

# FORGING COLLABORATION BETWEEN FORMAL AND INFORMAL FINANCIAL MARKETS: SOME THOUGHTS

Gladson I. Nwanna  
Morgan State University

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## 1. Introduction

It is widely acknowledged that future economic growth and development of Less Developed Countries (LDCs) will depend in part on efforts made in developing the rural sector and in improving the plight of rural inhabitants through support for their activities. Lack of accessibility to financial services is commonly, and increasingly, being cited as one of the major constraints to the development of the rural sector of LDCs, a sector sheltering a large part of LDC population. It comes as no surprise, therefore, at the heightened interest and efforts on the part of LDC governments and Development Assistance Agencies (DAA) to explore avenues to improve, as well as, increase such access.

In response to this challenge, various approaches and strategies have emerged. One such strategy places emphases on the need to forge collaboration between the formal and informal financial markets.<sup>1</sup> It is believed that by upgrading informal financial arrangements and linking them to Formal Financial Institutions (FFIs), financial services, particularly to the rural sector, the poor, and to microenterprises<sup>2</sup> will be expanded and deepened. This arrangement implies building upon not supplanting existing arrangements.

This paper explores avenues for forging that collaboration and linkage between the formal and informal financial markets. The importance of a linkage stems from the fact that in most LDCs, despite the many Informal Financial Institutions (IFIs) in operation and the active role played by them in resource allocation and resource mobilization, not many of them have links with formal financial institutions. Additional support and relevance of the need for collaboration and linkage between the markets stem from the differences between the two sectors and the "sectoral specialization" or segmentation of the financial markets. The

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1. The terms Formal and Informal financial markets/institutions are defined in the next section. For a general and elaborate discussion and usage of the terms "formal" and "informal", See Gladson Nwanna, "Stimulating Savings in the Informal Financial Sector of Less Developed Countries" *The Journal of Social, Political and Economic Studies*, Washington D. C. (Vol. 14 No. 3, Fall 1989; Anan G. Chandavarkar, "The Non-institutional Financial Sector in Developing Countries: Macroeconomic Implications for Savings Policies," *Savings and Development*, No. 2, 1985, p. 129. Note: The term FFM is used in this paper to include the activities of Semi Formal Financial Institutions (SFFIs) such as development financial institutions.

2. The term microenterprises is used here to include small and medium size businesses, mostly non-corporate.

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differences between the markets are particularly noticeable in the majority of developing countries.

## 2. Formal Versus Informal Financial Markets in LDCs

While FFM and IFM do share certain similarities, there appears to be more differences between the two markets; hence the opportunity envisaged in linking them. Formal Financial institutions comprise the FFM. These institutions and their activities are regulated and subject to official and direct monetary and financial controls. This contrast with IFIs, whose activities remain outside the supervision, review and control of monetary authorities. IFMs are dominated by the activities of informal financial institutions, including traders, moneylenders, pawnbrokers, ROSCAS, neighbors, friends and relatives.

Formal financial institutions in most LDCs tend to be located, and their services concentrated primarily in the urban centers (sector). Their presence and participation in the rural sector is very minimal. For the most part their activities in the rural sector is limited to operating a few rural branches and some mobile savings facilities. In some places they provide short-term, seasonal loans to a few large estate farmers. Informal financial institutions, on the other hand, are more widespread in the rural sector, providing most of the needed financial services in the rural sector. They also provide the bulk of the funds that go to finance the activities of microenterprises.

The limited presence and services of FFIs in the rural sector means that the rural sector, which comprises the majority of the population, and the "engine of growth" for most LDCs do not benefit from the resources of the formal financial sector. FFIs often cite, among other factors, the high transaction cost and risk of servicing the sector as reasons for their limited presence.

Informal financial institutions, on the other hand, have developed the means of providing services to the rural sector, the poor and microenterprises, but are unable to meet the demand for their services due to inadequate resources and their inability to access formal financial services. Importantly, IFIs have developed the means to provide a wide variety of services and to reach more rural inhabitants at a comparatively lower cost and risk than FFIs. In essence, the differences between the institutions and markets provide an avenue

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for both sides to benefit. By drawing on each others strengths, experiences and advantages through collaboration and linkage, greater financial intermediation will be accomplished between those who supply and those who demand financial services. This is especially the case since linkage, in effect, helps reduce some of the key barriers<sup>3</sup> to financial intermediation. With greater intermediation is the potential for the financial markets to become deepened and widened. Furthermore, accessibility to financial services for rural inhabitants will be increased.

Improvements in the provision of financial services would be gained by upgrading informal arrangements and linking them to formal institutions. This arrangement implies building upon, not supplanting, existing arrangements.<sup>4</sup> In most LDCs, however, despite the many IFIs in operation and despite the active role played by them in resource allocation, not many of them have links with formal financial institutions. Although various studies of the informal financial sector report significant amounts of IFIs funds deposited with FFIs for safe-keeping, these studies also report that the amount of borrowing from FFIs is considerably smaller.

### 3. Options and Strategies

Various options and strategies could be explored by respective LDC governments to forge collaboration and linkage between the financial markets. This will include:

#### 3.1. *Strengthening Existing Linkages:*

Some linkages do presently exist between the formal and the informal financial markets in LDCs. These linkages, however, are limited and are largely via group lending schemes and credit cooperatives. Furthermore, the relationship and collaboration are generally weak and limited; hence, supporting the need for such relationships and linkages to be

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3. This include, on the supply side, the high administrative costs, and risks associated with servicing the rural population, and on the demand side, the high cost of requesting for a loan and accessing other financial services.

4. World Bank, *World Development Report* 1989, p. 119.

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strengthened and broadened. This will require getting participants in both markets (formal and informal markets) associated with the activities of the other. It will also require adopting techniques of the other that are appropriate and beneficial, getting informal financial institutions to deposit surplus funds with FFIs and to meet their requirements of extra resources through borrowing from the FFM.

### *3.2. Experimenting with the use of IFIs as Intermediaries*

A number of IFIs play significant and active roles in resource allocation to rural households and microenterprises. Many of these IFIs are, however, unable to meet the loan needs of their clients. Furthermore, they are unable to mobilize or access term loans. IFIs, like rural households and microenterprises, see the increased potential for meeting their financial needs through the formal market, but are turned off, in preference of the informal market for various reasons. Although a significant number of the IFI banks (operate savings accounts) with FFIs, access to FFS credit remains considerably limited. This leaves a substantial number of loan requests by rural households and small businesses unmet by the limited amount of resources available to IFIs, who traditionally provide as well as cater to their financial needs.

Given the significant size of the IFM activities in several LDCs, their prominence in the rural sector and in servicing the credit needs of small businesses, the poor and rural sector, policy makers may consider using some of the IFIs as financial intermediaries. These institutions could intermediate in both savings and credit services between donor agencies, the governments, FFIs, and rural households.

It is envisaged, initially, with this strategy that with access to formal financial sector credit, IFIs will be able to meet the credit needs of their rural and small business clients. Once rural borrowers have come to build confidence in and rely upon these IFIs as dependable sources of funds, capable of meeting all or most of their credit needs, these intermediaries may evolve and be encouraged to take up the function of deposit taking. For the same reasons that these IFIs have survived and have become popular among rural households and microenterprises in several LDCs, particularly as a source of credit, one will expect that some of those positive factors may attract potential savers to bank with them even at deposit rates of interest smaller than available at urban-based FFIs. Although the first best approach is to encourage rural households to save with FFIs, the limited coverage and

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services presently provided by the FFIs make it worthwhile to experiment with this approach. In the long-term, as the system deepens and the economy becomes more developed and rural inhabitants more enlightened, one will expect FFIs to takeover and to play a greater role. As previously stated, many informal financial institutions as well as some rural households, do operate deposit accounts with FFIs. IFIs, however, continue to have difficulties meeting their credit and other financial needs through FFIs.

In practice, this option would allow qualified IFIs, for example, to borrow from the FFM and on-lend to the informal financial sector. As part of the loan or on-lending arrangement and interlinking process, such IFIs may be required to open accounts with FFIs. Furthermore, it would allow some IFIs, to serve as deposit-taking institutions or operate deposit facilities independently or in collaboration with FFIs. Obviously, such a role would require legal approval. Success with such a scheme, however, will depend on the extent to which there is limited interference by the government with the traditional mode of operation of IFIs or with the very factors or structures that continue to account for their popularity and acceptance by the rural population. Increased IFI access to FFM credit may lower the cost of funds to both parties and may lower interest charges on their loans. For one thing, it may lower the cost of lending/borrowing to both the lender and the ultimate borrower. Likewise, this may lead to more competition in the delivery of services to the rural sector, thus, adding more depth to the financial system.

In their "new role", some of the IFIs, as financial intermediaries with deposit-taking authority, may grow substantially large and graduate to formal institutions. This is the case for many building Societies in England and elsewhere, which began as ROSCAs and later became part of the formal financial system. In Cameroon and India, some ROSCAs have evolved into formal banks.

### *3.3. Experimenting with Non-Governmental Organizations (NGOs) as intermediaries*

With the disappointing and poor performances of traditional avenues from reaching and providing services to the poor and the rural sector, LDC policy makers and donors alike are beginning to show interest in NGOs. They envisage the use of NGOs as agents for reaching and servicing the poor, the rural households and micro-enterprises. Such a role for NGOs is useful, considering not only their interest in the rural sector and the poor, but also their successful methods and ability in reaching them.

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Among LDCs, the number, growth rate and activities of NGOs remain diverse. Whereas a number of active NGOs exist in some LDCs, in some others, there are only a handful. However, in almost every country, some of the active NGOs provided a variety of financial services, including credit allocation and savings mobilization. The majority of these NGOs were engaged primarily in financing income generating activities (IGA) as well as providing short-term, seasonal credit to farmers and microenterprises. In other words, savings mobilization was not emphasized. Only recently, with renewed interest in NGOs initiated by donors and DAA and the resultant increase in the number of new NGOs, are some of them expressing interest in broadening their activities to include an emphasis on savings mobilization.

A large number of NGOs in LDCs, like the IFIs, do not have adequate financial resources and incentives and, hence, they have been unable to meet the needs of their target groups. Most of them are small in size and poorly funded, depending, in some cases, on assistance from abroad. With few exceptions, most of their activities are limited to resource allocation. Nevertheless, with the renewed interest in NGOs and the growing interest in incorporating them into the strategy for rural development, FFIs may experiment with using the NGOs as agents for mobilizing resources. Some of the NGOs could, be encouraged to take deposits or establish some form of savings facility or arrangement to encourage savings among their members or target group. Members or beneficiaries may then be required, for example, to open savings accounts with them as a prerequisite to receiving assistance. Besides the obvious advantages of these arrangements to rural savers, it would enable NGOs to be viable and self sustaining. The resultant financial independence would also provide them with additional resources from which to on-lend to their members, invest, or deposit with the FFS. Alternatively, NGOs may require members to open savings accounts with FFIs as a condition for receiving service from the NGO.

In effect, NGOs can provide a critical and important link between the two major financial subsectors. Most of the NGOs presently have savings accounts at FFIs and some have been able to borrow from these FFIs. As FFIs come to recognize their successes in servicing the rural sector and microenterprises, one would expect additional interest and participation (directly or indirectly) by FFIs. Furthermore, one would expect to see even more collaboration between NGOs and FFIs.

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### 3.4. *Improving and Strengthening Loan recovery efforts of existing SFFIs/NBFIs<sup>5</sup>*

Strategies aimed at fostering a linkage between the various markets has the potential for improving the major weaknesses and factors constraining the sustainability and viability of the financial institutions presently active in the various markets. Several semi-formal financial institutions (SFFIs) in LDCs continue to be very active in providing financial services to the rural sector and to microenterprises. Most of these institutions, however, are reported to be facing problems and other constraints that continue to threaten their viability. Some of these problems and constraints include legal limitations on their activities (most of them cannot legally mobilize savings), high transaction costs, high default rates, and poor loan recoveries.

Poor loan recovery and the high cost of loan transactions discourage most of the FFIs from expanding their involvement and services to the rural sector and small scale businesses. Success in minimizing the problems currently being faced by most of the SFFIs may motivate other FFIs to become involved. As these SFFIs and NBFIs demonstrate their ability to be viable and self-sustainable, and as they show real improvement in loan collection, one can expect increased confidence and interest on the part of FFIs to advance credit to them for on-lending or even directly to rural borrowers. On-lending through SFFIs that are viable and sustainable will allow the FFIs to meet the needs of small, rural households and microenterprises without incurring the high cost and risk often associated with serving this group directly. This certainly will have a positive contribution to the overall development effort.

Improving loan recovery for some of the SFFIs (especially those that lend mostly to groups and clubs), inextricably revolves around various factors. These include the degree of independence of operation, the quality of loan appraisal and monitoring, method of group formation, but more importantly, the quality of enforcement and method of assessing liability to borrows (i.e Individual liability, joint voluntary liability or mandatory joint liability). Although each method has its relative weaknesses and strengths, lending institutions that

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5. Non-bank Financial Institutions. The terms SFFIs and NBFIs are used here to represent sub-components of formal financial institutions and comprise the formal financial market. Whereas the former is used to include such institutions collectively referred to as Development Finance Institutions, the latter represent those FFIs not largely defined as bank or authorized to operate as banks.

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have adopted mandatory joint liability have proven to be more effective in recovering loans. Whether this translates to lower cost or whether the recoveries were cost effective is not clear. Increased use of "joint and several liability" by the various institutions engaged in group lending in LDCs warrant exploration. Despite the poor recovery experience by some of the SFFIs in LDCs, this method of liability assessment has still not been adopted nor stringently enforced by a number of the SFFIs.

### *3.5. Expanding the legal mandates of existing SFFIs/NBFIs to allow them to broaden their range of financial services*

The limited and restrictive legal mandate is one of the constraints facing several of the SFFIs presently serving the rural sectors and small enterprises in LDCs. Many of these institutions are prohibited by law from engaging in either domestic resource mobilization, resource allocation or from extending their services to certain sectors or activities. These limitations on their activities and services have prevented them from venturing into profitable activities and from expanding their services to the majority of rural sector inhabitants and microenterprises who need them. These institutions, for the most part, operate and rely on funds from the central government and from external donors, a situation that continues to threaten their survival. To the extent that SFFIs remain active and potential sources and channels of financial services to the rural sector in several LDCs, and to the extent that they provide a potential first stage linkage between the informal and formal markets, ensuring their survival and self-sustainability are important. LDC governments should, therefore, re-examine the roles of these institutions with a view toward expanding their mandates and legal authority to allow them to provide other financial services. This would enable them to service more of the target group, while at the same time, providing them with the means of becoming viable and self-sustainable. In this way, the linkage process between the markets would be facilitated and strengthened.

## **4. Conclusion**

Certainly, forging collaboration and cooperation between the markets would provide a means of promoting rural development through increased access to a variety of financial instruments and services. Collaboration and linkage would allow the markets to draw on the strengths, experiences and advantages of the other. This arrangement may, ulti-



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mately, have a net positive effect on rural development. By and large, linkage will lead to a better intra and inter-sectoral/market allocation of resources as well as allow for a more effective macro-management of the economy.

As the governments in several LDCs progress with their financial reform efforts, it is important to recognize the need to forge a collaboration between the various markets. Such linkage would dictate, to a significant degree, the success in providing sufficient and timely financial services to the rural population and to microenterprises. Besides, it will dictate, to some degree, the extent to which the system can be deepened and to which competition can begin to set in. Obviously, the more inter-linked the markets are, the more successful and effective the governments can use fiscal and monetary policy to control and regulate the economy. Any sustainable collaboration depends, to a large extent, on the government providing the direction and an enabling environment (legal & policy).

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**Abstract**

*It is widely acknowledged that future economic growth and development of Less Developed Countries (LDCs) will depend in part on efforts made in developing the rural sector and in improving the plight of rural inhabitants through support for their activities. Incidentally, the lack of accessibility to financial services is commonly, and increasingly, being cited as one of the major constraints to the development of the rural sector of LDCs. It comes as no surprise, therefore, at the heightened interest and efforts on the part of LDC governments and Development Assistance Agencies to explore avenues to improve, as well as, increase such access.*

*In response to this challenge, various approaches and strategies have emerged. One such strategy places emphases on the need to forge collaboration between the formal and informal financial markets. It is believed that by upgrading informal financial arrangements and linking them to Formal Financial Institutions, financial services, particularly to the rural sector, the poor, and to microenterprises will be expanded and deepened.*

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## Résumé

### NOUER LA COLLABORATION ENTRE MARCHÉS FINANCIERS INSTITUTIONNEL ET NON-INSTITUTIONNEL: QUELQUES RÉFLEXIONS

Il est communément reconnu que le futur de la croissance économique et le développement des Pays Moins Développés (PMD), dépend, en partie, des efforts qui seront déployés en vue de développer le secteur rural et d'améliorer la situation des paysans en leur donnant le soutien nécessaire pour leurs activités.

Le manque d'accès aux services financiers est de plus en plus cité comme étant l'un des majeurs obstacles au développement du secteur rural dans les P.M.D. Il n'est donc pas surprenant de voir l'intérêt et les efforts sans cesse croissants des gouvernements des PMD et des agences d'aide au développement à explorer des voies qui puissent les aider à améliorer et à accroître un tel accès.

Pour faire face à un tel défi, plusieurs approches et stratégies ont été proposées. L'une d'elles insiste sur la nécessité de promouvoir la collaboration entre les marchés financiers formel et informel. La croyance générale, est que, en améliorant les arrangements financiers informels et en les unissant aux institutions financières formelles, les services financiers, particulièrement le faible secteur rural, et aux microentreprises, sera élargi et approfondi.

Cette communication explore les voies visant à promouvoir la collaboration et l'union entre les marchés financiers formel et informel. L'importance de cette union provient du fait que dans la plupart des pays moins développés malgré l'existence de nombreuses institutions financières informelles et le rôle actif de ces institutions dans l'allocation et la mobilisation de ressources, peu d'entre elles ont des liens avec les institutions financières formelles.