges the idea has merit, he starts to prepare a loan proposal. This preparation phase requires detailed planning, including financial analysis, and involves at least one visit to the client's place of business. Once the loan proposal documentation is in order, it is sent to the head office. A supervisor from the head office and the field officer visit the client at his place of business to discuss the proposal. The supervisor appraises the proposal and makes an independent evaluation of the client and his business. The proposal is then submitted to the loan committee for approval. The timeframe for the approval of an average loan is one month.

Terms of Loans

Size of loan and the repayment schedule is calculated in accordance with the cash flow of the project to be funded.

For first-time loans a maximum loan amount of up to CFA Francs 3.000.000 ($10,000) with a maximum duration of up to 12 months is fixed. Second loan amounts and durations are judged according to the needs of the loan project. The interest rate is 22 percent and is variable according to Central Bank Regulations.

Loan Collateral

The primary guarantee is the viability of the loan proposal. Confidence that the project will generate enough revenue to cover its own costs and make enough profit to repay the loan and cover the client's family needs is the primary loan security.

Also, to ensure that the client will take his financial obligations seriously, material security is required, such as a:

— Personal Guarantee	(Aval)
— Property Deed	(Titre foncier)
— Pledge of Contract	(Nantissement sur marché)
— Equipment Collateral	(Nantissement d'equipement)
— Pledge of Working Capital	(Nantissement du fonds de commerce)

Loan Follow-up and Collection

Usually clients replay their loans on a monthly basis either to the head office cashier, or to their local office. Payments are tracked closely at the head office and late payments are quickly followed up by a visit from a head office program officer. Late payment situations are also closely tracked by field officers. Loans that are non-performing for more than 90 days are foreclosed with initiation of legal proceedings for seizure of collateral.

The Bonus System

Field officers are motivated by a bonus/penalty system. This is paid in addition to salary and is calculated quarterly on all loans fully paid back or closed in default. The bonus is calculated at 3 percent (per year) of the loan amount borrowed and fully paid back. Penalties are levied on loans declared in default, calculated at 10 percent of the outstanding loan balance due. The bonus and penalty situation is kept in a separate account and never affects the field officer's basic salary.

RESULTS

The Small Business Program began making loans in September 1986. Results for the period September 1, 1986 to February 1, 1989, have been very encouraging. Three-hundred eighty-four loans to a total value of CFA 486 million ($1.57 million) have been made. Of this number, 150 loans have been fully repaid with interest. The loan default rate has been low, and only 15 loans have become nonperforming, representing a provisional loss of 4.5 percent of total funds borrowed and paid back to date.

Thirty clients out of the current portfolio of 234 are paying in arrears, but for reasons that were understood by the program.

A full range of activities embracing farming, manufacturing, commerce, and services has been financed as follows:

ACTIVITY	N. LOANS	CFA AMOUNT INVESTED (MILLIONS) ($1=CFA 310)
Vegetable and Cereals Production	25	15
Livestock Raising	51	43
Fishing	9	10
Commerce of AG Inputs and Products	37	51
Food Processing	19	23
Construction	22	40
Carpentry	5	6
Metalwork/Mechanic	17	15
Tailoring/Jewelry	16	19
Restaurant	2	2
Transportation	34	60
Retail General	125	170
Hardware	8	20
Pharmacies	14	12
TOTAL	384	486

The average loan is CFA 1.2 million ($3,870) for an average duration of 9 months. The purpose of the loans is for working capital (72 percent), purchase of equipment (13 percent), and for both working capital and equipment (15 percent).

From the 150 loans financed and fully paid back, an impact evaluation of 110 businesses indicates that the average asset value of each enterprise increased by 47 percent after the loan was paid back. The clients also show an average increase in profitability by 119 percent. The increased asset value reflects that 79 percent of clients reinvested their profits wholly or partially. Forty-two percent of the enterprises created jobs of which 41 were permanent and 135 temporary. These figures clearly demonstrate the degree to which the informal sector was suffocated by lack of capital.

LESSONS LEARNED

General lessons learned from the operation so far are as follows:

Informal Sector Businesses are Viable

Despite, or because of, traditional methods, many informal sector businesspeople run highly profitable operations. Many of the loan program's clients have a return on capital of more than 100 percent per year.

Informal Sector Businesses are Bankable

By using appropriate credit analysis techniques to evaluate the entrepreneur, his business, and his loan project, and by de-mystifying the loan-getting process, it is possible to lend money to informal sector business people and achieve a recovery rate well over 90 percent. It is also possible in the short term to recover transaction and default costs from interest and other fees in order to make the lending operation self-sustaining, providing that the loan funds are provided without cost. In the longer term it may be possible to generate sufficient loan volume and revenue to pay for capital and to generate a profit.

Informal Sector Borrowers Do Not Need to be Literate

Neither do they have to keep written accounts in order to use and repay loans.

It Is Not Necessary to Provide Training

The traditional sector has its own vocational training systems. Borrowers need no pre-loan preparation or counselling; they are capable of making good use of finance so long as the loan proposal is carefully analyzed, discussed, and agreed upon before it is funded. This "minimalist" approach is effective and economic.

Modest Storefront Offices Staffed by Field Agents Without High Level Qualifications are Efficient

Simple office premises such as those used by informal businesses themselves are easily accessible to borrowers and are a low cost overhead. The people most likely to succeed as field agents are those who are most like the clients. A specialized business education or experience could be a disadvantage in this case.

Reward Staff by Results

Paying staff for results is motivational and makes the work more interesting. It is also an important curb on the temptation to provide services to clients with non-viable proposals for family reasons or for bakshish. Staff may be promoted or dismissed according to their performance.

INSTITUTIONALIZATION

In USAID's original project paper, the Small Business Program of the Community and Enterprise Development Project was considered as a pilot activity that would assist small businesses to "graduate" to commercial bank credit. At the end of the project its portfolio was to be handed over to one of the commercial banks.

Graduation of informal sector clients

It became apparent early in the life of the program that its informal sector clients were never going to "graduate." The banks' general interest level was gauged when none of the local bank managers accepted a seat on the loan committee. The banks had no funds to lend to "graduates" anyway. All banks were still pursuing bad debtors from the government agricultural campaigns that had been financed more than 5 years previously. The banks associated these debts with rural sector and informal enterprises risk. This meant retrenchment of their activities in the regions, indeed one of the major banks closed its branch in Kaolack during 1988.

Nor did the Small Business Program push to "graduate" its clients. It continued on the assumption that its clients understood their businesses and ran them successfully.

Options Study

In early 1988 an evaluation of future program options was undertaken. All Senegalese banks and financial institutions were formally approached to solicit interest in the future of the program.

The commercial banks were not interested under the circumstances. The government financial institutions were interested in inheriting the loan fund but unspecific as to how they would integrate the system. These institutions were based in Dakar without any regional representation. It was unclear how the program's successful decentralized and field-based credit delivery mechanism could be incorporated.

A further issue was that the Small Business Program's results at that point were much better than those organizations that expressed an interest in taking it over.

Interest Rates

One technical problem of having the program integrated by a bank was an interest rate issue. Interest rates in Senegal are governed by the central bank (BCEAO) for all the West African CFA franc zone countries. In simple terms, banks (defined as deposit-taking institutions) have their normal lending rates to small enterprises fixed currently at 13.5 percent. When banks are refinanced by the central bank for small enterprise loans, their maximum permitted spread on investment is 3 percent. Central Bank regulations for Financial Institutions (defined as non-deposit-taking institutions) fix interest rates at a current maximum of 22 percent. Financial institutions are refinanced by the commercial banks at their fixed rate (i.e., 13.5 percent).

The Small Business Program charges the maximum interest allowable for a financial institution. A bank taking over the fund would not have the same privilege.

The interest rate issue has an importance beyond the problem of institutionalization. Presently in Senegal there is no coherence on the issue with regard to small business or informal sector lending.

- The banks claim that under present regulations they cannot lend to small businesses and recover their transaction costs, let alone cover risk.

- The government regards informal businesses as frail and unprofitable and is uneasy about high interest rates on informal sector loans.

- The small business program has proven that informal sector businesses are relatively insensitive to interest rates, and could probably raise its interest to 40 percent per annum without any loss of business or any increase in the default rate. The more important issue is one of access to credit. Thanks to present regulations to protect small business from usurious rates of interest, they are denied access to credit at any price.

Loan Collateral

Banks and Financial Institutions in Senegal lend only against collateral (even though their record of bad debts has not made them look beyond this). The Small Business Program makes loan decisions on the basis of an evaluation of the client, his business and his loan proposal; collateral is required subsequently.

Before a bank takes collateral, it is registered with the authorities so that in event of seizure the bank's legal right to the property is already established. Registration fees, particularly for property deeds, are very high.

The small business program does not require its client to pay these high fees. In event of default this exposes the program to some risk of not being able to seize the collateral. Program policy, however, is to take the necessary steps to avoid the default situation arising in the first place.

Creation of an Institution

The neglect of the informal sector by existing institutions and the success of the small business program demand that its activities continue but in an institutional form separate from USAID's Community and Enterprise Development Project.

A Private Non—Bank Financial Institution—The program management has held meetings with some members of the Senegalese business community to solicit their interest as private investors. Because of the ambiguous status of informal sector lending, the relatively short track-record of the program to date and the prospect of low yield on investment in the near and medium term, investors are not interested.

A Development Foundation—USAID is now committing to finance the expansion of the program including an increase in the loan fund from $750,000 to $1,250,000 with an increase in head office staff and the addition of 3 field offices in the Thies Region. This support will continue until 1992 when it is estimated the activity will become profitable.

Whereas USAID's commitment resolves issues of the small business program's immediate future, it does not yet resolve the problems of ownership and future leadership.

CONCLUSION

Senegal, like many other countries in Africa, is in the process of economic reform, letting the private sector assume a leading role in economic development.

Because the Government, the banks, and all of the modern sector institutions are only capable of interacting with formal businesses, it is supposed that this new engine of growth will be provided by the tenants of the industrial estates and the larger companies.

These larger companies, however, are predominantly owned by foreigners, and are managed in a way that is foreign to the majority of the population. Modern sector businesses are also in relative decline.

The sector that is actively expanding, and provides employment and goods and services to most of the population, is the informal traditional sector. Unfortunately the banks are not equipped to provide services to this sector, and the Government chooses to ignore it.

As it is doubtful that the modern sector will fulfill its hoped-for role in the Government's economic readjustment program, a reevaluation of the traditional sector now seems appropriate.

An experiment to test ways of offering formal support to the informal sector has been launched in Senegal's regions of Kaolack and Fatick. Its results are worth noticing. These results deserve much closer attention from the Government, the banks, and the business community than they have been afforded to date.