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Preface

Microfinance is one oft the most successful tools of development policy. Nevertheless, there is a considerable gap between demand and supply in microfinance. Demand for microcredits cannot be satisfied by formal and semi-formal suppliers. This also holds true for Sri Lanka, even though many microfinance institutions there supply credits. This gap is closed by informal credit suppliers in Sri Lanka. However, the credit supply of informal financial actors such as moneylenders and ROSCAs is inadequate because credit conditions are unfavourable. Moneylenders, for example, charge very high interest rates compared with suppliers from the formal or semi-formal financial sector, and moneylenders sometimes adopt illegal practices.

Despite the important role of informal credit suppliers for microfinance, they have until now been the subject of very little research in Sri Lanka. Clearly, it is very difficult to approach informal credit suppliers, particularly moneylenders. Nevertheless, our research team managed to conduct a number of interviews with the two most important informal suppliers of credit: moneylenders and ROSCAs. This empirical analysis would not have been possible without the support of many persons.

All members of the team, which consisted of 5 postgraduates taking part in the training programme offered by the German Development Institute (GDI) and one GDI economist, are grateful to everyone who supported them in preparing and carrying out the study. We would like to thank the German Agency for Technical Co-operation (GTZ) – particularly Armin Hofmann and Anke Wolf – for their support of the study. We are in debt to Mr. P.V. Pathirana, head of the microfinance department of the People's Bank, and to the staff of the People's Bank working with the GTZ project in Kandy. Thanks are also due to the staff of the People's Bank in Negombo, in particular Mervin Perera, and in Nuwara Eliya, in particular to Mr. Ghanathilake, who arranged the majority of our contacts to moneylenders as well as to many ROSCAs. Without these contacts we would not have been able to conduct the interviews, because it would have been very difficult to find such interviewees. In addition, we are grateful to all of our interview partners in Sri Lanka, especially for their willingness to contribute to the study. We would like to thank Tilmann Altenburg who accompanied the study in Germany at the GDI and who provided valuable comments. Last but not least, we would like to thank Amalie Ellegala, Ifsal Huzandeen, and Mrs. K. W. H. A. N. Someratne for translating these interviews from Sinhalese or Tamil into Englisch and for supporting us to analyse the results of our interviews.

Bonn, November 2002 Kathrin Berensmann, GDI

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List of Abbreviations

ADB	Asian Development Bank
app.	approximately
AusAID	Australian Government’s Overseas Aid Program
BWTP	Banking with the Poor
CC	Credit Co-operative
CCF	Community Credit Facilitator
CBO	Community Based Organisation
CRB	Co-operative Rural Bank
FCND	Food Consumption and Nutrition Division (from IFPRI)
GDRC	Global Development Research Centre
GEMINI	Growth and Equity through Microenterprise Investments and Institutions
GIS	Geographic Information System
GTZ	Gesellschaft für Technische Zusammenarbeit
ID	Identity Card
IDB	Inter-American Development Bank
IFPRI	International Food Policy Food Research Institute
JICA	Japan International Co-operation Agency
LDC	Least Developed Country
LKR	Sri Lankan Rupee (Exchange Rate in March 2002: US$ 1= LKR 90)
ME	Micro Enterprise
MFI	Microfinance Institution
MIS	Management Information System
ML	Moneylender
NGO	Non-Governmental Organisation
OECD	Organisation for Economic Co-operation and Development
p.a.	per annum
p.m.	per month
P.orgs	People’s organisation
PVO	Private Voluntarily Organisation
RBIP	Rural Banking Innovation Project
RDB	Regional Development Bank
ROSCA	Rotating Savings and Credit Association
RRDB	Regional Rural Development Bank
SEEDS	Sarvodaya Economic Enterprise Development Service
SME	Small and Medium Enterprise
SHG	Self Help Organisation
SSE	Small-Scale Enterprise
TCCS	Thrift and Credit Co-operative Society
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
US$	US-Dollar
USAID	U.S. Agency for International Development

Executive Summary

Background and Objective of the Study

In the literature, it is widely recognised that small-scale enterprises (SSEs) play a vital role in poverty reduction and employment creation in developing countries. This also applies for Sri Lanka. One of the major development constraints faced by SSEs is their lack of access to adequate credit. The main research question of this study is therefore: How can the access of SSEs to credit be improved?

In Sri Lanka, there is a **gap** between the credit supply of both informal and formal providers of credit to SSEs, which use both sources of credit, depending on the specific conditions and purposes of credit. The Sri Lankan financial system is marked by a dualistic structure, i.e. the financial sector is characterised by the existence side by side of formal and informal financial markets. In developing countries such as Sri Lanka this financial dualism arises because the formal financial sector is underdeveloped, a fact which is also reflected in an inadequate formal credit supply for SSEs, in particular by banks. The informal suppliers of credit make up in part for this lack of financial services. However, the financial services provided by informal suppliers are also inadequate.

Two approaches are suitable to narrow the gap. On the one hand, formal actors could adopt the strengths of informal actors, to the extent that this is possible for them: This is the so-called **downscaling approach**. Informal financial actors have certain strengths which formal actors could learn from in order to improve their credit supply for SSEs. On the other hand, informal actors could, as far as possible, be integrated into the formal system: The is the so-called **modified upgrading approach**.

Demand: The Unfulfilled Credit Needs of Small-Scale Enterprises (SSEs)

The role of SSEs as a source for employment is highly significant. Since SSEs operate on a labour-intensive basis, they are able to create employment. Estimates indicate that microenterprises provide work for 20-40 % of Sri Lanka's total labour force. Many people working in the SSE sector are poor. Accordingly, promotion of SSEs is considered to be an adequate tool of poverty alleviation. Empirical results from other studies conducted in Sri Lanka suggest that about 30 % of SSEs owners are considered poor.

Three general findings are dominant in the empirical analysis of the credit relations of SSEs. First, the SSEs that we interviewed turned out to have very diverse financial relations in both the formal and the informal sector. Some of our interview partners had only one source of credit, but the majority reported having access to three or four different sources. Second, many SSEs had relations to both formal and informal sources of credit at the same time. Third, some SSEs had no financial relations at all.

The wealthier and more formal an SSE, the more likely it is that it will have stable relations with banks, which are the preferred source of credit for the majority of credit needs. The more informal the business and the more survival-oriented the SSE, the stronger the tendency is to approach informal credit suppliers. In general, all SSEs have access to a range of different suppliers, namely pawnbrokers, family and friends, moneylenders, ROSCAs and banks. Only highly indebted SSEs appear to have a very limited supply of credit, and are without much choice.

Purposes of Loans for SSEs

In analysing the role of individual credit suppliers, we came to the conclusion that the purpose of a loan is the most determinative factor. The various purposes for which SSEs approach different credit suppliers cannot be separated distinctly. However, when we look at loans in terms of their purpose and their source, we do find some preferences.

As regards **business purposes**, different suppliers serve needs in three categories: start-ups, working capital and investment capital. **Start-ups** are mainly financed by either family members and friends or by banks. **Working capital** is the main reason cited for taking out a loan. All credit suppliers play a role in meeting this need, and even do so in an equally important manner. The most important condition if a loan is a certain flexibility in disbursement. **Investment capital** is borrowed by preference from banks and ROSCAs, because these sources are able to provide relatively large sums for planned purposes. **Debt repayment** plays a very important role here. Some of the SSEs interviewed were highly indebted and suffering from inadequate credit relations.

The Unsatisfied Credit Needs of SSEs

Even though SSEs have a choice between different suppliers, they are often unable to satisfy their financial needs. On the one hand, informal financial actors offer quick and easily accessible credit for the short-term. Informal suppliers are more flexible concerning collateral requirements than formal suppliers. However, the latters' credit conditions are uncertain and their interest rates are high. On the other hand, banks offer large long-term credits at moderate interest rates. However, transaction costs are high and the procedures are time-consuming. In addition, banks require formal collateral or guarantors. As a result, there is a need for quick, small and short-term credits at moderate interest rates, which may be used for liquidity management, working capital or emergencies. Moreover, there is the need for larger volumes of credit for longer periods, e.g. for start-ups or long-term investments. This means that both the informal credit supply and the formal credit supply need to be improved.

Supply: The Informal Providers of Credit for SSEs

The informal financial sector plays an important role in Sri Lanka. The main actors of the informal financial sector are moneylenders and Rotating Savings and Credit Associations (ROSCAs).

Moneylenders

Moneylenders are an important source of credit for SSEs in Sri Lanka. The main strengths of moneylenders must be sought in the areas of borrower selection, transaction costs, and quick accessibility. Their weaknesses include high interest rates, low credit volumes, the relatively short-term of their credits and illegal practices used to enforce repayment.

Borrower selection is based on trust and control. This appears to be a successful strategy, as moneylenders have very low default rates, even though their collateral requirements are very low. Furthermore, moneylenders' transaction costs are very low. Our findings show that the better a client is known, i.e. the higher the trust in a client, the lower all three cost components are. Accordingly, the lower the trust, the greater the need for control, and therefore the costs. Finally, the quick accessibility that has been perceived as the major strength of moneylenders is offered only to trusted clients. New clients have to wait until a moneylender has gathered enough information on the borrower and / or his collateral.

Moneylenders charge high interest rates which typically vary between 5% and 15 % per month (p.m.). High interest rates are explained in part by a lack of competition between moneylenders. Moneylenders do not exclusively rely on their own personal funds, and they may borrow from banks or use a ROSCA fund for on-lending purposes. Nevertheless, most moneylenders perceive their lack of funds as a major constraint.

Rotating Savings and Credit Associations (ROSCAs)

ROSCAs are an important source of credit for SSEs in Sri Lanka. One of the strengths of ROSCAs is the personal knowledge and trustful relationship that exists between members and organisers. Furthermore, the transaction costs of ROSCAs are low. The weaknesses of ROSCAs include their lack of legal means of enforcement and their inability to provide long-term credits. The study did not confirm the assumption that the predetermined order of distribution of ROSCA funds leads to inflexibility.

Many small-scale entrepreneurs participate in one or more ROSCAs for credit purposes. They are willing to pay a high interest rate and bid high sums to obtain the fund. Others use ROSCAs for saving, a service that banks do not offer on equally favourable terms. One factor that was frequently mentioned as an advantage is the discipline required to save in a ROSCA.

Principle Findings and Policy Recommendations

The present analysis has shown that one of the reasons why the credit needs of SSEs in Sri Lanka are not adequately met is the gap between formal and informal credit suppliers. The dualistic structure of the Sri Lankan financial system is characterised by an inadequate credit supply of the formal and informal financial actors to SSEs.

Two approaches would be appropriate to improve the quality of credit access for SSEs: **downscaling** and **modified upgrading**. Since this gap between the formal and the informal financial sectors cannot be closed on the basis one of these approaches alone, a bridge has to be built from both sides, aimed at meeting in the middle and integrating the two sectors, or, in other words, what is called for is a combination of a downscaling approach and a modified upgrading approach. The result would be a less strict division between the formal and informal markets. In addition, this would mean more competition between different suppliers. The answer to our research question is that adequate access to credit for SSEs in Sri Lanka can be improved only through more competition between the suppliers in an integrated financial system.

Downscaling of banks implies that banks enlarge their target group to include smaller clients who mainly obtain their credits from informal suppliers. In this way banks could adopt some of the strengths of informal credit suppliers. First, banks could reduce costs by simplifying procedures for small loans without leaving the formal framework. Second, like moneylenders, banks could accept a wider range of collateral because SSEs are often without the collateral required to obtain bank credits.

Third, bank officers could approach customers in what is known as the so-called “Field Officer Approach,” which is used in the Rural Banking Innovation Project (RBIP) of the People’s Bank / the GTZ as well as by the Hatton National Bank. In this approach the field officer establishes a closer relationship to the customer by linking the bank more closely to the client. Banks could implement more personalised relations to their SSE clients and improve their methods of checking customers. On the one hand, this would lower default costs because banks would in this case be in a better position to evaluate the financial capacity of their clients. However, on the other hand this would raise bank transaction costs.

Fourth, banks could increase their interest rates for small loans in order to realise profits, as is illustrated by the example of moneyshops, an approach that has been successfully introduced in the Philippines. The current credit supply practices of moneylenders indicate that SSEs are able to pay very high interest rates for flexible and quick credits.

The history of pawnbroking in Sri Lanka and moneyshops in the Philippines serve as examples to illustrate cases in which banks have successfully adopted lending techniques of informal credit suppliers.

Policy-makers could contribute to the process by establishing a legal framework to enable banks to implement the recommendations on downscaling. **Development organisations** could support banks in developing microfinance programmes. One example is the RBIP project of the GTZ and the People’s Bank mentioned above.

Upgrading informal financial sector actors means transformation of informal financial transactions in the direction of more formality and professionalism. Moneylenders have no incentives to formalise their business. Most moneylenders were reluctant to register their moneylending business, which would require them to pay taxes, because this would not be of any advantage to them. However, the negative aspects of informality suggest that even without full upgrading a **modi-**

fied approach to upgrading moneylenders could contribute to a better credit supply.

This approach could be used to formalise the moneylending business at least to some degree. The **Mediation Board**, which has a mandate to settle loan disputes between moneylenders and their borrowers in a semi-formal way, is one solution to this problem. This institution reduces moneylenders' risks and provides more security to the borrower. In cases of informal loan disputes mediation is possible if both parties agree to mediation, or if there is a written contract. Since the Mediation Board is not very well known in Sri Lanka, information on this mediation service should be improved. Sri Lankan policy-makers could support an enlarged scope for the Mediation Board as an institution for the settlement of informal loan disputes.

ROSCAs do not have much potential to upgrade their activities, either. The majority of ROSCA organisers reported that they would not be interested in a more professional approach to organising one or even several ROSCAs, because the risk and responsibility involved in the organisation of a ROSCA are large. Similarly, enlarging the size of the group was also not an attractive option for most ROSCA members. The particular social character of their ROSCAs would suffer if too many members were accepted. In addition, the larger the groups, the less foreseeable the risks, and the greater the likelihood of delay and default. The only promising approach to a **modified upgrading** of ROSCAs would be to adopt some legal measures aimed at minimising the risks of delay and default for members as well as for organisers.

On the one hand, introduction of some formal documentation for transactions in ROSCAs would conflict with the informal nature of ROSCAs. On the other hand, introduction of contracts between members and the organiser would give a legal form to the rules of ROSCAs. Such contracts could be used in court in cases of default to recover at least a part of the money concerned. Sri Lankan policy-makers could promote better legal integration of ROSCAs.

Measures to Adjust the Legal and Institutional Framework

Additional measures could be used to support these approaches. For a lack of adequate collateral, SSEs are often unable to obtain large credits from banks. To improve this situation, it would be possible, to formalise assets of SSEs. In particular, SSEs are often unable to use land properties as collateral because there are no clear regulations on proving property rights, and land titles are as a rule not registered. Although solving this problem would be a time-consuming and costly process, policy-makers should promote the registration of land titles.

Since SSEs are often highly indebted, the following steps could help to avoid high indebtedness of SSEs or solve the problems of highly indebted SSEs. First, policy-makers could establish an advisory board for highly indebted SSEs. The board not only could provide advice in cases of heavy indebtedness, it should also help SSEs to assess more carefully their own financial capacities. Second, policy-makers could promote a fair and transparent insolvency process for SSEs by building a semi-formal institution to regulate insolvency procedures. SSEs which service outstanding loans by taking out new loans need be able to break out of this circle; this would be their only chance to start again with a new business.

1 Introduction

It wasn't until the 1970s that international donors and policy-makers in developing countries recognised the potential of the informal financial sector. Experience and research in recent decades have shown that the informal financial sector can make a viable contribution to development. Today, its important role in the financing of rural and urban small-scale enterprises (SSEs), as well as the role played by SSEs in poverty reduction and employment creation, have been widely recognised.[1] One of the major constraints faced by SSEs' is the lack of access to adequate credit in the formal as well as in the informal financial sector.[2] On the one hand, for many SSEs' access to formal credit is constrained because of banking laws regulating collateral requirements as well as other rules in the formal sector. On the other hand, the informal credit market is an important source of finance. However, the informal financial sector is unable to satisfy the financial needs of SSEs due to high interest rates, default risks and lack of enforceability. The main research question of this study is therefore: How can access to credit for SSEs be improved?

1.1 Objective and Conduct of the Study

The objective of the present study is to find solutions which improve credit access for SSEs. With this in mind, we analysed the status quo and the problems of informal credit relations. Different approaches are currently under discussion by donors and experts in microfinance. The "financial systems approach" can be seen as the most holistic approach to the problem. It includes the micro-, meso- and macro-level. The main aim is to enable credit suppliers to operate profitably – instead of using subsidies or donor funds – and to provide good financial services to their clients, SSEs.

One part of this study examines the financial systems approach – financial institution building, which mainly comprises three (sub-)approaches. First, it would be possible to adapt the formal sector's services to the specific needs of the poor ("downscaling"). Second, the informal sector could be improved, or "upgraded." Third, the informal and the formal sector could be linked ("linkage approach"). None of these approaches excludes the others. They can complement each other and lead to an integration of a country's financial system in the long run.

As the formal financial sector in Sri Lanka and other countries has been studied extensively, we concentrate on the informal financial sector. The main suppliers of credit in the informal financial sector in Sri Lanka to be investigated in this paper are moneylenders (ML) and Rotating Savings and Credit Associations (ROSCAs). Despite the important role they play in financing SSEs, they have received very little attention by research in Sri Lanka until now. Moneylenders in particular have rarely been analysed systematically in Sri Lanka or other countries.

1.2 Research Methodology

Our questionnaires include qualitative and quantitative elements and are based on plausibility rather than statistical representativeness, since the sample of interviewees was too large. The data were analysed on the basis of an analysis and understanding of single cases. The arguments are supported by the literature as well as by some expert interviews.

The data used stem from semi-structured interviews conducted with SSEs and informal credit suppliers. We chose the semi-structured form of interview because it is more flexible and open than the structured interview.[3] The questionnaires

1 See, for example, ADB (1997), pp. 6-7; GEMINI (1995), p. 3; Karunanayake (2001), p. 12.

2 See ADB (2001), p. 4; Fernando (2001), p. 28 and JICA (2000), p. 18; Lankathilake (2000), p. 9; Weerasekara (2001), p. 106.

3 See Neubert (2001), p. 26.

were organised according to the objectives of our study: the first part aimed at a status quo analysis, the second part at a problem analysis and the third part at assessing approaches to improving the current situation. Interviewing both demanders and suppliers of credit, we cross-checked the information and validity of the data.

The research was carried out in two different regions, the Negombo area on the west coast and the area around Nuwara Eliya in the central highland province. We chose these regions because one of them is and the other is likely to be a project region of our counterparts, the People's Bank and the GTZ Rural Banking Innovations Project (RBIP), which facilitated contacts to many of our interview partners.

The sample of interview partners consists of 31 SSEs, 27 moneylenders, 19 ROSCAs and of 24 experts. It was chosen according to the following criteria: we concentrated on SSEs with informal credit relations. Access to moneylenders and ROSCAs was mainly facilitated by our counterparts, and we sought to cross-check our information e.g. by asking SSEs about their contacts with moneylenders, or vice-versa. However, the sample was also determined by practicality.

1.3 Organisation of Chapters

The report starts off with an analysis of the informal financial sector in Sri Lanka. The first section of the chapter outlines the significance of the informal sector. The three levels of a financial system – formal, semiformal and informal – are briefly sketched, focusing on the strengths and weaknesses of the informal financial sector and its potential to satisfy the credit needs of SSEs. The last section of Chapter 2 provides an overview of the approaches of development finance. Chapter 3 examines the demand side, i.e. the significance and financial needs of SSEs. The focus is on the credit relations of SSEs. Chapter 4 concentrates on the main suppliers of informal credit in Sri Lanka: moneylenders and ROSCAs, analysing their strengths and weaknesses and their potential to provide credit to SSEs. Finally, conclusions and recommendations are presented and discussed in Chapter 5.

2 Microfinance in Sri Lanka: The Role of Various Actors of the Financial Sector

This chapter outlines the components of the Financial System in Sri Lanka which are the formal, the informal, and the semiformal financial sectors. It further presents some approaches to development finance (2.2).

2.1 Components of the Financial System in Sri Lanka

As Figure 1 illustrates, all three segments of the financial sector, the informal, the semiformal, and the formal, are elements of the economic system. However, only the semiformal and formal financial sectors are covered by the legal system. In contrast to the informal and semiformal financial sector, the formal financial sector is subject to banking legislation. The main distinction between the three sectors is the question of operation inside or outside a country's legal system.

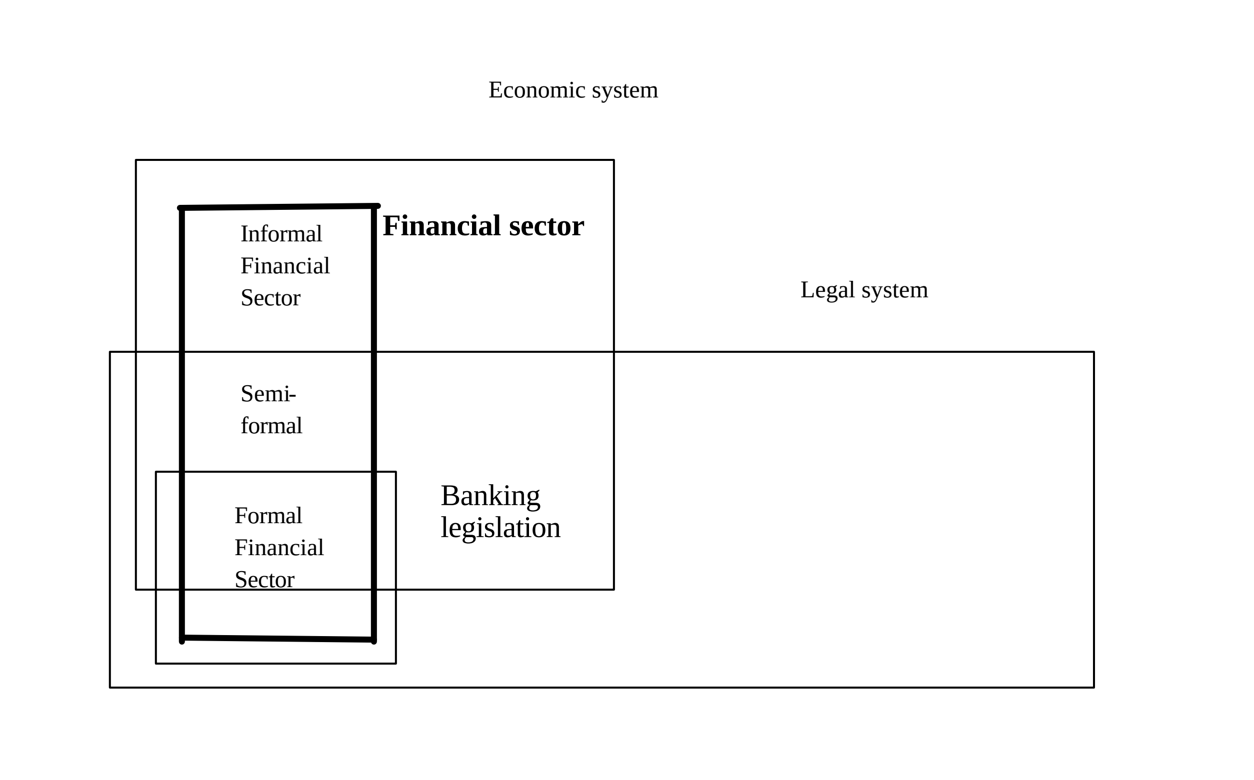
The legal system comprises all laws and regulations as well as all actors and activities involved in legal enforcement of the law.[4] Legal infrastructure provides enforcement mechanisms related to the actual demand for claim settlement. In developing countries, provision of legal infrastructure is often restricted to specific financial activities or agents, i.e. those within the formal financial sector.[5]

Before we come to the analysis of the different sectors, Figure 2 presents an overview of the actors of the financial system. The bold lines represent the respective actors' importance in this study, whereas the actors connected by thin lines are not considered: In this study, we concentrate

4 See Krahnen / Schmidt (1994), p. 33.

5 See Krahnen / Schmidt (1994), p. 35.

Figure 1: The Formal, Semiformal and Informal Financial Sectors



Source: Krahnen / Schmidt (1994), p. 34

on the demand side (SSEs) and the informal suppliers of credit. The credit suppliers of the Sri Lankan informal sector to be dealt with here are moneylenders and ROSCAs.

2.1.1 The Formal Financial Sector in Sri Lanka

2.1.1.1 Characteristics of the Formal Financial Sector in Sri Lanka

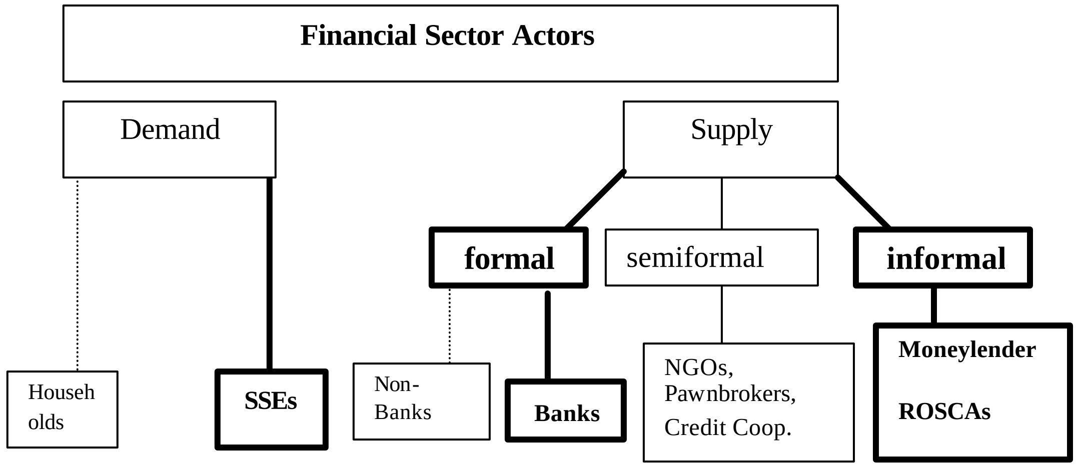
The present study mainly focuses on banks because these are the main actors of the formal financial sector in the field of microfinance, in Sri Lanka as well.[6] In the formal financial sector, lending activities are focused on large individual sums provided to private and government-owned enterprises in the modern industrial sector. High transaction costs reinforce this bias towards large loans. Fixed bureaucratic procedures dominate the process of lending.[7] Therefore, SSEs are often excluded from these loan schemes.

However, in Sri Lanka the formal financial sector has undertaken some efforts to become active in microfinance. Among the institutions regulated by the central bank, only banks play a relevant role in microfinance. There are two types of bank involved in the financing of SSEs in Sri Lanka: Regional Development Banks (RDBs) and

6 See Conroy (2000), p. 283.

7 See Krahnen / Schmidt (1994), p. 32.

Figure 2: Financial Sector Actors



Source: adapted from Ledgerwood (1999), p. 13

commercial banks. One popular form of credit in Sri Lanka is pawnbroking. Most pawnbrokers are registered and even commercial banks offer pawnbroking services to their clients.

2.1.1.2 Regional Development Banks

Regional Development Banks (RDBs) in Sri Lanka focus their activities on rural areas. In recent year they have undergone a major transformation process. They have succeeded the Regional Rural Development Banks (RRDB) which were set up in 1985 as government institutions with the objective of improving financial services to the rural poor. In order to support political decentralisation and to reduce the influence of the central bank, the country's 17 RRDBs were transformed into eight RDBs in 1998. The two primary tasks of the RDBs are to promote rural development and to develop the projects of Samurdhi[8] beneficiaries. Due to the fact that the RRDBs have been deeply engaged in government poverty-alleviation lending programmes, they have been subject to political interventions.[9] In spite of this, they are currently running their business in a sustainable manner and 80 % of their loan portfolio consists of microcredits, i.e. credits of less than LKR 100,000, which are considered microcredits[10]. By the end of the year 2000 the full amount of outstanding microcredits was LKR 5,244 million.[11]

2.1.1.3 Commercial Banks

Commercial banks have discovered the microfinance sector as a new field of interest. In the past, strict regulations on financial markets such as interest rate ceilings, high reserve requirements,

8 Samurdhi is a government programme aimed at supporting the incomes of the poor. Gunatilaka / Salih (1999) or Nayar / Gunatilaka (2000) provide a comprehensive overview of Samurdhi.

9 See McGuire, et al. (1998), p. 3.

10 100,000 Sri Lankan Rupees equal 1,141 Euro (March 2002).

11 See Charitonenko / de Silva (2001), pp. 28-29.

and directed credit lines prevented commercial banks from entering this sector. However, now that financial markets have been liberalised, and competition among the institutions in the sector is increasing, commercial banks are looking for new markets. By serving SSEs, some banks also wish to improve their public image. In addition, success stories from some other Asian countries are attracting new players to this field. In spite of these encouraging developments, there still remain several obstacles to commercial bank lending to SSEs.[12]

In general, there are three major reasons why involvement of banks in the financing of SSEs is limited. First, they are unable to assess a clients' risk in an appropriate manner. The instruments commonly used by banks to evaluate risks are credit checks, project appraisal and availability of formal collateral. However, SSEs in most cases neither have sound book-keeping, a credit ranking nor any viable collateral.[13] Second, the transaction costs involved in processing small and short-term loans are relatively high.[14] Overhead costs become prohibitively expensive, because they cannot be covered by the spreads on these small sums.[15] Third, it is difficult for most banks to build up a sound relationship with their SSE clients for the following reasons. Commonly, the overall commitment to SSE lending in commercial banks is weak. In addition, lack of personal relationships and high administrative requirements often keep SSE clients from borrowing from banks.[16]

However, compared to non-formal actors, banks also have some advantages in financing SSEs. Since they are subject to regulatory requirements, they have to meet the conditions of financial disclosure, ownership and capital adequacy. These conditions ensure careful management. Most banks have a vast network of branches, which enables them to serve a large number of clients. They also have the administrative and accounting systems as well as internal controls needed to cope with numerous transactions. In addition, commercial banks offer a wide range of financial products which can be of great value to SSEs.[17]

In Sri Lanka, there are 26 commercial banks, two of which are run by the state, six privately organised and 18 owned by foreign institutions.[18] In the commercial banking sector, four institutions play a major role in SSE-financing: the two state-owned banks (the People's Bank and the Bank of Ceylon) and two private commercial banks (Hatton National Bank and Seylan Bank).[19]

The two state-owned banks focus their activities on rural areas. However, the need to increase their competitiveness has induced them to reduce their business in the agricultural sector and to move away from small loans. They mainly have acted as financial intermediaries for government poverty alleviation programmes. Until now, they have hardly been able to reach the poor.[20]

The People's Bank started to provide microfinance when it was founded in 1961. However, costing an annual interest rate of 10-14 % (the market interest rate is around 24-28 % per annum, depending on the product), these activities are highly subsidised. By June 2001, the bank had 194,200 microcredits outstanding, with an average loan size of LKR 10,000. The figure has remained at about the same level for the past three years.[21]

In 1973 the Bank of Ceylon started out with its microfinance activities, which were initiated by the government in order to serve the poor. By 1999 the bank was serving about 330,000 clients. This figure declined to about 100,000 in 2001. During the same period, the volume of out-

12 See Baydas / Graham / Valenzuela (1997), pp. 1-2.

13 See Rhyne / Otero (1994), p. 13.

14 See UNCTAD (no time), p. 8.

15 See Jackelen (1989), p. 133.

16 See Baydas / Graham / Valenzuela (1997), p. 3.

17 See Baydas / Graham / Valenzuela (1997), p. 3.

18 See Conroy (2000), p. 2.

19 See Levitsky (1990), p. 45.

20 See McGuire, et al. (1998), p. 3.

21 See Charitonenko / de Silva (2001), p. 18.

standing loans declined from 3,020 to 1,831 million LKR. This shrinkage process clearly indicates the bank's shift away from the microfinance sector. The average recovery rate is 70 % for loans below LKR 50,000. By the end of 2001 the bank had to write off 27 % of its total microcredit portfolio. According to the bank's own estimations, it had lost LKR 43.7 million in its microfinance business by August 2001.[22]

By 1997, the Seylan Bank had become interested in the microfinance sector. This commitment goes back to the chairman's strong dedication to social questions. The bank runs a small number of projects in remote areas, primarily in the field of agriculture. Its credits range from LKR 10,000 to LKR 250,000, the average volume being LKR 25,000. The bank is strongly involved in "credit plus" activities for farmers. These include the organisation of health services, business training and even checking soil conditions. A pioneer in Sri Lanka, Seylan Bank has also introduced a credit card system. By June 2001, the Seylan Bank was serving about 4,500 clients with an overall credit volume of LKR 99 million. When this programme was initiated, the intention was not to run it in a profitable way. However, the bank intends to reach the break-even point within the coming years. Repayment ratios are subject to sharp fluctuations, as they are dependent on harvest results.[23]

Of all listed institutions, the Hatton National Bank is the only institution running a profitable microfinance business. The bank started its microfinance programme ("Gami Pubudu") in 1989 in view of emerging civil unrest due to high numbers of unemployed people, particularly in rural areas. At first, the government intended to co-operate with the bank, but then the Hatton National Bank decided to run its own programme. The bank wanted to reach three major objectives: social mobilisation, improvement of rural savings opportunities, particularly for women and children, and promotion of growing micro-enterprises to enable them to develop into small or even medium-sized enterprises. Like to the RBIP Project, the bank works with a field officer. Furthermore, collateral and application requirements have been adapted to the needs of clients.[24] Since its inception, the programme's concept has remained constant. However, some adjustments have had to be made in the past three years in order to make the programme profitable: interest rates rose from 18 % to 22 % per annum, the average loan size increased from LKR 26,000 to LKR 75,000, and the numbers of clients per field officer have been reduced. By June 2001 the bank was serving 9,237 clients.[25]

2.1.1.4 Pawnbroking in Sri Lanka

Pawnbroking is considered the oldest form of lending, and it plays a very important role in Sri Lanka. Due to the popularity and efficiency of pawnbroking, many Sri Lankan commercial banks offer pawnbroking services.

Pawnbrokers offer loans against collateral. This collateral can have various forms: household articles, machines or, a means very popular in Sri Lanka, gold. Registered pawnbrokers and banks usually accept only gold as pawned items. The size of the loans granted by licensed pawnbrokers varies between 50 % (banks) and 80 % of the value of the pawned article, depending on the customer and his records.[26] Loan periods tend to be up to one year, but customers are allowed to repay earlier. In the latter case, they pay only the interest for the time the money was borrowed. The interest rate, 2-4 % at banks and 5% at licensed pawnbrokers, is slightly higher than the commercial rate but much lower than interest rates of informal moneylenders. The main advantage of

22 See Charitonenko / de Silva (2001), pp. 17-18.

23 See Charitonenko / de Silva (2001), pp. 27-28, Expert Interview with the Chief Manager of the Bank's Development Banking Department.

24 See Gallardo et al. (1997a) and (1997b), pp. 1-3.

25 See Charitonenko / de Silva (2001), pp. 25-26.

26 See Bouman / Bastiaanssen (1992), p. 187.

pawnbroking is the fact that it is extremely fast; the entire transaction takes about five minutes.

There are two types of pawnbroker in Sri Lanka, private and public. The pawnbroking services offered by banks such as the People's Bank are considered public. Private pawnbrokers can be subdivided into registered and non-registered pawnbrokers. Registered pawnbrokers have a license and are subject to the Pawnbrokers Ordinance.[27] They pay only 2 % business turnover tax, which is passed on to clients. The only condition required to borrow from a licensed pawnbroker or a bank, apart from owning, say, an item of gold to pawn, is an identification card. Non-registered pawnbrokers do not pay taxes, but they charge interest rates higher than the pawnbrokers act allows. Thus, they make customers pay for the extra risk involved in illegal pawnbroking.[28] According to the definition of the formal financial sector (Figure 1), pawnbroking services offered by banks are classified as formal, licensed pawnbrokers as semiformal, and unlicensed pawnbrokers as informal.

The People's Bank was the first bank in Sri Lanka to offer pawning services to its clients, starting in 1964. The aim was to compete with the informal sector. By 1970, 90 rural banks were part of the People's Bank's network, 13 years later already 840 banks had joined the network. Pawnbroking in the People's Bank was so successful that by 1970 64 % of all loans provided by banks were based on pledged gold, and in 1983 pawn loans already made up 80 % of all loans disbursed by the People's Bank.[29] In 1998, an amendment was added to the banking law that allowed other banks to offer pawnbroking services. Since then, pawnbroking has become even more popular.[30]

2.1.2 The Semiformal Financial Sector

The term "semiformal" is commonly used as a label for the grey area between formality and informality. As illustrated in Figure 1, semiformal actors are financial institutions that are not subject to banking laws, though they do operate within a country's legal system.[31] The most common semiformal financial actors are non-governmental organisations (NGOs) and credit co-operatives (CCs)[32].[33]

Non-governmental organisations (NGOs) play an outstanding role in the field of microfinance projects and programmes in most developing countries. They account for more than half of all microfinance institutions (MFIs) in Asia, Africa, and Latin America. They have a broad outreach and as a rule provide the largest share of small loans.[34] NGOs are usually classified as *semiformal* MFIs, and operate between the formal level of banks and the often informal level of microcredit-demanding micro-entrepreneurs or poor individuals. However, NGOs are sometimes referred to as *informal* credit suppliers, mainly when the term "NGO" is used to include local, more grassroots-oriented collective organisations.[35]

Financial NGOs can fulfil different tasks in microfinance. Historically, many NGOs have engaged in distributing subsidised money as "loans." This kind of microcredit programme has

27 The Pawnbrokers' Ordinance No. 30 of 1942.

28 See Bouman / Bastiaanssen (1992), p. 187.

29 See Bouman / Bastiaanssen (1992), p. 186.

30 See Grashof (2002), p. 2.

31 See U Tun Wai (1992), p. 339; Krahnen / Schmidt (1994), p. 31; Ledgerwood (1999), p. 101.

32 Credit Co-operatives are sometimes also known as Credit Unions, Savings and Loans Co-operatives, Thrift and Credit Co-operatives (TCCs) or Financial Co-operatives. See Ledgerwood (1999), p. 101.

33 Matin, et al. (1999), p. 10.

34 See Lapenu / Zeller (2001), p. 23. The authors have compiled the experiences of 1,500 microfinance institutions in 85 developing countries.

35 There exist a variety of names for non-profit-oriented local organisations. Some authors use terms such as Private Voluntary Organisations (PVOs), Community Based Organisations (CBOs) or People's Organisation (P-Orgs), which here are all categorised as SHGs.

suffered from inefficiency and low repayment rates. Such programmes have been heavily criticised for these weaknesses.[36] Today, the common opinion on the role of financial NGOs emphasises is that they need to be financially sustainable and to operate on a profitable basis.

In Sri Lanka, the most important financial NGO is the *Sarvodaya Economic Enterprise Development Service* (SEEDS). SEEDS is the economic development arm of the large Sarvodaya movement, which mainly works in the field of participatory rural development. The members of SEEDS mainly participate in these financial programmes to gain access to savings rather than credit, so SEEDS is currently concentrating on the enlargement of a village banking network. Another major player is the quasi-NGO *Samurdhi,* with its Samurdhi Banking Societies. Although it is a governmental poverty-alleviation programme, it uses NGO methods in microfinance. Members are organised in basic self-help groups that collect savings and disburse group loans.[37]

Credit co-operatives (CCs) also play a significant role in the provision of financial services to poor entrepreneurs or individuals. CCs are organised according to basic co-operative principles: every member owns an equal share of the co-operative. There are no external shareholders. All members have equal rights in terms of policy influence or voting rights. CCs are run by co-operative meetings representing the entire membership, which are usually called the general assembly. Commonly, CCs belong to a national league of affiliated CCs, which is the called the "apex body".

CCs almost exclusively provide financial services. The members of a CC provide capital to the CC, mainly equal shares. At the same time, the members (and sometimes also non-members) can deposit savings. Parts of this accumulated, self-generated capital can then be disbursed as loans to members. CCs generally request little or no collateral, but attach much significance to personal references. Members become lenders and borrowers at the same time.

In Sri Lanka, two types of co-operatives play an outstanding role in microfinance, Co-operative Rural Banks (CRBs)[38] and Thrift and Credit Co-operatives (TCCs).[39] Both are regulated by the Department of Co-operatives and not by the Central Bank. CRBs have been an important source of mobilising savings but have some difficulties in lending on money effectively. Today, a network of co-operative rural banking unions operates 1,418 CRBs in the country, handling 5.3 million savings accounts. The TCCs in Sri Lanka are organised in a national federation, which is known as the SANASA movement. It was founded in 1906 in order to increase financial services in rural areas. Today, SANASA provides a large range of products, e.g. microfinance schemes, insurance, and training facilities and has been transformed into a social movement. More than 8,000 primary co-operative societies mobilise savings and offer microcredits for income-generating and consumption purposes to more than one million members.[40]

2.1.3 The Informal Financial Sector

The informal financial sector in developing countries is important for financing informal sector clients, i.e. SSEs. 30 to 70 % of total employment in developing countries is accounted

36 See Dichter (1996); Schmidt / Zeitinger (1995); Abugre (1994); Rhyne / Otero (1994).

37 See Conroy (2000), pp. 289-291. For a history of development of SEEDS, see SEEDS (1999) and (2000). Other NGOs are, for example, Agromart, Arthacharya Foundation, South Asian Partnership in Sri or Lanka. See Gant et al. (2002), pp. 125-127.

38 In 2000, RDB / RRDBs provided more than 50 % of all microcredits in Sri Lanka. Senanayake (2001), p. 4.

39 Hulme / Montgomery (1994) provide an overview of TCCs in Sri Lanka.

40 See Conroy (2000), pp. 286-289 and Sharif (2000), pp. 8-11. In 2000, TCCs and SANASA Development Bank provided 13 % of all microcredits in Sri Lanka. Senanayake (2001), p. 4.

for by the informal sector.[41] This is also the case in Sri Lanka.

Informal financial markets in Sri Lanka originated from the colonial banking system, which provided no services to the local population, either rural or urban.[42] The informal suppliers of microcredits play the most important role in Sri Lanka.[43] According to Sanderatne and Senanayake, the informal financial sector accounts for an estimated 30 % of all financial transactions in Sri Lanka.[44] In 1986/87 a central bank survey even stated that 75 % of credit transactions in Sri Lanka originated from the informal financial sector.[45]

In contrast to the formal financial sector, the informal sector acts outside the regulations imposed on the formal sector. Informal actors are not subject to supervision by the banking and monetary authorities; they often do not comply with book-keeping standards and are not reflected in official statistics. Furthermore, informal actors do not pay taxes and are not subject to statutes on usury.[46] They are not allowed to take deposits. The main actors in the informal financial sector are moneylenders and self-help groups such as ROSCAs.

The characteristics of informality include personal knowledge of the client and flexibility in respect of working hours, collateral and interest rates, to name only a few. Suppliers concentrate on small loans for SSEs. Loans are often disbursed without formal collateral, sometimes even without interest.[47] Repayment rates are generally high, even though interest rates are above average. Familiarity with clients and social sanctions substitute for collateral and legal enforcement. However, lack of legal enforceability leads economic agents to develop tailor-made contract forms that diminish the risk involved in lending. Generally, the credit terms and procedures are adapted to the situation of the client, i.e. they are not bureaucratic.[48]

Contrary to the general notion that informal financial markets are located in rural areas only, Sanderatne and Senanayake point out that informal lenders are responsible for many financial transactions in the urban sector in Sri Lanka. Thus, urban small enterprises are mostly financed through informal loans.[49] However, according to the Foundation for Development Co-operation, informal credit suppliers are even more important in rural areas: 75 % of the financial needs of the rural poor in Sri Lanka are satisfied by the informal sector.[50]

Informal finance can also harm the national economy, and it may involve a criminal background. Krahnen and Schmidt argue that assignment of an activity to the informal sector may also be a matter of choice, for example in the case of illegal business transactions.[51] Also, many urban actors invest in the urban informal market because of the high returns it offers.[52] Even in the field of savings and credit, there is a genuine choice available between informal rotating clubs and semiformal credit co-operatives.[53]

2.2 Financial Development Approaches

In this section, financial development approaches are discussed with a view to improving the access of SSEs to credits. The term “development

41 See ADB (1990), p. 187; Krahnen / Schmidt (1994), p. 31.

42 See Sanderatne / Senanayake (1989), p. 127.

43 See Conroy (2000), p. 283.

44 See Sanderatne / Senanayake (1989), p. 133.

45 See Conroy (2000), p. 283.

46 See ADB (1990), p. 187.

47 See U Tun Wai (1992), p. 341.

48 See Germidis / Kessler / Meghir (1991), pp. 48-49.

49 See Sanderatne / Senanayake (1989), p. 131.

50 See Foundation for Development Co-operation (1993), p. 186.

51 See Krahnen / Schmidt (1994), p. 36.

52 See Sanderatne / Senanayake (1989), p. 131.

53 See Krahnen / Schmidt (1994), p. 36.

finance" comprises the field of development co-operation and thus refers to all aspects of the financial system of developing countries, including the national specifications of a financial system, its influence on national economic development and approaches used by development co-operation to change the system.[54]

Since the experiences made with financial institution building has differed in various developing countries, there is a lively discussion under way on the best ways to improve financial systems. Germidis, Kessler and Meghir summarise: "*While it is clear that there is a common goal - improve the functioning of financial systems in developing countries, reduce the need for external funds, ease the debt burden and provide financial services to as wide a population as possible so that people may gradually better their socio-economic condition - it is equally obvious that there are many different avenues to reach it.*"[55]

One major issue in the discussion is assessment of the informal financial sector. As discussed in Section 2.1, the existence of the informal financial sector is a fact in most developing countries. This is partly due to a dualistic economic structure, but also due to a number of advantages provided by informal financial actors (see Chapter 4). The relationship between the formal and the informal sector is characterised by three features: competition, complementarity, and co-operation. If regulation of the formal sector causes financial transactions to be shifted to the informal sector, competition develops between the two sectors. Formal and informal suppliers of financial services can complement each other in their supply of customer-oriented services.[56] Co-operation between the formal and the informal sector entails linking the two.

Competition can best be illustrated by an example: In several countries, such as Bolivia, the

Box 1: A Brief History of Financial Development Co-operation

A quick look at the history of development finance suggests that a couple of paradigm shifts have taken place. When it set out to influence financial systems in developing countries in the 1960s, lack of capital was identified as the most important constraint for financial development. The intention was to overcome this constraint by means of large capital transfers for industrialisation and infrastructure projects. However, soon development policy-makers had to recognise that large external capital transfers were not effective and failed to contribute to any broader access to capital for the majority of the population. On the contrary, it favoured the development of a dualistic structure (see Section 2.1).

Consequently, the following phase of development finance concentrated on a broad outreach of credit programmes and fostered the target-group orientation approach. However, in the early 1980s the results of microcredit schemes were found to be disastrous in terms of effectiveness and sustainability. The credit programmes distributed money to poor people rather than lending it, thanks to highly subsidised capital and low or no interest rates, which resulted in low repayment rates.

During the 1980s, lack of external capital was no longer seen as the major bottleneck of development finance. Two other policy fields formed the core of new approaches: liberalisation of financial markets and "financial institution building." These two approaches are summed up under the term "financial system approaches." The financial system approach takes into account the lessons learned from history, for example the fact that subsidised credits undermine financial development and that poor people are definitely able to pay market interest rates. Therefore, financial service providers in a financial system approach are expected to operate on a profitable basis ("financial sustainability").[a]

Today, development finance mainly concentrates on financial institution building. This means supporting financial actors and promoting sustainable and profitable financial institutions for all clients.

Source: See Schmidt (2000), pp. 1-6.

a See Ledgerwood (1999), pp. 1-3 for further details.

54 See Schmidt (2000), p. 1.

55 Germidis / Kessler / Meghir (1991), p. 293.

Philippines or Sri Lanka, informal finance grew when formal financial markets were underdeveloped.[57] Thus, rigid regulation of the formal sector, such as repressive and interventionist financial market policy, can enhance the growth prospects of the informal sector.

A **complementary** relation between the two sectors is characterised by the very different services offered by formal and informal suppliers. Informal actors are regarded as logical suppliers of Fiebig points out, formal opportunities to save money can be the first contact of clients from the informal sector with formal finance, whereas microcredit remains in the realm of the informal sector.[58] This example illustrates that the two sectors are not necessarily contradictory.

Co-operation between the formal and informal financial sector can take on various forms. An example would be a moneylender who receives a formal loan and lends it on informally; or a ROSCA that saves money in the informal sector and deposits it in a commercial bank account. This already describes what is understood by linking the two financial sectors.

However, most approaches to financial development agree on the need to eliminate the broad outreach of informal activities and aim to reduce this financial dualism.[59] Krahnen and Schmidt go even further and state that a liberalised, formal financial market is a necessity to create a sufficient supply of financial services for a broader mass of people.[60] This strong orientation towards more formalised financial sectors is somewhat in contrast to some experiences made in South-East Asia. There, the "Banking with the Poor Project" has made positive experiences with approaches involving co-operation between the informal and the formal financial sector.[61]

Three different approaches have been commonly addressed in the discussion over development finance and institution building:[62]

- *Downscaling* the formal financial sector
- *Upgrading* the informal financial sector
- *Linking* the two financial sectors

Downscaling refers to an approach that advocates strengthening the role of formal banks in the financial system. The approach consists of a number of measures that make banks "come down" to their clients, which means in effect becoming more accessible to the target group. This includes not only creation of more and smaller branches, but also supply of more adequate financial products to poorer clients and a stronger target-group orientation. One major tool of this approach is provision of training for commercial banks. Bank clerks are taught how to approach poorer clients and what microcredit products to supply.[63]

Upgrading the informal sector means a qualitative transformation towards formality and professionalism of informal financial activities. Upgrading can include measures aimed at further capacitating informal actors or improving their knowledge of financial business. The idea is to become more formal without losing the advantages of operating informally, the insight being that "*the informal financial sector can become a more efficient structure for collecting savings and distributing loans, particularly in rural areas, than it is at the present time.*"[64]

56 See Fiebig (1999), p. 34.

57 See U Tun Wai (1992), p. 340.

58 See Fiebig (1999), p. 36.

59 See, for example, Schmidt (2000), p. 5; Germidis / Kessler / Meghir (1991), p. 207.

60 See Krahnen / Schmidt (1994), p. 122.

61 See Foundation for Development Co-operation (1993), pp. 20-21.

62 These three approaches are defined as "three-strategies view" by Krahnen / Schmidt (1994), p. 82. It can also be found in Germidis / Kesser / Meghir (1991), pp. 214-139, although these authors add, as another approach a reform of macroeconomic policies.

63 See Krahnen / Schmidt (1994), p. 83.

64 Germidis / Kessler / Meghir (1991), p .232.

Linking the formal and informal financial sectors is an approach favoured by those who do not trust the two other approaches, i.e. who doubt that a bank will have enough social commitment to downgrade, and who believe that informal financial actors lose too many of their advantages in becoming more formal. The idea of linkage is to preserve the strengths of the existing informal financial actors, their appropriate organisational principles and their flexibility, while enhancing their financial impact through formal sector assistance. In this way each actor can make use of his comparative advantages in financial service provision. A common approach is to link community-based self-help groups with banks via financial NGOs with a view to supplying more financial services to communities[65]. The linkage approach allows a broader outreach, which also allows banks to pass on their increasing transaction costs to the informal actor or the financial intermediary.

All approaches to improving the financial system either deal with institution building or the relations among financial sector actors. There is a lively discussion under way on the appropriateness and effectiveness of the different approaches. The categorisation of three approaches, although widely used in development finance, is criticised as unnecessarily simplifying and reducing the set of opportunities available in the field of financial institution building. In particular, Krahnen and Schmidt complain about the inconsistency and incompleteness of this "three-strategies view." They argue that the three categories are artificial, because a successful linkage approach necessarily has to include elements of downscaling of the formal financial actors involved as well as of upgrading informal financial actors. They additionally emphasise that concentrating on these three approaches would leave out the possibility of creating new financial institutions, which can be an appropriate solution as well.[66]

Schmidt goes even further by stating that only creation of a new type of financial institution, in the form of a private corporation, would be suitable as an approach that is efficient and target-group-oriented at the same time. His strong orientation to bank-like formal institutions and individual clients excludes all forms of linking up with traditional informal group lending, and he thus rejects the appropriateness of upgrading as well as of linkage approaches.[67] However, his strong criticism of upgrading and linkage approaches mainly results from his experiences in Latin America, where he found the results of the two approaches to be disappointing.[68] By contrast, experiences made with the Banking with the Poor Project in South-East Asia are different and much more positive.

Germidis, Kessler and Meghir propose a strategy which is a mix between linking the two sectors and at the same time improving each of the actors involved. This combination is supposed to lead to an integration of the two financial sectors in the long-term. The authors give a range of recommendations on how to reduce the gap between the formal and informal financial sectors in order to improve a financial system.[69] They are less rigid in their policy recommendations and emphasise the need for integrated and complementary strategies. The three approaches all contain important elements of an improvement of the financial sector and should go hand in hand to "softly integrate" the informal financial sector into the formal sector. While strongly favouring the formality of financial institutions, Germidis, Kessler and Meghir point out the important linkage potential of informal institutions in developing

65 This type of linkage approach was pursued by the „Banking with the Poor Project." See Foundation for Development Co-operation (1993).

66 See Krahnen / Schmidt (1994), pp. 81-89, for the overall discussion and a critique of these three approaches.

67 See Schmidt (2000), p. 8.

68 See Schmidt / Zeitinger (1995) for an evaluation of credit-granting NGOs in Latin America.

69 Germidis / Kessler / Meghir (1991), pp. 214-138.

countries, namely ROSCAs, Credit Co-operatives, and moneylenders.[70]

Thus, the three different approaches do not automatically exclude each other. In the long-term, the three approaches together can lead to what Germidis, Kessler and Meghir call integration of the financial system.

Having had a look at some of the diverse arguments on how to improve financial systems in developing countries, and which approach might best be pursued, it is necessary to focus on particular approaches and in particular on actors at the same time, as in our case study in Sri Lanka.

3 Demand: The Unfulfilled Credit Needs of Small-Scale Enterprises (SSEs)

Before looking into the supply side (Chapter 4), it is necessary to study the demand side, i.e. to examine the credit needs of SSEs in Sri Lanka. The present chapter will start out by analysing the significance of SSEs for poverty reduction and employment in Sri Lanka (3.1), before examining the characteristics of SSEs (3.2) and the financial obstacles they face (3.3), and then going on to discuss the existing status of the credit relations of SSEs (3.4). The choices between different suppliers for various purposes are presented in 3.5.1, and the next section (3.5.2) looks into the unsatisfied credit needs of SSEs.

3.1 The Significance of SSEs for Poverty Reduction and Employment in Sri Lanka

The role of SSEs as a source for employment is highly significant. Since SSEs operate on a labour-intensive basis, they are able to create employment. Due to low entry barriers in most sectors in which SSEs operate, start-ups absorb large shares of the workforce. Furthermore, SSEs offer job opportunities for low-skill and unskilled workers. Estimates indicate that microenterprises provide work for 20-40 % of Sri Lanka's total labour force.[71] If we include small enterprises, this share is assumed to be slightly higher.

Many people working in the SSE sector are poor. Accordingly, promotion of SSEs is considered to be an adequate tool of poverty alleviation. However, it is essential to note that the SSE sector is not homogeneous but an extremely heterogeneous assemblage of enterprises. SSE owners are generally not as poor as their employees. Empirical results from other studies conducted in Sri Lanka suggest that about 30 % of SSEs owners are considered poor.[72] This number slightly exceeds the national level of 25-30 %. In addition to this, the poverty profile of the SSE sector varies from region to region. In Sri Lanka, coastal areas are much more highly developed than the highlands. On average, employees of SSEs are poorer and have less formal education than those working in larger enterprises.[73]

3.2 Characteristics of SSEs in Sri Lanka

One criterion commonly used to identify SSEs in Sri Lanka is the number of employees.[74] Other criteria such as capital or turnover are less appropriate for SSEs. Since there is often no bookkeeping, it is difficult to use these criteria. According to this definition, SSEs comprise all businesses with a maximum of 25 employees. They can be classified in two categories: small enterprises and microenterprises (MEs). While small enterprises employ 6-25 workers (according to the Department of Census and Statistics in Sri

70 See Germidis / Kessler / Meghir (1991), pp. 234-236.

71 See Charitonenko / de Silva (2001), p. 15.

72 See Weeratunge (2002), p. 39. For the purpose of the study, we refer only to consumption poverty; according to the department for census and statistics, the upper poverty line per person and month is US$ 10.

73 See Gulli (1998), pp. 7-9.

74 See Fernando (2001), p. 7.

Lanka)[75], microenterprises provide work for five or less people.[76] SSEs can be categorised in many different ways. Corresponding to categorisations found in Sri Lanka, SSEs are classified in four sectors: services, trade, manufacturing and agriculture.[77]

Although a common characteristic of SSEs in other countries is their informality, which implies that they are not registered and therefore pay no taxes, these results do not correspond with our findings from Sri Lanka. A recent survey from Central Province found that about 95 % of all enterprises are registered with the local authority. As microenterprises make up 70 % of all these enterprises, we conclude that the majority of SSEs operate in the formal sector.[78] Fernando arrived at similar results, stating that "*almost all entrepreneurs in all categories have realised the value of the legal status of their business*".[79]

It is difficult to distinguish formal from informal activities on the basis of their legal status. In most developing countries there are different institutions with which firms are required to register, and this may entail different legal consequences. For example, registration with one authority is adequate to qualify for a bank loan, but does not imply that the respective person has to pay taxes. It is therefore not possible to draw a clear-cut dividing line between formal and informal. It is rather a continuum. This fact makes international comparison rather difficult. However, due to a lack of adequate alternatives, we will stick with this approach for our purpose.

Empirical studies suggest that most SSEs are run by men, but women make up the majority of employees in the SSE sector. This patriarchal structure is consistent with other results from South Asia.[80] In contrast, SSEs headed by women are more likely to work from the household.[81] According to a survey in the Mahaweli district (Sri Lanka), 75 % of employees in MEs are women. Various programmes promoting SSEs suggest that most people working in SSEs are women.[82]

It is difficult to evaluate the growth of SSEs because data on SSEs in Sri Lanka are rarely available. GEMINI reports that most microenterprises in Sri Lanka do not grow; they concentrate on surviving rather than growing. This holds true in particular for those microenterprises in Sri Lanka which employ family members.[83] Data on Small-Scale Industries (SSIs) show that their growth rates amount to 3 % per annum.[84]

75 See Premaratne (2000), p. 10. Sometimes empirical data about SSEs were unavailable, since the common classification of enterprises in Sri Lanka appears to break down into microenterprises on the hand and small and medium enterprises on the other. Therefore, we sometimes used data of microenterprises as a proxy for the whole SSE sector. This approach can be justified in two ways: first, Sri Lankan and international evidence suggests that small enterprises hold a very small share within the SSE group. Second, within our sample we only dealt with five of 31 enterprises which are small size businesses.

76 See Teszler (1993), pp. 21-22. Using the criterion of employment size to separate economic activity involves some inadequacy. It does not take into account whether the labour force is underemployed or whether it is in disguised employment. Similarly, marginal productivity is not considered. Nevertheless, due to the deficiencies of alternative criteria, the employment criterion can serve as a second best solution. See Ngwira (1995), pp. 50-52. In addition, our methodology did not enable us to take other criteria (like turnover or fixed assets) into consideration. Approaching our interview partners from the street, number of employees was the only suitable selection criterion.

77 See Weerasekara (2001), p. 87.

78 See Weerasekara (2001), pp. 97-98.

79 See Fernando (2001), p. 6.

80 See Batten / Hettihewa (1999), p. 208.

81 See USAID (1995), p. 1. Due to this fact we faced some difficulties in interviewing women as heads of SSEs. Within our sample women represent only 10 % of all our interview partners.

82 See Charitonenko / de Silva (2001), p. 15.

83 See GEMINI (1995), p. 2.

84 See Lankathilake (2000), p. 12. Corresponding to our definition, SSIs are only SSEs in the manufacturing sector. No data were available on SSEs.

Usually, the quality of SSEs' products are hardly in a position to compete with the trade-marked output of larger enterprises. However, their low prices make these goods available for a wide range of poor people. However, the market in Sri Lanka for these cheap products is growing narrower, with even poor people demanding higher-quality products. As in other developing countries[85], SSEs in Sri Lanka make use of existing artisan traditions and knowledge for their production processes. SSEs usually use local raw materials. However, supplies of local raw materials have become increasingly difficult to obtain over the last years. Many SSEs owners see their growth chances restricted by scarcity of materials like wood, clay, rushes and reeds.[86]

The management structure of most SSEs is weak and working conditions are poor. There is hardly any precise division of labour in Sri Lankan SSEs. Most SSEs do not keep books. They thus have no internal controlling mechanisms to indicate deficits. This lack of book-keeping makes it difficult for SSEs to gain access to formal sources of credit. Furthermore, wages are very low and fringe benefits are inferior to those of larger enterprises.[87]

3.3 Financial Obstacles Facing SSEs

The development and activities of SSEs are constrained by various obstacles, which include lack of access to markets, insufficient availability of inputs, limited saving possibilities, lack of access to credits, etc. While Weerasekara points out that access to sources of finance is just one of same constraints, Fernando states that in Sri Lanka most entrepreneurs consider access to financial resources as their major problem.[88]

In Sri Lanka, as in most developing countries, SSEs have no access or only restricted access to the formal banking sector. From the banks' perspective, SSEs are for the most part considered unbankable. The major reasons are their high fixed transaction costs as well as their inability to conduct thorough risk assessment (many SSEs have no sound book-keeping). In the literature, findings on Sri Lanka are mixed. A USAID report reveals that *"[l]ess than 3 per cent of entrepreneurs in microenterprises have received bank loans. The formal financial systems are underdeveloped and unable to extend credit to significant numbers of these entrepreneurs."*[89] However, Fernando identified banks (as opposed to informal sources) as the most important source of finance for SSEs in Central Province.[90] Our findings indicate that only very poor SSEs do not have access to formal sources of financing. However, for those which do have access, the credit conditions are mostly inadequate. Many SSEs therefore enter the informal financial sector to obtain credits.

However, the shortcomings of the informal financial sector constrain the development opportunities of SSEs in Sri Lanka. Often, entrepreneurs borrow the capital they need from their family, friends or local moneylenders. In many cases the products or the terms of loans do not fit the requirements of SSEs. In addition, interest rates of moneylenders are often very high. Due to the shortcomings mentioned, the financial needs of SSEs cannot be met adequately by informal sector actors.

85 See Schneider-Barthold (1998), p. 2.

86 See Karunanayake (2001), p. 14.

87 See Halvorson-Quevedo (1991), p. 8.

88 See Weerasekara (2001), p. 106; Fernando (2001), p. 28.

89 See GEMINI (1995), p. vi.

90 See Fernando (2001), p. 9.

Box 2: The Impact of Microcredit on the Enterprises and Poverty

In general, an additional supply of credit increases the output of enterprises. However, these increases are distributed unevenly. As the results of several impact studies[a] show, the overall effects are positive, though the picture is heterogeneous. Especially as far as women are concerned, the sales of enterprises have increased and products and services have been diversified. However, not all output has increased. Some sales figures have stagnated or even decreased. As one study notes, the effect largely depends on market conditions. In addition, it was found that the impact on manufacturing enterprises was less pronounced than on the other sectors.

The impacts on the income of SSEs were generally positive. On average, incomes have risen by 25-40 % due to the availability of additional financial resources. Regular borrowers in particular have raised their incomes. However, for some SSEs income has stagnated or even decreased. This shows that credit on its own is not enough.

The outcomes on employment are mixed, though some features can be identified. In most cases, impacts on wages and labour are positive but limited. This increase has been concentrated among a small share of enterprises. As some studies show, men seem to benefit more from new opportunities than women. Most SSEs have only increased the number of family workers. This can be regarded as positive if it leads to higher productivity. It would be negative if the opportunity costs for the additional workload were not compensated for. In general, microcredits appear to have more of an impact on job stability than on job creation.

Information on the impact of credits on productivity is limited. Results from Ecuador show that women tended to reduce their working hours because they earned more per hour, suggesting an increase in productivity. A study from Bangladesh found that income effects are lower than asset effects. This indicates that there are no significant effects on productivity.

Source: See Sebstad / Chen (1996), pp. 8-19.

a Sebstad / Chen (1996) give an overview, which contains the findings of 32 research reports that investigated the impact of microcredits. The outline covers case studies of 42 programmes in Latin America, Africa, and Asia.

3.4 Empirical Results: The Financial Relations of SSEs in Sri Lanka

Before presenting the study's detailed results, three general findings will be cited to introduce the empirical analysis of the credit relations of SSEs. First, the SSEs interviewed turned out to have very diverse financial relations in the formal and informal sectors. Some of our interview partners had only one source of credit, but the majority reported having relations to three or four different sources of credit. Second, many SSEs had relations to formal and informal financial sources at the same time. Third, some SSEs had no financial relations at all.

As Table 1 illustrates, of the 31 SSEs we interviewed, four had never taken out a loan. They lived on their savings and earnings or received transfers of money from their families. Among those who had credit relations, 21 had approached one or more moneylenders, 17 had taken out one or more bank loans, 16 were participating in a ROSCA and 19 pawned items regularly. Family and friends played an important role (named 15 times respectively). Two persons had approached a leasing company. The following sections aim to analyse the role which each source of credit plays for small-scale entrepreneurs.

Table 1: Credit Sources of SSEs in the Sample

Sources of Credit:	Number of SSEs Approaching this Source of Credit	Number of Loans Obtained from this Source
Moneylender	21	31
Bank	17	27
ROSCA	16	22
Pawnbroker	19	27
In-kind Credits	16	16
Family & Friends	15	18
Leasing	2	2
Total	106	143

Source: Authors' survey

3.4.1 The Role of Informal Credit Suppliers

The Role of Moneylender Loans

Moneylenders were the largest source group of loans taken out in our sample; on the whole, 21 SSEs had financial relations with one or more moneylenders, and this does not include in-kind relations or credits granted by friends and relatives. The average conditions are compiled in Table 2.

One important finding of the interviews is that monthly interest rates varied from region to region between about 4 and 11 %. About one half of loans were based on trust, and involved no physical collateral. Thus, trust is the outstanding basis of many moneylender loans. This underlines the fact that not taking formal collateral is an important strength of moneylenders. However, some SSEs reported that they had to hand in post-dated cheques to their moneylenders. Some entrepreneurs told us that they were required to sign "blank sheets." In the event of default, the moneylender then can insert his name, the volume of the loan and whatever else he might see fit to include as collateral or loan conditions. Although these "blank sheets" are not legally enforceable, the clients of these moneylenders believed that it is the moneylender's right to demand them. Moneylenders appeared to use these "blank sheets" to threaten their clients. However, some SSEs stated that they had handed in "formal" collateral such as a deed to a house or vehicle papers.

The most frequently named purposes of money-lender loans were business purposes. Among all purposes, "debt repayment" was named nine times, followed by working capital (8) and investment purposes (5). Among debt repayment, the most important purpose of primary loans was working capital, mainly the purchase of inputs. Other primary loans were taken out to start up a business. In three cases a primary loan was taken out to repay debts to another moneylender, to a ROSCA, and to a pawnbroker. Thus, the money-lender loan was the last (thus far) in a chain of loans taken out to service previous debts. The private purposes named were mainly house construction or weddings, while education and emergencies played a minor role.

Table 2: Characteristics of Moneylender Loans

Loan Conditions:	Average	Median	Maximum	Minimum
Loan Amount	62,183 LKR	25,000 LKR	350,000 LKR	1,000 LKR
Interest Rate	7.8 % p.m.	6 % p.m.	20 % p.m.	0 % p.m.
Repayment Period	13 months	4.5 months	72 months	1 month
Collateral	Mainly based on trust	/	/	/

Source: Authors' survey

The perceptions of our interview partners as regards the strengths of moneylenders are quite diverse. Quick accessibility to moneylenders is definitely seen as an advantage, as is prompt loan disbursement. In summary, emphasis was placed on the low transaction costs involved in moneylender loans. It was additionally seen as an advantage that some moneylenders do not require collateral, that they are flexible in their loan conditions and that most moneylenders do not ask about the purpose of loans. However, these positive aspects were mainly mentioned by SSEs who take out regular loans with a known money-lender. Persons who do not have a stable financial or social relation to a moneylender may see this differently. Most moneylenders tend to check a potential borrower very carefully before lending. Sometimes they even deny loans to persons unknown to them. Some of our entrepreneurs had approached a moneylender as the "lender of last resort," without having any alternative. They complained about dependencies and usurious interest rates. Some interview partners even feared their moneylenders.

Looking into weaknesses, the high interest rates taken by most moneylenders are perceived as the principle weakness. However, interviewees also complained about repayment modalities. Moneylenders usually collect a monthly interest rate, but want to have the principal back at once. This causes problems for clients, as many entrepreneurs would prefer to pay mixed instalments. However, there were also SSEs that named no disadvantages and seemed to be quite content with their financial relations to their moneylender. In sum, the function of moneylenders for SSEs is to provide quick, short-term loans.

The Role of In-kind Credit Relations

In-kind credit relations played a role for half of the entrepreneurs interviewed. These in-kind relations mainly are bound up with purchases of inputs on commission. This also includes to the very commonly mentioned need for loans for "working capital," which means in the majority of cases purchases of inputs.

There are different reasons for purchase of inputs on commission. The practice indicates a tight relation between input supplier and entrepreneur. However, in the majority of cases reported to us entrepreneurs had no money at hand to pay their input dealer when they approached him and therefore had to buy the goods on commission. The repayment period was usually not longer than one month. It was difficult to determine whether interest is paid in in-kind relationships. This is due to the fact that most interview partners did not know whether or not they pay interest in the event that they pay their debt a month later. Sometimes 1 % of the purchase price is charged as a commission.

One common way to secure in-kind credits is to hand over a post-dated cheque, which serves as collateral for the input supplier. This cheque can be cashed about one month later, when the entrepreneur has sold some items and gained more liquidity. We consider most cases of in-kind credits as normal and durable business relations, particularly important in the trading sector.

Many entrepreneurs reported that in-kind credit on purchases is very convenient for them. The transaction costs involved in searching for and purchasing goods are reduced in this way and this may also entail the establishment of stable supplier-seller relations. Thus, one strength of in-kind relations is the ease and reliability of the transaction. The input supplier does not demand money immediately, a fact which can be seen as a service to his client. However, this involves a danger that some SSEs will have no choice on where to purchase their inputs. Some may not be well informed about the market and always approach always the same input supplier, even though the latter sells his products at exploitative prices.

The Role of Friends and Family Members

Looking at all informal loans, friends and family members played a significant role for our interview partners (18 loans). The **conditions** for loans granted by friends or family members were quite similar. Friends and family members do not ask for interest or collateral. They usually do not fix the repayment period (apart from one case where the repayment for a LKR 50,000 loan was fixed at two years), whereas financial relations to friends appear to be of shorter duration.

There are two frequent purposes of such loans: working capital and business start-ups, and this makes this source the most important one for business newcomers. Reasons stated for loans were mainly business purposes, not private ones. There are two explanations for this phenomenon: first, if there is money in the family to borrow, it is cheaper and easier to obtain it from family members than elsewhere; second, it may be that only friends and family are willing and able to provide high-risk credits. There were no weaknesses mentioned. Consequently, friends and family are the cheapest and most convenient source of credit for SSEs.

The Role of ROSCAs

More than half of our SSE interview partners participated in one or more ROSCAs. Overall, they explained to us the characteristics of 22 ROSCAs. The basic data are described in Table 3.

Summing up the purposes for which the funds were used as well as the strengths and weaknesses of ROSCAs, it becomes obvious that the role of ROSCAs for the SSEs interviewed was to provide flexible savings services and credits in various amounts on a trust basis and without any collateral requirement.

Table 3: Characteristics of ROSCAs (SSE members)

Characteristics	Average	Median	Maximum	Minimum
Fund	118,000 LKR	72,000 LKR	480,000 LKR	4,500 LKR
Contribution (p.m.)	8,250 LKR	6,000 LKR	30,000 LKR	1,000 LKR
Members	15	15	26	9
Duration	14 months	15 months	26 months	4 months

Source: Authors' survey

The funds were used for business and private purposes. House construction played the major role within private consumption. Some ROSCA funds were also used for working capital and debt repayment, which included all sorts of primary loans obtained from moneylenders, pawnbrokers and family members.

To sum up the reported strengths of ROSCA membership, for most of the SSEs interviewed the need to save was the most important incentive to participate in a ROSCA. In addition, easy access to a large volume of money and flexibility on payment modalities were mentioned. There were only a few weaknesses associated with ROSCA membership: lack of legal enforceability and the fact that quick disbursement is not always guaranteed.

3.4.2 The Role of Formal Credit Suppliers

The Role of Banks

Half of the SSEs interviewed had taken out one or more bank loans. Table 4 compiles the basic data on these bank loans and their conditions.

The usual collateral provided for a bank loan was a mortgage on a house, on land or on both. To secure bank loans with two or three guarantors was the other large group of collateral. Interestingly, guarantors were required exclusively in the Hill Country (Nuwara Eliya and Maskeliya), but not in Negombo. Some SSEs stated that it was their personal relation to a bank staff or manager

Table 4: Characteristics of Bank Loans

Loan Conditions:	Average	Median	Maximum	Minimum
Loan Amount	135,385 LKR	205,000 LKR	1,000,000 LKR	10,000 LKR
Interest Rate p.a.	19.1 %	23.5 %	30 %	3.5 %
Repayment Period	3 years	4 years	10 years	1 month
Collateral	Mortgage on houses / land (14) Guarantors (7)	/	/	/

Source: Authors' survey

that secured their bank loans. However, only some interview partners mentioned that their own savings at the bank may have served as collateral.

As regards the purpose of bank loans, SSEs mainly asked banks for loans for working capital for their business. They used their access to bank loans as a source of liquidity, often for the purchase of inputs. The second most important reasons indicated for bank loans were to invest and to repay debts. It is easy to explain why bank loans serve for investment purposes. Bank loans are on average larger and the repayment period is longer than with all other sources of credit, but banks takes longer to disburse the money. Since larger business investments are usually not ad hoc, the long procedures at banks can be taken into account in planning an investment.

Repayment of debts to moneylenders, pawnbrokers and ROSCAs was another main purpose of bank loans. Obviously, bank loans may play a role in informal debt repayment. This is surprising because people usually do not formulate a loan proposal to a bank specifying debt repayment as the purpose of the loan – to say nothing of the likelihood of obtaining a bank loan for that purpose. The original objective of most interview partners in applying for a bank loan was related to business (either working capital or investment needs), but once the loan was obtained, it was sometimes used for different purposes, such as repayment of other debts. Looking at the efforts of some credit schemes to promote self-employment, we found some entrepreneurs who used a bank loan to start-up a business.

The outstanding strength of banks as credit suppliers is seen in their low interest rates. Another important advantage of bank loans is that those who know how the bank system works found the procedures transparent and the requirements reliable – the keyword mentioned in the interviews was "secure loan conditions." Some interview partners mentioned that they very much appreciate the fact that the repayment instalments already contain part of capital recovery. This is not the case for most loans taken from moneylenders and pawnbrokers, where usually only the monthly interest is paid, while the full principle amount remains to be recovered at once. In addition, some SSEs favour banks for providing them with larger volumes of money. Other interviewees commented e.g. that a bank is easily accessible and that banks are reliable partners in planning the future of a business.

The most important weakness is the fact that banks are known for the long procedures they need from the appraisal to the disbursement of a loan. A disadvantage was seen in the fact that a borrower is required pay back a current bank loan before obtaining a new one. This is an indication of the credit-seeking mentality of some SSEs, which are so in need of money that they tend to take more and more credit without being able to service their debts. Other disadvantages were onerous documentation requirements, complicated paperwork and the need to put up formal collateral.

The role of banks as credit suppliers can be summarised as follows: banks provide cheap money with secure conditions and convenient repayment modalities. They make large amounts of money available, but they take their time in processing a loan and they provide no short-term loans. Bank loans serve to satisfy needs for large sums for use as predictable working capital and long-term investments.

The Role of Pawnbrokers

Pawnbrokers were often approached by SSEs, and sometimes these SSEs had received more than one loan from a pawnbroker. Our interview partners approached both licensed pawnbrokers and pawning centres of banks. Table 5 provides more details on the loan conditions of pawnbrokers.

Several interview partners mentioned that bank pawning centres have lower interest rates (2-4 % per month), but do not give more than 50 % of the value of the pawned item as a loan. In contrast, licensed pawnbrokers tend to take higher interest rates (4-5 % per month), but give up to 90 % of the value of the pawned item as a loan. Licensed pawnbrokers are therefore a credit source of last

Table 5: Characteristics of Pawnbroker Loans				
Loan Conditions:	**Average**	**Median**	**Maximum**	**Minimum**
Loan Amount	27,500 LKR	12,000 LKR	200,000 LKR	3,000 LKR
Interest Rate (p.m.)	3.7 %	3 %	12.5 %	1.5 %
Repayment Period	8 months	12 months	Generally 12 months	2 months

Source: Authors' survey

resort. This is illustrated by the high number of emergency cases in which pawnbrokers are approached. The items pawned were exclusively gold jewellery, and it appeared that many pawnbrokers accept only items of gold, due to the relative ease of establishing their value[91].

Pawnbroker loans were mostly used for working capital, and again debt repayment also played a very important role. These debts were accumulated with moneylenders or banks. The original purpose of these primary loans was always for business; either for working capital or for investment purposes. Some entrepreneurs had approached a pawnbroker to obtain cash for a ROSCA contribution. One of these three used a ROSCA fund for lending-on purposes (moneylender). One person used a loan to pay off in-kind debts with his input supplier.

The major strengths emphasised by our interview partners are easy and immediate access to pawnbrokers in combination with quick disbursement of money. The procedures are very simple, as the conditions are regulated by the Pawnbrokers Act. In particular poor people without formal collateral (for bank loans) and without many social relations (for loans from family, friends or moneylenders) can benefit from the easy access offered by this source of credit. The weaknesses of pawning included high interest rates and the small amounts of money given for pawned items.

In general, pawnbrokers are very easy to approach, and they offer fixed terms and secure conditions. This explains why pawnbrokers are approached in cases of emergency. Their role is provision of short-term and small loans for urgent occasions, either in business or in the family.

3.5 Credit Provision to SSEs

The present section interprets the answers provided on our SSE questionnaires and focuses on the following two issues. First, the purposes for which SSEs approach various suppliers of loans. Second, remaining problems are discussed under the header "unsatisfied needs."

3.5.1 What Supplier is Approached for what Credit Purpose?

SSEs in Sri Lanka have a certain set of different choices when they decide the answer the question: "Where to go to obtain what loan for what purpose?" The number of different credit suppliers among which an entrepreneur can choose depends on the purposes of the loan[92].

The wealthier and more formal an SSE, the more likely it is to have stable bank relations, banks being the preferred source of credit for the majority of credit needs. The more informal the

91 It is much more difficult to determine the value of gold than that of gems. Items other than jewels appear to be pawned only rarely. The bank pawning centres only accept gold. See Skully (1994).

92 We assume that this set of opportunities is also influenced by other factors, such as the past and present economic situation of the business or the entrepreneur's experiences with credit sources. However, we analysed only loan purpose as a decisive factor.

business and the more survival-oriented the SSE, the more informal credit suppliers tend to be approached. In general, all SSEs have a range of different suppliers that are easily accessible, namely pawnbrokers, family and friends, money-lenders, ROSCAs and banks. Only highly indebted SSEs seem to have a very limited supply of credit and very little choice.

Purposes of SSE Loans

In analysing the role of individual credit suppliers, we came to the conclusion that the purpose of a loan is the most determinative factor. The purpose of a loan inherently determines a number of the conditions that should be fulfilled by the credit supplier. The various purposes for which SSEs approach different credit suppliers cannot be separated distinctly. However, some preferences can be seen when we compare all loans for purpose and source.

As far as **business purposes** are concerned, the three categories start-up, working capital and investment capital are served by different suppliers. **Start-ups** are mainly financed by either family members and friends or banks. These two sources are able to provide money and seem to be willing to take the risk. As mentioned above, Sri Lanka's banks provide credit for a number of particular start-up schemes. However, according to our information, it was difficult for entrepreneurs to satisfy requirements such as guarantors for loan schemes.

Working capital is the principle reason to take out a loan. All credit suppliers play a role in meeting this need, and even in an equally important manner. The most important loan condition is a certain flexibility in disbursement.

By preference, **investment capital** is borrowed from banks and ROSCAs because these sources are able to provide the large amounts needed for planned occasions. As long as capital needs are not higher than LKR 100,000, moneylenders are approached. They provide the additional bonus of not caring too much about the purpose of a loan, which may mean that such money is used illegally, e.g. for smuggling activities or illegal migration to the Middle East and Europe.

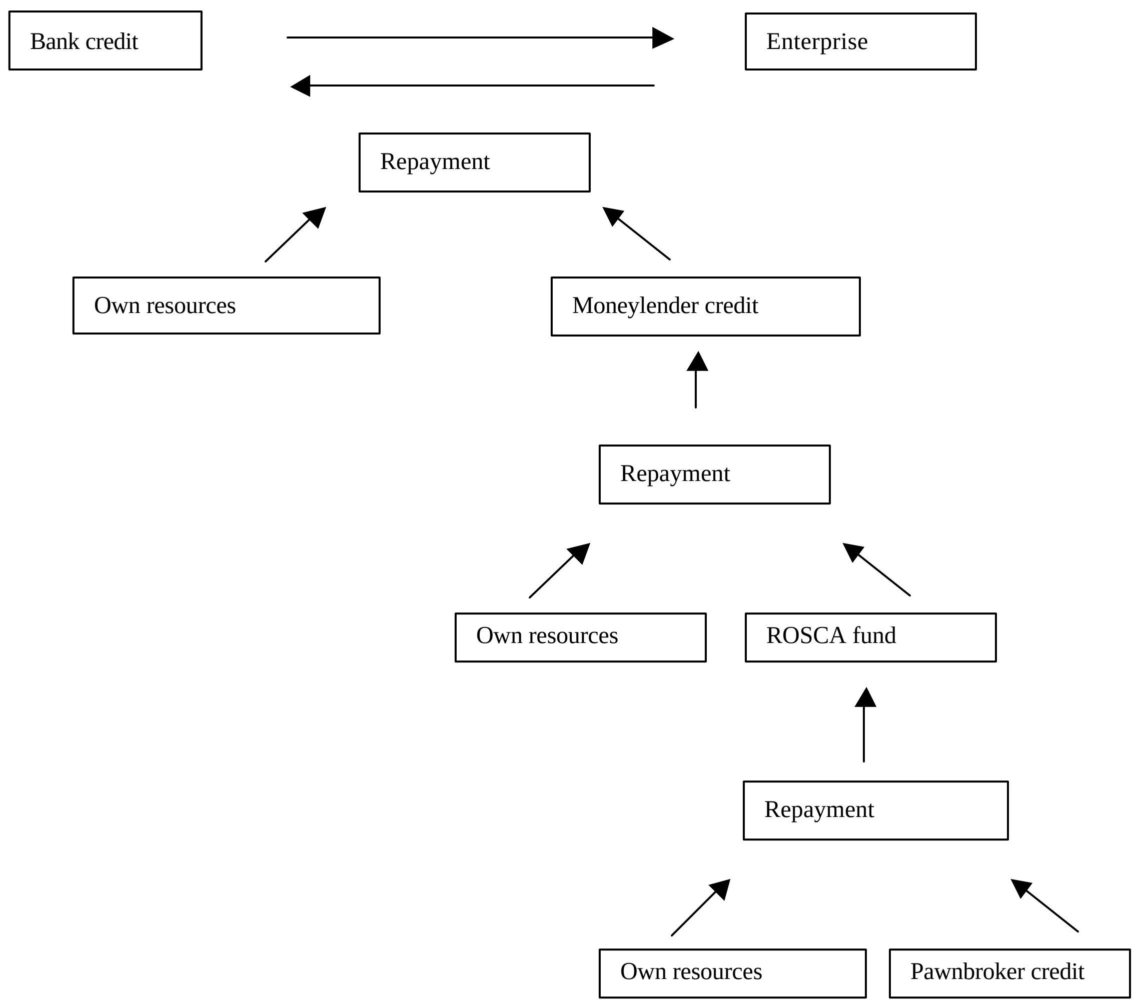
For **private loan needs**, ROSCAs, moneylenders and pawnbrokers play the most important role. All sorts of consumption-related needs are met with the aid of ROSCA funds or by pawning an item. However, larger private investments such as house construction or purchase of a vehicle, which are not an ad hoc decision, are often financed by either banks or moneylenders. Pawnbrokers, with their immediate accessibility, also play a role in providing for emergency needs.

Debt repayment played a very important role. Some of the SSEs interviewed were highly in debted and suffered from inadequate credit relations. Some entrepreneurs could not even tell us the amounts of their current loans and when they slipped into their "indebtedness trap." They did not remember the first loan that started the chain leading to more and more expensive loans.

Such cases partly explain the coexistence of formal and informal credits (Figure 3). Once they are unable to repay a bank loan, people approach informal sources such as moneylenders for funds to repay it. Struggling to meet the monthly interest payments on a moneylender loan, some entrepreneurs lost sight of their business cash flows and saw no way to repay their moneylender. One trader told us that when he failed to repay his moneylender, the moneylender forced him to participate in his ROSCA in order to repay the loan. If during this time any kind of emergency occurs, the last exit available is to pawn one's last items at a pawning centre or with a licensed pawnbroker. In such cases, indebted people have no choice of "where to go when," and find themselves in a vicious circle involving more and more loans. Once in the circle, the next loan will predictably be at worse conditions.

The reasons noted for indebtedness are as follows. Some SSEs may have overestimated their management and entrepreneurial capacity and even taken out too large loans to start up their business. Some SSEs were negatively affected by the economic depression during the last three years.

Figure 3: Example for a Highly Indebted Enterprise



Source: Authors' compilation

Some SSEs were simply poor and had little choice as to how to earn their living. In addition, in the informal financial sector lenders are not fully informed about other debts. Some moneylenders and ROSCA organisers seem to be well informed and make inquiries about a client's indebtedness. Nevertheless, it is easier for an indebted person to obtain a loan in the informal sector. Some moneylenders increase the interest rate for such clients, since they are more risky to deal with. This business behaviour of moneylenders worsens the situation of indebted people. Since informal credit suppliers act outside the legal system, there are, on the one hand, no laws and rules that forbid lending to indebted people. On the other hand, the formal sector lacks insolvency laws and advisory services for indebted people.

Although SSEs have a choice between different credit suppliers, and a number of their needs are satisfied by formal and informal credit suppliers, many SSEs would prefer bank relations in the place of their relations with moneylenders and pawnbrokers.

3.5.2 Unsatisfied Credit Needs of SSEs

Even though SSEs have a choice between different suppliers, they are often unable to satisfy their financial needs. Our results from Sri Lanka reveal that credits are needed for all purposes (start-ups, working-capital, investment). Prompt provision of credit is a major concern for many SSEs. Long and complicated procedures for bank credits is one reason for the important role of informal suppliers in financing SSEs.

We distinguish credit needs according to type of credit and the purpose for which a credit is used. On the one hand, informal financial actors offer quick and easily accessible credit for the short term. Informal suppliers are more flexible concerning collateral requirements than formal suppliers. However, credit conditions are insecure and interest rates are high. On the other hand, banks offer large credits for the long-term at moderate interest rates. However, transaction costs are high and the procedures are time-consuming. In addition, banks require formal collateral or guarantors. There is therefore a need for quick, small and short-term credits at moderate interest rates for use for liquidity management or working capital or emergencies. Moreover, there is also a need for larger sums for longer periods, e.g. for start-ups or long-term investments. This means that both the informal and formal supply of credit needs to be improved.

4 Supply: Informal Providers of Credit for SSEs

The objective of the present chapter is to investigate the main actors in the supply of informal credit: moneylenders and ROSCAs. They are presented with a view to their characteristics, strengths and weaknesses.

4.1 The Credit Supply of Moneylenders to SSEs

The role of moneylenders has long been the subject of a lively debate. The opinion dominant for many years was that moneylenders exploit borrowers and do more harm than good to national welfare. In recent years, however, the view has gained ground that moneylenders fulfil an important function in the economy in providing informal credit to SSEs and other clients. Today, positions are less contradictory, though opposing views still exist.[93]

The picture presented in the literature did not make it clear whether moneylenders are an important source of credit for SSEs. Our empirical findings on moneylenders in Sri Lanka show that SSEs are prominent clients of the moneylenders in the sample. However, their credit supply is insufficient. On the one hand, moneylenders are important because they provide informal credit and their business practice includes certain strengths that correspond to the needs of SSEs. On the other hand, there are still major deficits in their credit supply to SSEs.

4.1.1 Characteristics of Moneylenders

As providers of informal credit, moneylenders are a heterogeneous group. The term moneylender is used in different ways, and there are different types of moneylenders.[94] Figure 4 provides a typology of moneylenders based on five criteria used to structure their characteristics and to outline different types of moneylenders.

The first criterion concerns **lending within groups as opposed to lending to others**. The present study applies the term moneylender only to the latter.[95] The second criterion refers to the relationships between moneylenders and their clients, which may be of a **commercial or non-commercial** nature. Non-commercial relations are not exclusively based on economic interests and

93 See Bolnick, (1992), p. 62; Germidis / Kessler / Meghir (1991), pp. 200-201 and pp. 206-207.

94 See ADB (1990), pp. 190-199; von Pischke (1996), pp. 74-187; Sanderatne / Senanayake (1989), pp. 133-141; Germidis / Kessler / Meghir (1991), pp. 158-164.

95 See ADB (1990), p. 191; Sanderatne / Senanayake (1989), p. 134.

often rest on family relations. Social issues such as loyalty, kinship and solidarity play a decisive role, in part substituting for financial flows. The relations between lender and borrower are characterised by reciprocal responsibilities. The borrower may be bound to an implicit promise to help the lender if he is faced with a crisis or in need of liquidity. Family and friends often demand neither interest nor collateral.[96]

The third criterion is the characterisation of **credit as untied or tied**. Untied credits are lent and repaid – including interest – in cash. Tied credits are tied to another transaction between the borrower and the lender, for example the provision of inputs or the marketing of outputs. Either the credit or the repayment or both may be in kind (Box 3).[97]

Box 3:	**Tied Credits in Sri Lanka**
The four tied moneylenders we interviewed lend to SSEs who buy their inputs on credit. One example is a welder who buys all his materials for contract work at a retail shop in Kandy. Once the welder has finished his job and his customer has paid him, he repays his credit to the retail shop, i.e. his tied moneylender. Interest rates of the tied moneylenders interviewed range between 3 and 7% p.m. Like untied moneylenders, tied moneylenders are flexible in their borrower selection. This is mainly based on trust and "history." All four of our tied moneylenders know their customers and are thus familiar with their repayment capacity. Tied credit is thus made available very promptly to borrowers who are already known to the lender. New borrowers have to build up a good reputation before they can obtain a tied credit. Debt with a supplier means that the borrower (and customer) has a continuing relationship with the lender which may lead to new sales. None of our tied moneylenders used illegal practices, and SEEs who have used tied credit are as a rule highly satisfied with it. To sum up, tied moneylending may not always be strictly defined as moneylending, but it can be seen as a conventional business relationship.	
Source:	Interviews with tied moneylenders and SSEs in Kandy, Negombo and Maskeliya

The fourth criterion is whether moneylenders lend as their main occupation or whether they lend only as a sideline. Lending is the main activity of **professional moneylenders**. Non-professional untied moneylenders[98] lend only on the side. Normally, non-professional moneylenders, who for example provide tied credits, are mainly shopkeepers, merchants, artisans, employees, landlords or farmers (Box 4).[99]

Box 4:	**A Non-Professional Moneylender**
A grocery store owner in Upcott, near Maskeliya, lends between LKR 1,000 and 10,000 at interest rates of 6-8 % to 26 clients and provides tied credits to estate labourers. Even though his main business is his grocery store, moneylending is more profitable than the grocery business. To assess the two types of business, he keeps two sets of accounts, even though these are difficult to keep separate. He has employees who sometimes assist in collecting repayments. In such cases, the costs involved are impossible to measure because these persons are paid as shop assistants. His lending activity thus does not differ substantially from that of moneylenders who consider themselves professional or full-time moneylenders.	
Source:	Interview with a moneylender near Maskeliya

The more important the moneylending business. the more professional the moneylenders. One indicator for the importance of moneylending business is the number of employees involved in a lending business and the amount of money lent out by it. For example, a large-scale moneylender in Ja Ela stated that moneylending was not his main business, but according to our criteria this moneylender was nevertheless highly professional. His loan sizes were the highest in our overall sample: the maximum volume being LKR 2,000,000.

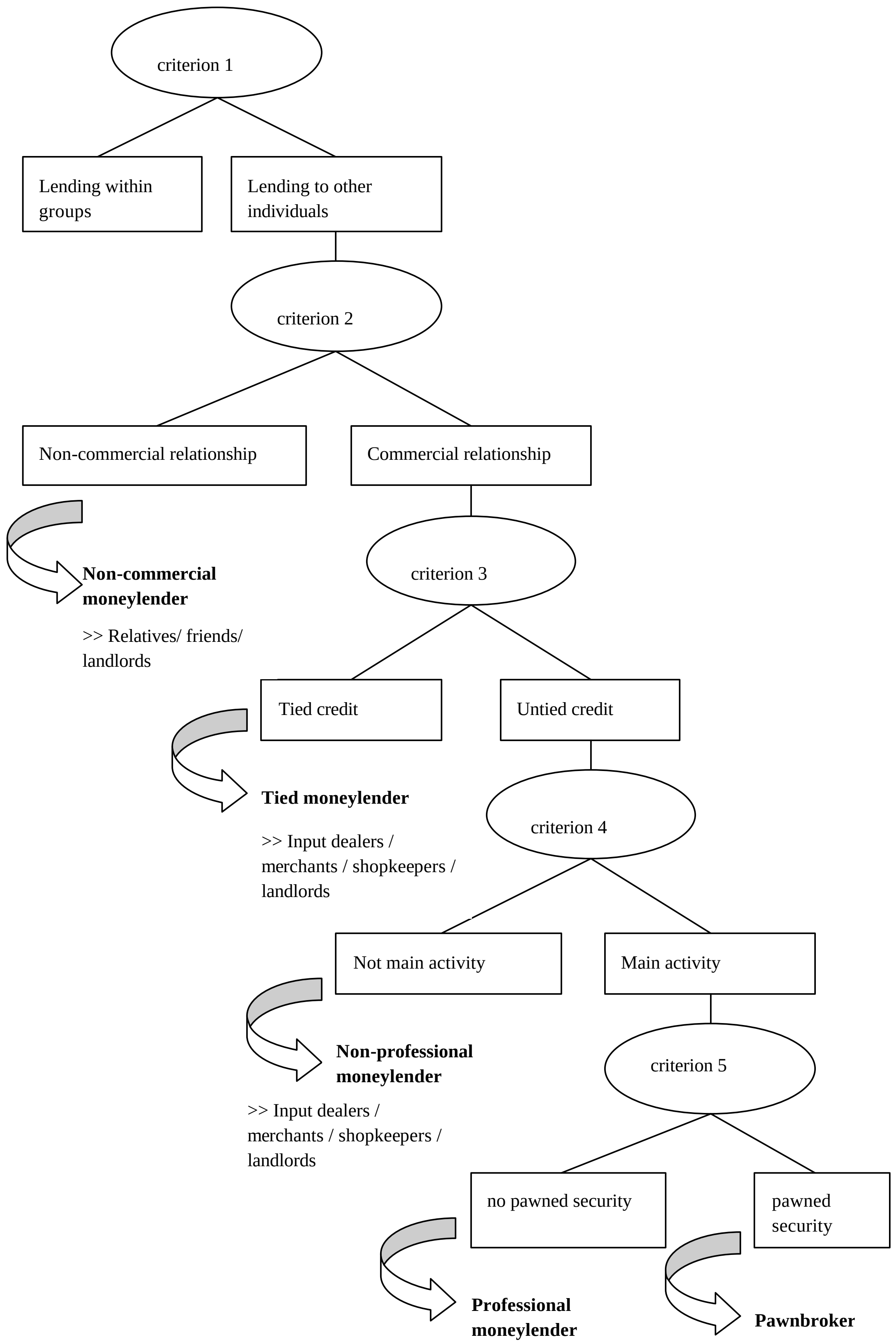
96 See ADB (1990), p. 192; Adams (1992), p. 12; Fernando (1988), p. 257.

97 See ADB (1990), pp. 192-193; Sanderatne and Senanayake (1989) use the terms direct and indirect lending, but the idea is basically the same.

98 For convenience, they will be referred to as non-professional moneylenders, although tied and the non-commercial moneylenders are also non-professional lenders.

99 See Germidis / Kessler / Meghir (1991), p. 41; Sanderatne and Senanayake (1989)use the terms professional and semi-professional moneylenders. The ADB (1990) uses the terms regular and intermittent moneylenders.

Figure 4: Typology of Moneylenders



Source: Authors' compilation, based on ADB (1990), pp. 190-199 and Sanderatne / Senanayake (1989)

4.1.2 Strengths of Moneylenders

Three specific strengths, found in previous studies, explain the attractiveness of moneylenders for SSEs: flexible borrower selection, low transaction costs, and quick access to credit. These strengths are often interlinked and sometimes difficult to separate.

4.1.2.1 Flexible Borrower Selection

According to Sanderatne et al., all types of moneylenders base their decision to lend on the borrower's overall repayment capacity, including his ability to provide collateral, and not on the specific purpose of the credit. As a result, moneylenders in Sri Lanka are willing to extend credit for production- and for consumption-related purposes.[100]

Box 5: Borrower Selection of two Moneylenders in Sri Lanka

One of the female moneylenders we interviewed is not aware and not interested in the purpose of the loans she provides to her borrowers. She lives in a small neighbourhood of fishermen in Negombo and only lends to people from this neighbourhood, i.e. mainly to fishermen. She assumes that these fishermen need the money to buy nets or for emergencies, but she does not ask them. She lends to them, mostly without collateral, because she is familiar with their financial situation. If she has any doubt, she demands collateral. Another moneylender from Negombo town knows all his borrowers from the market. He knows when they need money for their businesses or an emergency, but this makes no difference to him and it is not a criterion for his borrower selection. However, when he sees another moneylender visit one of his potential clients, he knows they have not repaid an instalment on a loan. They are then automatically excluded from his circle of borrowers. The two examples illustrate that the purpose of a loan is as a rule not of interest to the moneylender. It is legitimate to borrow for consumption purposes or for an emergency, the main thing is that the borrower's repayment capacity is estimated to be good enough.

Source: Interviews conducted in Negombo

Trust and Control

Moneylenders use two major mechanisms to reduce their credit risk: **trust and control**. In practice, these mechanisms are not mutually exclusive, and may even be complementary. According to our interviews, the flexibility of borrower selection varies, with some moneylenders demanding substantial collateral and others not demanding any security apart from trust. In general, however, borrower selection is an efficient instrument of risk management and is mainly based on the borrower's overall repayment capacity.

Trust, experience and personal knowledge of the borrower play an important role when the moneylender assesses his clients. Previous borrower repayment records and long-standing relations are important criteria for the assessment of clients.[101] Our interviews showed that in Sri Lanka trust and personal knowledge are also important for most credit transactions of moneylenders. Trust can be based on family relations as well as on "friendship." For example, if a moneylender borrows money from another moneylender or the bank, he usually lends it on at an interest rate 1 % p.m. higher than the interest rate that he himself pays. Family members are not required to pay this extra interest.

Apart from family members, "friends" also enjoy some privileges based on trust. "Friends" are often required to pay lower interest rates and are given higher loans than new clients. Some moneylenders even stated that they lend *only* to friends. Our results show that "friends" are more likely to be defined by their good repayment performance - and therefore their role as "good clients" - than by their personal relationship to the moneylender. This can be illustrated by several

100 See Sanderatne / Senanayake (1989), p. 150 and pp. 154-155.

101 See Christen (1989), pp. 22-23; ADB (1990), p. 192; Germidis / Kessler / Meghir (1991), p. 164; Adams (1994), p. 3.

cases in which “good clients“ became “friends“ because of their good repayment performance. However, this “friendship“ continues only as long as the rules are obeyed, i.e. it lasts until as the loan is repaid.

Another element of trust is knowledge. Personal knowledge of a person and experience with his repayment record contribute to building trust. One criterion for borrower selection may be geographical distance. For example, one moneylender lends exclusively to people living in his village. Knowledge is built through good customer relations, especially where moneylenders own a shop and know their borrowers as customers or as neighbouring shop owners. Of course, knowledge and information-gathering are also an instrument of control and automatically lower transaction costs.

Where trust is not sufficient, borrower selection is complemented by **control**. Moneylenders in Sri Lanka use collateral as security for their loans.[102] The lender does not distinguish between the assets of an enterprise and the belongings of a household. Collateral may consist of moveable goods, such as jewellery and gold, or durable consumer goods, immovable property or inventory and equipment.[103]

Our empirical findings indicate that land, vehicle papers and cheques (mostly post-dated) are the most popular forms of collateral among the moneylenders in our sample. Some moneylenders also use jewellery or what they call “blank sheets” as security, the latter being a empty sheet of paper signed by the borrower on which the lender can write a contract of his own as an instrument to ensure repayment. This is merely a means of exerting psychological pressure, and none of our interviewees had ever had to use it. The question of how moneylenders gain access to collateral in cases of default could not be answered because default was very rare amongst our sample. In Sri Lanka, promissory notes are legally enforceable: the Mediation Board, a semi-formal institution for conflict resolution at local level, settles loan disputes and accepts written contracts or promissory notes by moneylenders and their clients as evidence. However, this is only the case if both parties agree to mediation.

Sometimes a guarantor can be used to make up for lack of trust or knowledge of the borrower. A guarantor may either provide information about a borrower or have more successful means than the moneylender to induce him to repay. In this case, the moneylender pays a commission to the guarantor. However, the guarantor does not bail out the borrower in case of default.[104] In Sri Lanka we found that guarantors can operate as “introducers” of new clients to moneylenders. For example, one moneylender in Negombo accepts only new borrowers that are introduced by old clients. The old client acts as a guarantor for the new one and even assumes responsibility for the new client's first loan. Sometimes the old client may even take the loan and then pass it on to the new client. Usually, the new client would not have to pay the old client for this service; but even if he were required to, this fact would be of no interest to the moneylender.

Moneylenders achieve high repayment ratios because they have credible means to **sanction default**. The consequence of having no access to credit for future needs of his SSE is an important incentive for a borrower to repay.[105] We identified a variety of sanction mechanisms used by moneylenders in Sri Lanka to deal with defaulters and delayers. The border between default – ultimate non-repayment – and delay is a fluid one. The moneylender and the specific situation involved determine the point of time at which a loan is considered “lost“ as well as the time it might be worthwhile to seek to recover it. Sanctions are one way of enforcing repayment. They can be broken down into preventive

102 Sanderatne (1980), p. 13.

103 See Sanderatne / Senanayake (1989), pp. 150-151.

104 See Christen (1989), p. 22; von Pischke (1996), p. 177; Germidis / Kessler / Meghir (1991), p. 164.

105 See Christen (1989), Krahnen / Schmidt (1994), p. 37; p. 25; Adams (1994), p. 3; Zander (1994), p. 4.

measures and measures to enforce repayment or to “punish“ default.

Preventive sanctions include the elements analysed above: social and physical control of borrowers. Some moneylenders use contracts, which may be written instruments signed before a lawyer or have the form of a blank sheet of paper which the borrower is required to sign.

Repayment is enforced in different ways. Some moneylenders openly admitted that they physically threaten borrowers who do not repay on time. Another scenario is informal co-operation of moneylenders with the police. In addition, moneylenders use the Mediation Board, a local level governmental dispute-settlement institution, to enforce the repayment of loans. One moneylender, for example, settled a loan dispute with a borrower by referring the matter to the Mediation Board. The agreement brokered by the Mediation Board specified that the borrower had to repay the loan with less interest than originally was agreed upon.

The most common sanction used by moneylenders appears to be exclusion from credit. This is a severe problem for the potential defaulter because in most cases it means that he will never again be able to obtain a loan from any moneylender in the area. This mechanism may also be used by the moneylender to set an example for other borrowers and to prevent future defaults.

4.1.2.2 Low Transaction Costs

Our second hypothesis was that one major strength of moneylenders is their ability to operate with very low transaction costs in specific circumstances. However, in the literature there are some opposing views about the transaction costs of lenders, which depend on some of the characteristics of lending, e.g. type of moneylender, type of the contract, etc.[106]

106 See Robinson (2001), pp. 193-196.

Transaction costs involve information costs as well as the costs of the physical act of delivering the credit and obtaining repayment. Information costs normally include identification of the borrower, collection and verification of application documents, assessment of collateral, follow-up and monitoring. The most important components of costs for employees are transport costs and the opportunity costs involved in travel time.[107]

This strength of moneylenders is confirmed by our interviews. The transaction costs of the sample of moneylenders interviewed can be broken down roughly into information costs, collection and transport costs, time costs in general and costs of employees or agents. However, it must be stressed that our findings on costs are difficult to measure. All costs are to a certain extent interlinked. Information gathering is often done in the process of collecting repayments. Sometimes an employee or broker does this job, saving the moneylender time and receiving a commission for it.

As regards the costs of information gathering, it has been explained above that this factor is mostly relevant for new clients. New clients have to be checked to assess their repayment capacity. These costs include transport costs and time costs. If the borrower offers collateral, the moneylender also has to check the validity of the collateral offered. Land titles, for example, can be checked with the land registration authority. However, land titles are often not registered, a factor which poses major problems for borrowers and lenders alike.

Some moneylenders told us that information-gathering costs tend to be low because they know most of their clients from their shop or their neighbourhood. However, it is rather difficult to measure exact costs for information-gathering.

Collection costs vary among moneylenders. Some moneylenders have few repayment collection costs because their main job makes it possible for

107 See McGuire / Conroy (1997), p. 8.

them to collect payments in the course of work (bus drivers, milkmen etc.). Others have transport, time, and wage costs. Some moneylenders drive to their clients and collect repayments on their own and others send an employee from their main business or a broker to collect repayments.

The time factor involved in moneylending is further taken into account in assessing transaction costs. We have to distinguish here between moneylenders who engage in moneylending as an additional business and those whose main business is moneylending. Those with another major business spend less time on lending. Often the two businesses are interlinked, and the time spent on each business is difficult to specify. Most transactions take place at the moneylenders' main business, a shop or grocery store. The time factor is thus very low in these cases.

Moneylenders who clearly lend money as a major business devote the better part of their day to lending. We must further distinguish here between large-scale moneylenders and those engaged in more or less small-scale lending.[108] The first type is more likely to use a broker or co-ordinator to find new clients and to collect repayments. Our results show that the eight moneylenders with the highest loan volume (above LKR 100,000) have at least one person working for them. This person may be a lawyer or a broker. Brokers usually receive a commission of about 1 % of the interest on a loan. Less professional moneylenders often use an employee from their shop for their lending business.

4.1.2.3 Quick Access to Credit

Our third hypothesis was that moneylenders provide quick access to credit. From the borrower's point of view, the important consideration is whether the moneylender provides quick access to credit or the borrower is able to obtain credit only from time to time. Professional moneylenders provide credit when other types of moneylenders refuse it, and access to their loans is comparatively easy.[109] According to many authors, all types of moneylenders usually provide credit almost instantly because they have intimate knowledge of their clients and do not need to spend time collecting information. According to Sanderatne, this is also true for Sri Lanka. Quick access to credit can be crucial for SSEs because otherwise they may miss business opportunities that are only temporarily available and thus incur costs for forgone profits.[110]

This hypothesis was confirmed only in part and needs to be modified. It became clear that "good clients" have very fast access to money because the relevant information is already available. While new clients have to be "checked" first, well-known clients who have good records and do not need to be rechecked obtain their loans within a period of five minutes to three days at the most. New customers sometimes have to wait until the moneylender has gathered sufficient information on the borrower's financial situation and reputation. This can take up to four weeks. Still, this is much faster than a bank loan. The average time-span between application for a bank loan and loan disbursement is, according to our interviews, 2-3 months.

4.1.3 Weaknesses of Moneylenders

As mentioned above, moneylenders not only have strengths, they also have weaknesses. These weaknesses affect their lending to SSEs in a negative way. Three weaknesses are of high relevance here: high interest rates, lack of constant access and access to large and long-term loans, and inadequate legal enforceability.

108 Moneylenders whose maximum loan volume is up to LKR 100,000 are considered to be small-scale lenders.

109 See Robinson (2001), p. 185; Zander (1994), p. 5.

110 See Christen (1989), p. 17. von Pischke (1996), p. 185; Sanderatne / Senanayake (1989), p. 132; ADB (1990), p. 192; Zander (1994), p. 6.

4.1.3.1 High Interest Rates and Low Competition

High interest rates have always been regarded as the major problem associated with moneylenders' activities. Today the debate has become more diverse. One prominent view is still that moneylenders exploit their borrowers by charging high interest rates. The opposing view maintains that moneylenders charge a fair price for the product they provide. In addition, there is a continuum of more differentiated views in between.[111]

Accordingly, two questions have to be answered for our study: First, are the interest rates of moneylenders' that lend to SSEs in Sri Lanka high? Second, what is the reason for this – or, more specifically, can interest levels be explained by a lack of competition?

Interest Rates

Surveys and field studies from Sri Lanka show that the interest rates charged by moneylenders vary greatly. Table 6 lists the results of these surveys and field studies. However, most of the information is based on surveys which date back to the 1970s and 1980s and were conducted mainly in rural Sri Lanka, excluding urban areas. Only Sanderatne / Senanayake (1989) provide information on moneylending to small enterprises. They estimate that smaller business are required to pay an interest rate of 3-5 % monthly.

Table 6 shows that a large part of the loans provided by moneylenders are disbursed at very low interest rates, or even interest-free, while at the same time there is a large segment in the range of more than 100 % annually. Less expensive loans are extended mainly by non-commercial moneylenders such as relatives and friends. Professional moneylenders charge the highest rates.[112]

These findings were in the main confirmed by our study. Family and friends were an important source of credit for our SSEs. These loans were provided without interest. Typical interest rates vary between 5% and 10 % monthly. However, they can range much higher, as is shown by one example in which credit was provided to about 300 shopkeepers at an interest rate of about 17 % monthly.

Thus, considering that moneylenders tend to have low transaction costs and low default rates, the answer to the first question is that the interest rates that moneylenders charge for SSE credits are in fact high. Even if inflation (about 9% p.a. on average in 1996-2000[113]) is taken into account, a nominal interest rate of 5 % monthly means a real rate of 53 % p.a. This leads us to the second question: Are these high interest rates based on a lack of competition?

Competition

In the literature one criterion used to measure the degree of competition among moneylenders is borrower mobility, which is bound up with a certain borrower dependency that makes it virtually impossible for the borrower to switch from one moneylender to another. Another criterion is the number of potential moneylenders in a given area, often very limited because many people lack either the funds to lend or the necessary information about borrowers.[114]

We went beyond the literature and used three different criteria to assess the degree of competi-

111 See Bolnick (1992), p. 62; Germidis / Kessler / Meghir (1991), pp. 200-201, pp. 206-207; Robinson (2001), pp. 177-182.

112 See Sanderatne (1992), p. 89; Zander (1994), p. 5; Fernando (1988), p. 255.

113 See http://www.economist.com/countries/SriLanka/profile.cfm?folder=Profile-FactSheet.

114 See Germidis / Kessler / Meghir (1991), p. 180; Schrader (1992), p. 78; Bolnick (1992); p. 57, p. 63; Robinson (2001), p. 184.

Table 6: Overview of Empirical Studies on the Interest Rates of Moneylenders

Interest rates in the informal sector – I

Survey	Nominal interest rate (p.a.):	Credit volume in % of total credit:
Survey: Central Bank of Ceylon, Survey of Credit and Indebtedness among Paddy Farmers, 1979 Source: Sanderatne (1992), p. 92	0 %	54 %
	0-20 %	14.6 %
	20-100 %	7.0 %
	100-... %	24.3 %

Interest rates in the informal sector – II

Survey	Nominal interest rate (p.a.):	Credit volume in % of total credit	Real interest rate (p.a.):
Survey: Central Bank of Ceylon, Report on Consumer Finance and Socio Economic Survey, 1981/82 Source: Fernando (1992), p. 252	0 %	42.9 %	- 12.4 %
	0-30 %	20.3 %	- 12.4-13 %
	30-100 %	18.1 %	13-75 %
	100-... %	18.7 %	75-... %

Interest rates of professional moneylenders

Survey	Nominal interest rate (p.a.):	Credit volume in % of total credit:
Survey: Central Bank of Ceylon, Survey of Credit and Indebtedness among Paddy Farmers, 1976. Source: Fernando (1992), p. 255	0-11 %	6.6 %
	11-25 %	42.4 %
	25-100 %	42.6 %
	100-... %	8.4 %

Average interest rates on loans and deposits (p.a.)

Survey	Type of lender:	Semi-urban Mabodale	Remote Rural Makkaduwawe
Survey: Two field studies in Mabodale and Makkaduwawe (1990). Source: Zander (1994), p. 5	Friends / relatives	0 %	0 %
	Professional ML	151 % p.a.	165 % p.a.
	Traders	50 % p.a.	0 %

Urban Moneylenders

Source: Sanderatne / Senanayake (1989), p. 132	Interest rates are mostly per month or day.
	Petty traders pay about 10 % per day.
	For direct lending, small and medium-sized enterprises pay 3-5 % p.m.
	For non-direct loans, larger enterprises pay 5-10 % p.m.

Professional Moneylenders

Survey: One hundred questionnaires in each of four villages and towns. Source: Olsen (2001), p. 24	Typical interest rates are 10, 20, or 30 % p.m.

tion among moneylenders in the areas under consideration. The first criterion is **borrower mobility**, i.e. the opportunity to switch from one moneylender to another or to use various moneylenders at the same time. The second criterion is **interest rate differentials** in a given area. In this case, it has to be taken into account that not all moneylenders provide identical products – a factor that may explain different prices (interest rates) – and that it is quite difficult to obtain a clear notion of the limits of borrower mobility in a given area. As a third criterion, we analysed the **choice of a first-time borrower** made by different moneylenders.

The **mobility of moneylenders' clients** is limited, and this creates space for monopolistic practices. There is only limited competition for clients who are already considered to be the client of another moneylender. The moneylenders from our sample explained that a client does not switch from "his" moneylender to another moneylender. When moneylenders talked about "their" clients, they meant not only clients borrowing from them but also the fact that *"clients belong exclusively to one moneylender."* The issue can be illustrated by an example: One moneylender told us that there are five moneylenders in her village. However, moneylender A would never accept moneylender B's clients. In a similar sense, another moneylender noted that every moneylender has his own set of clients and rejects the clients of other moneylenders.

These statements demonstrate that once a relationship to a client has been established, a moneylender considers him to be "his" client and other moneylenders will be reluctant accept him as a borrower. There is an interesting case which illustrates the respect accorded to these "rights" to a client: A moneylender works with a broker who introduces new clients to him. The broker charges the client 1 % interest p.m. in addition to the moneylender's interest rate. After some months or years, the moneylender will be able to judge the client's repayment capacity by himself, but he will never give him direct access – saving him the broker's 1 % – because this is, and must remain, the broker's contact. Clearly, there are other reasons not to accept other moneylenders' customers, e.g. low client repayment capacity.

Even though moneylenders do not break into existing moneylender-borrower relationships, moneylenders are still in effect forced to abide by certain criteria of competitiveness. Otherwise they risk losing clients, for example if one moneylender increases his interest rates. Consequently there are limits on the room for monopolistic manoeuvre. In order to avoid losing clients, one moneylender pawned some of his property to increase his fund. Another moneylender states: *"If you are fair, borrowers come to you."* If he charged higher interest rates, he would be in danger of losing his clients. Similarly, one moneylender states that although every moneylender has his own set of clients, competition from 5-6 moneylenders in Maskeliya prevents him from raising his interest rates.

Many moneylenders express the idea of a certain standard of competitiveness by distinguishing between two types of moneylenders with regard to their interest rates. Two of them claim that borrowers will first try to obtain credit from moneylenders who charge about 5 % interest p.m.. These customers will approach "those expensive moneylenders" only if they are rejected by the first type.

The second criterion – **interest rate differentials** – confirms that there is in fact room for monopolistic practices. Interest rates vary between 2-8 % in Maskeliya, 2.5-10 % in Negombo, or 3-10 % in Nuwara Eliya. Although it is difficult to establish exact geographical limits of borrower mobility, the existing interest rate differentials are an indication of a lower level of competition.

As regards the third criterion – the **choice of a first-time borrower by different moneylenders** – analysis of our empirical results show that competition is not only a matter of opportunities to change financial providers, but also a matter of the choice of a first provider. In this case competition appears to be stronger and room for monopolistic practices smaller. A statement made by one interviewee demonstrates the way in which competition for new clients may influence moneylender business practices: *"Yes, once a new client wanted to get a loan for 4 % instead of 5 %. I rejected. However, then I changed my mind and offered the client 4 % interest rate for his loan."* Another moneylender maintains that he is strict with his rates, not lowering them for anybody. Yet at the same time he confirms that there is competition by stating that *"borrowers ask various moneylenders before taking a credit."* Moreover, the fact that moneylenders seek contacts with new clients supports the observation that there is a certain measure of competition for good new clients.

However, competition for new clients does not imply that every borrower has the same range of choices, or indeed any choices at all. Customers who are not considered good clients may be forced to enter into a credit relationship with one of *"those expensive moneylenders."* Moreover, degree of remoteness and diversity of contacts also play a role in a borrower's freedom of choice. In this case, regional differences come into the picture. For some of the tea estate workers around Maskeliya, the moneylender was the only contact to the world outside the tea estate, and this of course means a considerable reduction of competition.

This confirms the view of the Asian Development Bank that moneylenders perform the function of a *„lender of last resort"*[115] for borrowers who do not have access to credits from other sources. Consequently, often poorer people and sometimes SSEs have to pay the highest interest rates.[116] This is also the finding of another field study which has been recently conducted in Sri Lanka.[117]

To sum up, interest rates of moneylenders are high and may be explained in part by lack of competition. However, there is some competition among moneylenders, particularly competition for new good clients.

4.1.3.2 Access: Lack of Constant Supply and of Large Long-term Credits

One of their weaknesses is that moneylenders are unable to provide either constant access to credit or large and long-term credits. One feature common to all types of moneylenders is that they use their own personal funds for lending, and these are limited and at times unavailable. Unlike banks, they generally do not have other people's saving deposits at their disposal. It is therefore argued that moneylenders as individuals are not a reliable constant source of credit.[118] However, there are also people who take out formal loans and use them for informal on-lending.[119]

The empirical results confirm this weakness, but our explanations go far beyond the literature. Two questions derive from these considerations: First, does the volume of funds available to moneylenders in Sri Lanka constitute a crucial constraint which leads to unsteady access to credit or a lack of large and long-term credit? Second, do moneylenders in Sri Lanka rely exclusively on their own funds or do they have access to other sources of finance?

Concerning the first question, our interviews showed that the financial resources available were perceived by most moneylenders as a major constraint for their moneylending business. Although most moneylenders have access to other sources of finance, they are sometimes unable to satisfy the credit needs of their clients for lack of sufficient funds. If they do not have the necessary

115 ADB (1990), p. 192.

116 See von Pischke (1996), p. 184; ADB (1990), pp. 195-196.

117 See Olsen (2001), p. 24.

118 See Ledgerwood (1999), pp. 93-94; Christen (1989), p. 15; ADB (1990), p. 188.

119 See Schrader (1992), p. 78; ADB (1990), p. 191. Sanderatne / Senanayake (1989), p. 131 also report that urban moneylenders act as financial intermediaries, taking small savings and lending larger sums. Also, in our sample one moneylender took the pension fond of tea estate workers as savings, paying 4% in monthly interest and lending from these sums smaller credits at 7-8 % monthly interest.

funds available, moneylenders often offer a volume smaller than the sum requested, or access may be delayed because the moneylender has to wait for another borrower's repayment, or the moneylender may need time to obtain the money elsewhere.

Limited financial resources are also the reason why credit is provided only for the short term. By fixing shorter periods moneylenders can better control their money: a moneylender can decide either to prolong the credit period – as often requested by borrowers – or to call on the borrower to repay the credit. Although moneylenders can be quite flexible with their repayment periods, there is no fixed time horizon for the borrower.

Compared with data on the volumes and periods of bank loans to SSEs, the findings of the qualitative analysis of our interviews with moneylenders on the fund constraint as well as on credit volumes and periods are also confirmed by the more quantitative results of our SSE interviews. These are summarised in Table 7.

Table 7: Credit Volumes and Lending Periods: Moneylenders as Compared with Banks

Credit volume	Credit period
24 SSE loans from MLs:	22 SSE loans from MLs:
Median = LKR 25,000	8 loans = not fixed
21 loans ? LKR 50,000	10 loans ? 6 months
3 loans ? LKR 50,000	4 loans ? 6 months
26 SSE loans from banks:	25 SSE loans from banks:
Median = LKR 205,000	Average = 36 months
10 loans ? LKR 50,000	4 loans ? 6 months
16 loans ? LKR 50,000	21 loans ? 6 months

Source: Author's survey

Whereas the evidence on the first question indicates that there is a fund constraint, the findings of the interviews on the second question outline some of the dimensions of the problem. It is not simply a problem of being limited to their own personal funds – moneylenders do use other financial sources for their business – but nevertheless their financial capacity remains limited.

Apart from their own personal funds – and moneylenders do usually not keep separate accounts for their official main business and their moneylending activities – moneylenders use banks and ROSCAs as sources of finance and they exchange funds with other moneylenders.

Banks provide moneylenders with funds either through loans or through overdrafts. For example, one moneylender informed his bank that he needed a loan for his shop; and he later used the loan for his moneylending business. Similarly, another interviewee obtained a loan of LKR 200,000 which is now the working capital of his jewellery shop and his moneylending business alike. Another moneylender obtained an even larger bank loan of LKR 1,000,000 at an interest rate of 2.5 % p.m.; he also lends the money on.

Bank overdrafts are used by moneylenders mainly as *"a buffer for lending."* Although there are no exact figures for all interviewees, two examples may serve to illustrate the issue: One moneylender has an overdraft limit of LKR 100,000, whereas the other's overdraft limit is LKR 40,000. Both use their overdrafts for moneylending. The importance of overdrafts is also confirmed by moneylenders who are without one: one example is a moneylender who wishes he had an overdraft in order to be able to satisfy additional demand for credit, while another moneylender complains that the bank has cancelled his overdraft. However, not all moneylenders who have an overdraft use it for lending. Some moneylenders we interviewed have a bank overdraft, but they do not use it for lending because the risk posed by defaulting or delaying clients is too high. In these cases moneylending is not likely to be the first priority of the respective moneylenders, and they prefer to preserve good relations with their bank for other business needs or important consumption-related spending.

The main advantage of refinancing through banks is obviously the low interest rate, which leaves a profit margin for the moneylender, or which may even be passed on to the borrower without loosing competitiveness. One major disadvantage, however, is that banks are less flexible with repayment than other sources. One moneylender borrows from a "friend" – probably another moneylender – and from a bank to refinance his moneylending business. However, he prefers the "friend" because the bank is very strict on repayment and he must anticipate difficulties if a borrower delays repayment.

ROSCAs are used by moneylenders - either as members or as organisers - to refinance their lending. Two of our interviewees are members in three different ROSCAs, and both use the funds for lending. Another moneylender is a member in five auction ROSCAs and bids for funds in one of them *"when a trustworthy client needs credit."* Being a member in more than one ROSCA is clearly an advantage for moneylenders, because this enables them to avoid having to bid for an early fund. Bidding early for funds involves high costs. In order to avoid an early bid, a moneylender has to choose ROSCAs whose starting dates are distributed evenly over the year.

Three of the moneylenders interviewed are ROSCA organisers. One source of finance for them is that, as ROSCA organisers, they can obtain the first or the second fund without bidding and can use this fund for lending. In addition, the contributions are sometimes collected well ahead of the distribution of the fund, and the ROSCA organiser can lend on these contributions in the meantime. However, the contributions can be used only for short-term credits of up to one month at the maximum because the moneylender has to disburse the fund every month to one of the members.

Generally, membership in a ROSCA corresponds very well with the liquidity needs of moneylenders. A moneylender's incoming cash flows consist of small regular interest payments and his outgoing cash flows tend to be larger, irregular sums. This case is reversed for a ROSCA member. His outgoing cash flows are small regular contributions to the ROSCA, and his incoming cash flows are large, irregular sums across the overall cycle.

Nevertheless, there are also some costs involved in participation in a ROSCA. Although ROSCA membership is not very time-consuming, membership in three or more ROSCAs definitely entails some time-related opportunity costs. Moreover, bidding is sometimes in an early phase of the cycle, and this leads to high implicit interest rates.

Various statements of interviewees show how the exchange of funds between moneylenders is organised. One moneylender refers to an instance in which she refinanced another moneylender, and another moneylender has offered her the same service. One other moneylender has an arrangement that allows him to use other moneylenders' funds for a commission of 0.5-1 % p.m. The same applies for a third moneylender. He is able to obtain funds from other moneylenders at a rate of 3-4 % p.m. Often moneylenders speak of giving a fund to so-called brokers for on-lending. There are different profit-sharing arrangements for the co-operation between moneylender and broker. The moneylender may charge his normal rate, with the broker adding something between 1% and 5% p.m., or the moneylender may lend to the broker at a preferential rate about 1 % lower than his normal rate, and again the broker will add his profit margin. However, access at a rate of 0.5-1 % p.m. is an exception.

Access to other moneylenders' funds extends a moneylender's lending capacity beyond his own personal funds. The need for the lending moneylender to co-operate is bound up with the fact that although he has the funds, he may not have the contacts he needs to lend to a client. What this means is that exchanging funds is a reasonable and profitable strategy for both parties concerned. In addition, it also means better access for borrowers.[120]

These various sources of finance show that on the one hand moneylenders are able to extend their financial capacity beyond the limits of their own personal funds. On the other hand, it also demonstrates that financial resources are scarce for moneylenders as well. Their funds are therefore often not sufficient to guarantee constant access to credit or to provide large and long-term credits.

4.1.3.3 Lack of Legal Enforceability

As actors of the informal financial sector, moneylenders usually have no access to legal institutions. Thus they lack the legal means to enforce repayment of their credits. This is considered a weakness of moneylenders because it has negative impacts on borrowers. Borrowers are more directly affected if the moneylender uses threats (and acts) of violence in the place of legal enforcement.[121] The effects are more indirect if the moneylender decides to ration credit due his lack of legal recourse and the risk of default. In the first case, the borrower's physical integrity is endangered, in the second he is barred from access to credit.

Our study gave rise to two questions involving the context of legal enforceability: First, what is the legal situation of moneylenders in Sri Lanka? Second, how does the legal situation affect the moneylending business?

The relevant source for the first question is the Money Lending Ordinance of 1918. The Ordinance is a six-page document stating that moneylending is in principle a legal activity and defining the legal conditions for it. Apart from more vaguely defined issues such as a ban on lending based on "*undue influence,*" "*harassing or intimidating*" borrowers and requiring "*a regular account of each loan,*"[122] the Ordinance sets out exact limits for interest rates. The interest rate for a loan of more than LKR 2,500 may not exceed 15 % p.a., and the total amount paid in interest may not be more than the principal.[123]

A rate of 15 % p.a. is lower than the interest rate moneylenders actually charge. However, the Ordinance allows a higher rate only in cases in which "*the creditor ... shall satisfy the court that ... the rate charged was in fact reasonable.*"[124] Thus, as a rule, moneylending is legally not possible as a professional business and is permitted only as an exception under vaguely defined conditions.

On the other hand, we learned from our counterpart, the People's Bank, that promissory notes – documents often used by moneylenders to secure credits and prove the validity of a claim – are legally enforceable in Sri Lanka. Promissory notes are also mentioned in the Money Lending Ordinance as a legal instrument. However, the note must set out the interest rate charged.[125] Consequently, a moneylender would still have to prove that an interest rate higher than 15 % p.a. was appropriate.

In Sri Lanka the majority of moneylenders neither use the legal system to enforce repayment nor need to fear any legal persecution, except by the tax authority. Although some moneylenders state that they could go to court to enforce repayment

120 The exchange of funds among moneylenders also demonstrates that funds are not the only constraint – contacts to good clients are a second constraint (if not, there would be no reason to co-operate for the lending moneylender who has the funds).

121 See Christen (1989), p. 25.

122 Money Lending Ordinance (1918), p. 140, p. 143 and p. 142.

123 See Money Lending Ordinance (1918), pp. 140-141.

124 Money Lending Ordinance (1918), p. 141.

125 See Money Lending Ordinance (1918), pp. 143-144.

of credits, most of them prefer not to do so. First, moneylenders fear losing the trust of other borrowers. Second, the legal system in Sri Lanka is seen as very slow.

To come to the second question, i.e. whether legal enforceability lacking or at least not operable - how do moneylenders deal with enforcement? In our interviews at least some moneylenders admitted that they threaten their borrowers, or as one moneylender said to us: *"I talk to them properly."* Moreover, at least two of the SSEs interviewed showed outright fear of their moneylender. The following statement of another moneylender seems to confirm that borrowers commonly expect that a moneylender may use violence or threats: *"People come to me because I am not an aggressive person."* Altogether it is reasonable to assume that the problem is more widespread than we have been able to establish. Clearly, due to the nature of the topic not all moneylenders were willing to talk about it.

The problem of legal enforceability is a twofold one: it is not only a threat to borrowers but also a risk for moneylenders. Although most moneylenders have very low default rates, many perceive default as one of their main problems. An extreme example is a moneylender who stated that the business was very risky for him, although he never had a single defaulter in 20 years of moneylending. This may be explained by the fact that the probability of default is low, though due to the lack of legal enforceability losses in cases of default are high.

To sum up, both problems – threats and credit rationing – are part of the moneylending business in Sri Lanka. However, our empirical finding indicate two other ways in which moneylenders deal with the lack of legal enforceability.

One way to deal with defaulters is to co-operate with other moneylenders and exchange information on the *"trustworthiness of borrowers."* One moneylender explains: *"We [*moneylenders*] meet in our Seetu [ROSCA] and exchange information about good and bad clients."* Others, however, emphasise that the exchange of information mainly concerns *"bad clients"* or *"defaulters."* Exchanging information on bad clients has two functions: First, it serves as a warning against lending to a defaulter. Second, it serves as a sanction mechanism and an incentive for borrowers to repay. Most moneylenders state that if a borrower defaults, they will never lend to him again. However, this becomes an even stronger incentive when the consequence of default is not only the impossibility of obtaining credit from his moneylender again, but a defaulter will be unable to obtain credit from any other moneylender.

This approach to dealing with defaulters may be preferable to violent acts. But it is not in line with the general principles of the insolvency process, because the defaulter is personally marked and will never have a chance for a fresh start with a new business.

The other approach, as we learned from one moneylender, is to go to the **Mediation Board** with a defaulting client. The Mediation Board is a local institution organised by the central government. Such boards exist in all 250 electorates of Sri Lanka. "Minor" disputes have to be brought to the Mediation Board before they can be addressed in court. Major crimes are not considered. Mediation is free of charge, apart from a fee of LKR 5. Only if both parties agree to mediation can a settlement be reached. If the two parties fail to agree, the Mediation Board issues a statement, and the parties can go to court.[126]

The Board consists of 15-25 members of different religions who may not be members of any political party. Selection of members is based on a central government decision. Accordingly, the Board is attached not to local government but to the national government, with the local or regional government proposing the candidates. After selection, the members participate in a one-week workshop on mediation. Once constituted, the Mediation Board meets every week. In the case of

126 See Mediation Boards Act, No. 72 of 1988. Published as a Supplement to Part II of the Gazette of the Democratic Socialist Republic of Sri Lanka of December 23, 1988.

a loan dispute between a moneylender and a client, the moneylender can expect to secure repayment of at least a part of his loan. The client, on the other hand, will as a rule not have to repay the whole amount. Moreover, moneylenders do not have to fear any legal persecution in this connection.

A member of the Mediation Board in Maskeliya informed us that there is an agreement that the interest rate must not exceed 100 % p.a. if it is to be eligible to a settlement before the Mediation Board. This would be (for loans of less than 1 year) in accordance with the stipulation in the Money Lending Ordinance that interest payments may not exceed the principal of the loan. In the case of the moneylender we interviewed, the borrower had to repay the principal, but his interest payment was cancelled. Thus the moneylender was unable to avoid a loss, but his potential loss was reduced substantially. A typical outcome could also be, according to the Mediation Board in Kandy, that the borrower is required to pay only 50 % of the interest previously stipulated.

4.2 The Credit Supply Provided by Rotating Savings and Credit Associations (ROSCAs) to SSEs

Next to moneylenders, ROSCAs, which are called Seetus in Sri Lanka, are the most common providers of financial services in the informal financial sector in Sri Lanka.[127] ROSCAs are institutions with a long tradition. They exist in many developing countries, in rural and urban regions alike.[128] ROSCAs can be seen as a promising opportunity for those who have no access or only restricted access to the formal financial system.[129] They are very appropriate creators of credit and savings because they work on a sustainable basis.[130] ROSCAs can provide SSEs with a variety of financial services. ROSCAs are an important source of credit and savings for SSEs, and most ROSCA organisers and members we interviewed are small entrepreneurs.

The first part of this section defines what a ROSCA is and defines the framework for our analysis. Furthermore, it outlines the different characteristics of ROSCAs (4.2.1). The second section (4.2.2) will illustrate the role of ROSCAs as a source of credit and savings for SSEs. The last section will analyse the strengths and weaknesses of ROSCAs (4.2.3 and 4.2.4).

4.2.1 Characteristics of ROSCAs

Ardener defines a ROSCA as *"an association formed upon a core of participants to make regular contributions to a fund which is given, in whole or in part, to each contributor in rotation."*[131] The definition contains the two crucial principles that distinguish ROSCAs from other savings associations: rotation and regularity.[132]

In Sri Lanka, ROSCAs normally reorganise after one cycle. We interviewed ROSCAs that have already existed for 20 years, and most of them exist for four to five years. They always repeat the cycle once it has been completed.

ROSCAs are highly heterogeneous. It is important to mention some features in order to define them precisely: Some ROSCAs have different kinds of official positions, such as the organiser, the secretary and the treasurer.[133] Some ROSCAs do not have an organiser at all, whereas others have more than one.[134] The organiser's task is to collect

127 See Padmanabhan (1996), p. 45 and Matin, et al. (1999), pp. 13-14.

128 Asian Development Bank (1990), p. 198.

129 See Kimuyu (1999), p. 1299; Tchuindjo (1999), p. 15.

130 See Von Pischke (1992), p. 326.

131 Ardener (1964), p. 201.

132 See Ardener (1964), p. 201.

133 See Ardener (1964), p. 211.

134 See Ardener (1964), p. 211.

member deposits and to give the entire fund to the member whose turn it is to receive it.[135]

The ROSCAs we interviewed in Sri Lanka all have one organiser who at the same time is the treasurer of the association. He always receives the first fund (in ROSCAs that draw lots) or the second fund (in ROSCAs that auction the fund).[136]

Box 6:	**Typical Operation of a ROSCA**
A ROSCA with ten members that meets once a month may serve as an example: since there are ten members, the cycle takes ten months. During a defined cycle, the first member receiving the fund is a debtor to the other members until he has made his last contribution. The last member to receive the fund is a creditor to the other members. The duration of the cycle depends on the number of members and the frequency of meetings. Once each member has received the fund, the cycle is completed and the ROSCA disbands or reorganises.[a] To obtain another fund, members have to wait until the next cycle begins, provided that the ROSCA reorganises. Loans are a one-off event.	
Source:	See Ardener (1964), p. 201; Bouman (1995), p. 374.
a	Round is used to refer to each contribution, whereas the term cycle is used for the complete set of rounds

This is a kind of remuneration for the duty he performs. If a member defaults, the organiser is responsible for compensating the other members for their losses; he pays the contributions of the defaulter, in this way guaranteeing a regular functioning of the ROSCA.[137]

The mode of operation of ROSCAs is determined by the different methods used to decide the order of rotation. According to Ardener, there are five important methods used to determine the order of rotation: The order may either be determined by consent of all members or fixed by the organiser.

135 See Krahnen /Schmidt (1994), p. 46; Adams / Canavesi (1989), p. 228 and p. 232.

136 The different methods used to determine the order of rotation are described in the following paragraph.

137 For similar findings, see Fernando (1986), p. 26.

In both cases, members who urgently need money often obtain the fund at the beginning of the round. Another possibility is to proceed on the basis of predetermined factors such as age or kinship. Some of the more technical methods include the system of drawing lots[138] and the auction mechanism.[139] These are reported to be very important modes of operation.[140]

Our empirical findings from Sri Lanka indicate that ROSCAs operate on the basis of two different systems: a system based on lots and an auction mechanism. In the former, numbered lots are put in a bowl and every member draws one. The numbers correspond to the number of members, except the organiser, who is given the first fund. The number drawn indicates the round in which a member will receive the fund. Members receive the same amount from the fund that they contribute to it. Only in a very few ROSCAs do members have to pay a commission to the organiser when they receive a fund; this may range between 0.5 and 1.3 % of the fund's total amount.

The auction mechanism in Sri Lankan ROSCAs works as described above. In auction ROSCAs, the organiser always receives the second fund without having to bid.[141] The auction mechanism is more complicated than drawing lots. The condition on which it rests is that at least some members will be willing and able to bid a high sum to get the fund. If they are not willing or able to bid, they have to wait until the end of the procedure.

138 To compensate the member who drew the last lot, the ROSCA may put him at the beginning of the next cycle. This member now has the option to pool both funds and make larger investments. See Bouman (1995), p. 379.

139 See Ardener (1964), pp. 210-211.

140 See Kovsted / Lyk-Jensen (1999), p. 145.

141 The same or similar findings have been made by Sanderatne and Senanayake and Fernando. See Sanderatne / Senanayake (1989), p. 141; Fernando (1986), pp. 25-26.

Box 7: Operation of an Auction ROSCA
Auction ROSCAs work on the basis of an open auction. Only members who have not already received the fund are allowed to bid. An example will used to illustrate the mechanism: the fund may contain a hundred units (ten members paying ten units). A member may opt to take ninety-five instead of a hundred units. Another member may be willing to accept an even lower sum, e.g. ninety units. The member offering the lowest sum is given the fund. The difference between the nominal fund and the effective fund can be seen as an interest rate on the fund (in this case, the interest rate would be 10 %). This sum (interest rate) is divided up among the members as compensation for their regular contributions. The ten units (100 – 90) are broken down by individual contributions (10 units), so that every member has to pay in only nine units in the next round. Since this is repeated in all the following rounds, the effective interest paid is not as high as it may seem and may be considered moderate. Individuals who bid relatively small sums in the early rounds of the ROSCA cycle pay relatively high rates of interest on their loans, while individuals who consistently offer high sums and receive their fund towards the end of the cycle realise relatively high interest rates on their deposits. This system makes it possible to compensate for the advantages or disadvantages involved in any particular position in the order of rotation.
Source: Authors' compilation

Although this might lead to the assumption that auction ROSCAs, being more flexible, would be more frequented by SSEs, we found that both auction and lot ROSCAs are equally relevant for SSEs, particularly with regard to their size, monthly contributions and fund volumes (see Table 8).

Table 8: Difference between ROSCAs as Regards the Order of Rotation in Sri Lanka

Indicators	**Auction ROSCAs (13)**	**Lot ROSCAs (7)**
Average size (members)	15.6	15.4
Average duration (months)	13.5	12.8
Average monthly contribution (in LKR)	12,190	13,000
Average monthly fund volume (in LKR)	193,000	190,000

Source: Authors' survey

According to the literature, the organisation of ROSCAs differs considerably in terms of size and frequency and meeting place. The size of an association may vary between five and several hundred members, the average size being between ten and fifty.[142] Some ROSCAs meet weekly or every two weeks; others meet only every few months. The average frequency of meetings is one per month. The money involved may be collected at a special meeting house or a member's house, or the members may meet at the organiser's house, in the marketplace or a beer-hall.[143]

In Sri Lanka, almost all ROSCAs that we interviewed meet monthly. One experienced organiser of lot ROSCAs declared that they only meet once, the first time, when the lots are drawn. After that, the members bring their contributions to the organiser or he collects them and hands over the fund to the due recipient. However, the entire group no longer meets. The average size of the ROSCAs interviewed is 15.5 members, and the average duration of a ROSCA is 13 months. The reason why these figures do not correspond is that some ROSCAs meet not monthly but weekly or every ten days. In other ROSCAs it is possible for

142 See Schrieder / Cuevas (1992), p. 49.

143 See Ardener (1964), p. 211.

members to contribute for two members and receive double the amount of the fund. This accelerates the cycle. ROSCAs in Sri Lanka normally meet at the organiser's house or shop.

Membership can be determined by geographical proximity. This is especially true for rural areas. Other important criteria for membership are profession, sex, age, kinship and religion. Social or ethnic criteria may play an important role as well.[144]

Our empirical findings from Sri Lanka indicate that trust is a very important element in most ROSCAs, though not in all of them. Organisers choose their members because they trust them as persons whom they know and in whose financial capacities they trust. Many organisers stated that they had already known the other members for a number of years.

In some ROSCAs, the element of trust is not very important. They come together because the members' financial resources are similar in nature and members have, roughly speaking, the same professions and similar social backgrounds. In this case, the organisers base new memberships mainly on inquiries conducted into potential participants. It is important for the organisers to be sure that members are able to pay their regular contributions. Members are therefore normally expected to have a prospering business, which guarantees their savings capacity, creditworthiness and reputation.[145]

Contributions may be made in cash or in kind; combinations of both are possible as well. To accelerate the cycle, two members can pay double contributions and receive their funds at the same time; or members may pay more than one contribution into the fund and accordingly receive more than one loan. Since ROSCA members make equal or similar contributions, their income situation has to be similar. A group is therefore usually quite homogeneous in terms of member incomes.[146]

In Sri Lanka we encountered only ROSCAs in which members are allowed to contribute in cash. We did not interview any ROSCAs whose members are allowed to pay in kind. In some ROSCAs, members can pay with on-dated or post-dated cheques. On the one hand, this can be seen as a special service of the organiser aimed at making it easier for members to make regular contributions when they are short of cash. On the other hand, this is a kind of insurance for the organiser, because when members lack the necessary cash, he at least has a cheque to ensure payment.

It is important to mention that in general contributions are made when the ROSCA meets, which is monthly in most cases. However, there are some members who are required to pay their contributions daily. These appear to be less trustworthy members, and the organisers use this kind of "control" to ensure regular payment.

4.2.2 ROSCAs as a Source of Credit and Savings for SSEs

ROSCAs offer financial and social services to their members on a rotating basis. Their financial services are explicitly characterised by the term *Rotating Saving and Credit Association*: they facilitate savings and provide credits for their participants.[147] Thus ROSCAs assume a financial intermediation function between savers and borrowers. *"It is traditional, as the name indicates, to analyse the ROSCAs in terms of financial intermediation: Members of the group receiving the kitty are seen as the 'borrowers' ... The members who have not collected the kitty yet are net savers who accumulate claims on those members who have already collected the kitty and*

144 See Ardener (1964), p. 210; Germidis / Kessler / Meghir (1991), p. 152.

145 Fernando comes to the same result. See Fernando (1986), p. 26.

146 See Bouman (1995), p. 374.

147 See Sika / Strasser (2000), pp. 316-317.

are the net borrowers."[148] Because of the rotation of the fund, its capital is always in the hands of one member and therefore used.

We can thus distinguish between two kinds of financial services of a ROSCA: The first is to provides possibilities to save money. The reciprocal agreement between the members even forces them to save regularly. Also, participating in a ROSCA keeps member resources from being absorbed by their families. In this way members are able to control their cash flows throughout the year.[149]

The second function of a ROSCA is transformation of the volume of savings: having saved a fixed sum regularly for a certain period of time, a bigger sum of money is available to the saver in a period of time shorter than if he were saving individually. Members who receive the first fund may even be able to obtain a lump sum of money without having saved beforehand. This may be regarded as credit, and members repay their "debts" by paying their contributions regularly.[150]

Furthermore, ROSCAs are perceived as less intimidating than banks or other financial institutions, and the credit they provide is not bound to any specific ends. Members can use their fund for whatever purpose they want, without being obliged to document its use.[151] ROSCAs represent an important source of finance for SSEs, because in such cases enterprise and family are often inseparable and SSEs often need credits that are not directed to a specific use.

There are **business-oriented ROSCAs** as well as **consumption-oriented ROSCAs**. Business-oriented ROSCAs usually operate with a long-term perspective. Thanks to their profitability, members often join together again at the end of each cycle. Consumption-oriented ROSCAs have a shorter duration and regularly disband at the end of the cycle.[152] This difference results in different uses of the fund. These may range from consumption- or production-related uses to investment-related purposes. In urban areas, ROSCA members often use their funds for investment purposes. They may invest in their own businesses or in an expansion of their business activities. In rural areas, where many ROSCA members are farmers, the ROSCA fund is mainly used for production purposes. Members may invest in fertilisers, seeds or other equipment, in labour or in means of transport.[153]

The **social function** of ROSCAs is a more implicit one. Since ROSCA members set their own rules, the mechanisms are easy for them to understand and do not constitute an obstacle to participation. Furthermore, the rules are consistent with the accepted norms of the society in which ROSCAs are set.[154] The commitment of their members makes it possible for ROSCAs to offer a kind of social security, which in most developing countries is not provided by the state or other formal actors. "*It is the commitment to participate in these rotating credit societies which gives the psychological impetus for contributing the agreed amounts.*"[155] In addition, members use the meetings to exchange information and news and to help one other.[156]

Our interviews have shown that most members and all organisers of the ROSCAs we looked into are businessmen who belong to the group of SSEs. In most ROSCAs all members, including the organiser, are small entrepreneurs. Four of our ROSCAs are mixed groups in which some of the members are SSEs and the others are civil servants or employees. In Maskeliya and Kandy we did not interview any mixed ROSCAs. These

148 Callier (1990), p. 274.

149 See Sika / Strasser (2000), p. 317.

150 See Krahnen / Schmidt (1992), pp. 47-48.

151 See Tchuindjo (1999), p. 15.

152 See ADB (1990), p. 203.

153 See Bouman (1995), p. 373; Germidis / Kessler / Meghir (1991), p. 161.

154 See Tchuindjo (1999), p. 14.

155 Sanderatne / Senanayake (1989), p. 141.

156 See Bouman (1997), pp. 188-189.

were frequented exclusively by small entrepreneurs.

People participate in a ROSCA in order to obtain a lump sum of money without any particular complications. It can be inferred from out interviews that the motivation to participate is a kind of **liquidity management**. Members need certainty about their cash flows. As members of a ROSCA, they always know when they have to contribute. They either know when they are to receive a lump sum (lot ROSCAs), or they decide to distribute it by auction (auction ROSCAs). This makes it possible for members to plan in advance when to use the money and what to use it for. We can break them down into two groups: some of them are motivated by the credit aspect, for others disciplined saving is the incentive for participation.

The purpose of receiving a lump sum of money may be regarded as equivalent to obtaining a **credit**. This was noted by about half of the persons interviewed (organisers as well as members): they participate in a ROSCA to gain easy, cheap and fast access to credit. For some of them it is easier to get credit from a ROSCA than from a bank, because in the former case they do not need any collateral or guarantor. This is important because small entrepreneurs often cannot provide the collateral required by a bank.[157] Members who participate in lot ROSCAs mentioned that for them it is important not to have to pay any interest. One organiser noted that the ROSCA was a substitute for a bank loan. As soon as a bank were prepared to give him a loan, he noted, he would do without the ROSCA.[158]

About half of the interview partners who stated that credit is the most important motive for participation specified their motivation, noting that they needed a source of finance for their businesses. Some of them needed capital to start a business, others needed a regular source of credit for working capital. For other entrepreneurs, the motive for participation was not businesses financing but consumption, investment in assets such as vehicles or immovable goods or provision for emergency cases such as funerals or illness of family members. The need to finance weddings was also mentioned.

Some of the organisers interviewed declared that their main motivation was to obtain additional income, or to have an income in the first place. Getting regularly the ROSCA fund allows them to have extra expenses. One of our interviewees uses the ROSCA to attain a certain lifestyle. Once he has reached it, he plans to drop his ROSCA activity.

Receipt of a lump sum of money is also linked to a certain measure of discipline in savings. Some organisers stated that **discipline in saving** was one of the motives inducing them to start out organising the ROSCA. They also stated that for their members savings are an incentive to participate in the ROSCA. This is because members have to contribute regularly, and often the date, and sometimes even the hour, for contributions are fixed.

In addition, we were informed that there is certain connection between ROSCAs and moneylenders. We found that there are some ROSCA organisers and ROSCA members who are also active in the field of moneylending. These persons use the ROSCA fund for lending purposes. The ROSCA fund provides them the possibility to enlarge their liquidity and thus to engage in moneylending. Many organisers state that they lend interest-free to members when they are in financial need. The daily contributions of some members make it possible for these persons to lend out paid-in contributions for a very short period of time. This credit has to be paid back by the next disbursement of the fund. The maximum lending period is thus normally one month.

157 Banks often require land deeds or titles, which they do not possess.

158 He assumed that he is refused a bank loan because he is too young. He was 22 years old.

4.2.3 Strengths of ROSCAs

The major strengths of ROSCAs are low default rates, high flexibility concerning their adaptation to member needs, low interest rates and low transaction costs.

4.2.3.1 Low Default Rates

Since their members are selected on the basis of confidence, proximity and honour, ROSCAs are self-stabilising. The reciprocity between the members results in a kind of mutual control, so-called "peer-monitoring." This mutual control implies that no supervision of the members' use of the fund is needed. Lenders are interested in the regular contributions of net borrowers, which ensure that the net lender will get the fund later. This is closely related to the high rates of return. Since each member depends on the solidarity and aid of the others, members contribute correctly and repay credits on time. ROSCAs operate entirely on promise, trust and consent.[159]

Furthermore, ROSCA members often fear social exclusion if they default because of the pressure of public opinion within the membership. Since sanctions are more social, the repayment rate is very good – members do not want to lose their reputation.[160] This is also why ROSCAs do not require any guarantees or collateral. This makes them attractive for SSEs.

ROSCAs in Sri Lanka have a low default rate. Some organisers stated explicitly that they had had default cases. Some said that they had never experienced a default, and six declared that default and delay occur very rarely. The main reason is that ROSCAs are mainly based on mutual trust and personal knowledge.

Most of ROSCA organisers emphasise that **trust** is a very important element in their ROSCAs. They have often known their members for some years. Our interviews show that organisers do not require **collateral** from members with whom they have trustful relationships. Most organisers stated that they do not require any collateral from their members. The only condition for entry is personal knowledge and mutual trust.[161]

Another consequence of a trust-based relationship is that the majority of members pay their contributions. The **default rate** is therefore very low. First, we found that default does occur in some of the ROSCAs we interviewed. However, the organisers who noted that default occurs in their ROSCA have on average had experience with one or two default cases. Some organisers have had no experience at all with defaulters. Although they always compensate defaulters with their own money, default is perceived as a very rare phenomenon and not seen as a problem for the organisers. Only one organiser told us that it is a major problem for him when someone defaults. In this case he has to approach a moneylender or a pawnbroker to make up for the defaulter's contribution. Fortunately, in his ROSCA this has occurred only very rarely.

A phenomenon that occurs more frequently is **delayed payment**. To ensure that the ROSCA functions properly, organisers make up for contributions of members who pay late, later demanding repayment from the member concerned. In these cases, the organisers also stated that they do not regard delay as a problem because they are sure to receive their money back. Since neither members nor organisers see the ROSCA exclusively as a "credit institute," the relationship between them is both financial and social. They are therefore interested in a smooth functioning of the ROSCA, and they normally pay their contributions regularly.

In other ROSCAs where there is no personal relationship between organiser and members, organisers restrict membership to criteria other than trust. This means, for instance, that the

159 See Krahnen / Schmidt (1994), pp. 49-50; Sika / Strasser (2000), p. 317.

160 See Ardener (1964), p. 216.

161 This was stated both by the organisers and the members.

organiser may inquire for information on members' financial situations. One condition for membership is that their businesses are operating well. One organiser even requires family members to be employed in the business of the ROSCA member, in this way gaining additional assurance that contributions will be paid. Another organiser requires a guarantor for members whom he does not know very well. The same organiser also requires a cheque from members who have received their fund before having contributed the entire amount.[162] The only female organiser we interviewed stated that she requires a letter from her members, in which they confirm the regular contributions at a fixed date. If they do not pay, she would go to the police. In these ROSCAs, we cannot speak of a personal relation between the organiser and the members because the relation is restricted to the knowledge of the members' well running business. Nevertheless, it is a successful instrument to minimise the risk of default.

One point to mention is that in certain ROSCAs some members pay the monthly contribution in a lump sum and the others pay daily instalments of the contribution. An example would be a monthly contribution of LKR 12,000 per member that has to be paid on the 20th of every month, before the whole fund is disbursed to the receiver on the 30th. Some pay a lump sum of LKR 12,000 at the 20th, others pay every day LKR 400. In 30 days they contribute LKR 12,000 as well. It seems that in most cases the monthly contributions are a kind of privilege for the members because the organiser trusts them that they will contribute in time. Members, who does not seem to be trustworthy, have to pay their contributions daily.

It has been shown that the default rate is low. However, in cases, default or delayed payment happen, all organisers confirmed that they compensate default with their own money, so that every member gets the fund in time and does not have any negative consequences. This responsibility of the organiser is part of the indirect agreement between the organisers and the members. Knowing this, the members can trust the organiser because they know that they will not lose their contributions. Furthermore, all organisers stated that they exclude defaulters from the next ROSCA cycle.

4.2.3.2 Flexibility

As a result of the solidarity and the autonomy, ROSCAs are quite flexible and are able to adapt to the individual needs of members. Giving the collected contribution to the member who is most in need, the fund may serve as an assistance fund. It is also possible to transfer it to another person. If a ROSCA member is in urgent need and borrows money from someone else, he can transfer his rights to obtain the fund to this person, who does not necessarily have to be a member of the ROSCA. Paying his contributions regularly, he gradually pays back his debt.[163] Two members can split their fund, so that both have a certain sum at the early stage of the round and one share later, provided that both have the necessity to obtain a credit and to accumulate savings.[164] In the context of high social and economic insecurity, this flexibility is one of the determinants of success.[165]

Our interviews have shown that ROSCA organisers handle the ROSCAs very flexible in order to make the participation attractive for the members. Thus, we can confirm our hypothesis that ROSCAs are flexible because often the members' personal needs are taken into account from the organisers. The following analysis is based on the information we got from auction as well as from lot ROSCAs.

162 This particular ROSCA organiser emphasised his trust in his members, but it appeared that trust is in fact restricted to knowledge on of the members' businesses. We had the impression that there is no trust at all, because the collateral he requires and the restrictions he imposes are comparatively high.

163 See Ardener (1964), p. 215.

164 See Bouman (1995), p. 378.

165 See Tchuindjo (1999), p. 13.

The paying modalities are handled flexible in most ROSCAs we interviewed. In nearly all ROSCAs, members have to hand in their contributions to the organiser. However, some organisers collect the contributions from their members. On the one hand, it means a reduction of transaction costs for the members, when the organiser collects the contributions from them. On the other hand, it has the connotation that the organiser does not trust his members and prefers collecting the contributions than receiving them late or never.

Some organisers allow their members to pay with on-dated or post-dated cheques, if they do not have cash at the contribution time. This is a big advantage for the members because some members affirmed that fixed contribution dates are difficult to realise.

In some ROSCAs it is possible for a member to pay the double contribution and then get the double fund. The member can choose whether to take the double amount of the fund at the same time or to take two disbursements of the fund.

We have seen above that all organisers pay the contributions of delayers or defaulters, which is one instrument to guarantee a trouble-free functioning of the ROSCA. Furthermore, this allows members to handle their contributions in a more flexible manner. Although this is a very attractive service, it has to be considered that the organiser will accept delay only in emergency cases. Members who often pay too late are likely to be excluded from the ROSCA in the long run.

In general, lot ROSCAs are more inflexible than auction ROSCAs. This is due to the fact that the order of rotation is predetermined by lot. This inflexibility can lead to the problem that the point of time at which a member receives the fund may not correspond to his financial requirements. In general, this is true for the lot ROSCAs in Sri Lanka as well. However, there is also a certain flexibility among members. In all of the lot ROSCAs we interviewed, it is possible to exchange lots. In the event that a member needs money urgently, he can exchange his lot with someone who has drawn an earlier one. If two members need the fund at the same time, they sometimes share it. In other words, these two members are given the fund in two instalments. Often there is a mutual agreement among members to help one another.

4.2.3.3 Low Interest Rates

One reason why ROSCAs are in general very attractive for their members is that ROSCAs – compared with other informal sources of finance – offer quite low interest. ROSCAs that determine the order of rotation by lot or by consent normally charge no interest.

Auction ROSCAs charge interest. Although their interest rates may appear high, not all members have to pay them. Members have to choose between the returns on a given investment which they could realise with an early fund and the interest that they would receive for a later fund. Furthermore, it should be considered that clients in the informal financial sector, and particularly SSEs, often need prompt disbursement of short-term credits. People with regular income or with small enterprises normally have enough money to participate in an auction ROSCA and can choose the ROSCA with the highest frequency of meetings and the highest contributions, provided that no other barriers such as ethnic, religious or other aspects prevent their participation in the one they have chosen. They prefer auction ROSCAs because the latter can either mobilise investment capital or offer a high return on their savings. In the context of a liquidity shortage it may make sense to take an “expensive” credit to make immediate investments aimed at covering short-time costs.[166]

The empirical information obtained from our interviews largely confirms the hypothesis that interest rates are low. In the lot ROSCAs we interviewed, members do not have to pay any

166 The average interest rate is calculated to be between 5 and 10 % p.m. See Rutherford (1999), pp. 27-28.

interest. They always receive the same amount they contribute. As mentioned above, only in some cases do they have to pay a commission to the organiser, which is, first, very low, between 0.5 and 1.3 %, and, second, is not considered real interest but is seen as compensation for the organiser's work. On the one hand, members have to take into account their losses in foregone interest; after all, they could have saved with a bank or joined an auction ROSCA. On the other hand, there are ROSCA members who do not have a savings account at a bank. Members are willing to let fortune decide when the lump sum is theirs because they in this way gain access to very cheap and easy credit, without collateral and guarantor. Furthermore, they are forced to save a fixed amount of money, which is a major incentive to participate in a ROSCA.

In auction ROSCAs, members have to pay a certain sum to obtain the fund; this is equivalent to interest. Normally, organisers fix a minimum rate that has to be paid to obtain the first fund. In most cases the rate is higher at the beginning of the cycle than at the end.[167] One organiser sets a minimum bid for every round. Sometimes there are no bids because no member needs the money at that moment. In this case the organiser opts for the lot system, and the member who draws the lot has to take the fund for the amount fixed.

At the beginning of a cycle, bids for the fund are normally very high. The average first bid is 20-25 % of the amount of the fund. One organiser told us that winning bid for one first fund was even 49 %.[168] Towards the end, the amounts of bids decrease because there are fewer people competing for the fund. The average amount is about 4 % for the last funds bid on. One example would be a ROSCA with a fund of LKR 120,000. LKR 42,400 was bid for the first fund, and bid for the tenth fund was LKR 3,000. There were no bids for the last two funds, and so the recipients of the last two funds were given the entire fund.

It is important to mention that the interest members pay to obtain the fund is only "fictional" interest because the amount bid ("fictional" interest) is distributed among members, so that in every round all member receive a certain amount of their money back. The effective interest is very difficult to calculate; no ROSCA provided us with information about amounts bid in each round.

The bidding system is one of the very big advantages of auction ROSCAs. There are members who urgently need money and have the financial capacity to bid a high sum to obtain the credit as quickly as possible. Many members who are willing to bid a high sum use the fund to invest in their businesses. Others who have no urgent needs wait until the end of the cycle. They use the ROSCA more for savings purposes.

4.2.3.4 Low Transaction Costs

ROSCAs have low transaction costs.[169] Administrative costs are low as well.[170] Often, the only assets they have is a book and a pen to record all transactions. Since they often meet at the organiser's house or in houses of members, they do not need to rent a room.[171] Both deposits and borrowing entail transaction costs. Deposits may be difficult to make because of pressure within the family, e.g. if a family member needs medical help. Borrowing costs are quite high because it may be necessary to borrow from different persons or to obtain information about the best conditions available, etc. Since ROSCAs normally operate outside the legal system, members do not have to cope with the bureaucratic procedures required to apply for credit.[172]

167 In some ROSCAs, the rate is constant throughout the overall cycle.

168 It has to be mentioned that interest is fictional because every member is given back a certain amount of money.

169 In this context they include information, overhead and management costs.

170 Bouman (1984), p. 241.

171 See Fernando (1986), p. 27.

172 See Burkett (1989), p. 403; Tchuindjo (1999), p. 15.

The hypothesis that ROSCAs have low transaction costs was confirmed by our empirical survey. The accounting system, which is normally put down under transaction costs, cannot be considered a cost factor. Organisers who do keep accounts only wrote down the names of members, contributions and dates as well as the amounts bid in the case of auction ROSCAs. All of the ROSCAs we interviewed operate quite simply, and thus there are no complicated bureaucratic procedures involved.

Organisers have more costs than members, but in most cases these are negligible. Normally, meetings are held in the organiser's house, which means that the latter incur no rental or transport costs. Although some organisers stated that they collect all contributions, most of them collect contributions only from some members. In general, they combine their collection tours with other transactions, and thus such transport costs are not only attributable to the ROSCA. Two organisers pay agents to collect contributions from the members, but these are very small sums.[173] Some organisers prepare a social event for members when they meet, which means a certain amount of expenses for them. Considerable transaction costs are involved when potential members are unknown to the organiser, because in this case organisers are forced to gather information about new members.

Compensation for delayed payments or default are the organisers' only real costs. Although many organisers did not perceive default as a real problem, the organisers' responsibility to provide compensation in cases of delay or default represents an important advantage as well as security for members. Members' costs are far lower than those borne by organisers. Members have to travel to the organiser's house for meetings. Usually they are required bring their contributions to the organiser. New membership entails some information costs. Members often know the organiser well, or another member may introduce them to the ROSCA.

In most lot ROSCAs, members are not required to pay any interest or commissions. Only in three ROSCAs do the organisers require a very small commission from the member who is given the fund. The amount varies between 0.5 % and 1.3 % of the amount of the fund. In one case the members were even able to decide whether to pay a commission to the organiser.

4.2.4 Weaknesses of ROSCAs

Apart from their strengths, ROSCAs are also subject to certain weaknesses. The most relevant weaknesses are that ROSCAs cannot provide long-term credits and that they are without any means of legal enforcement.

4.2.4.1 No Long-term Credits

The most important weakness of ROSCAs is that they do not offer any possibility to convert short-term savings into long-term credits. The duration of a credit cannot exceed the duration of a cycle, which is 13 months on average. Therefore, on the one hand, there is no incentive to use ROSCA funds to finance longer-term projects. On the other hand, cycles can be renewed, and it would be possible to collect contributions for more than one cycle until a given sum is available. It might also be possible to transfer individual contributions to the next cycle. This would allow ROSCAs to grant medium- and long-term loans. The problem lies in the time gap between rounds, when the money is not saved but held by members. During this period it is nearly impossible not to spend the money until the next round begins.[174] To solve this problem, some ROSCAs give the organiser the first fund, and he can lend it on to a member who is in financial

173 One stated that his agent earns LKR 200 per month. The other stated that a boy who is employed in his shop is used for the purpose.

174 See Sika / Strasser (2000), p. 317; Tchuindjo (1999), p. 16.

need in between two cycles. However, some organisers demand quite high interest rates and in this way "*become moneylenders in disguise.*"[175]

This hypothesis was confirmed in our empirical study in Sri Lanka. The period of a credit is restricted to the duration of a ROSCA cycle, which is on average 13 months. We were informed that all ROSCAs renew the cycle when it has been completed, and thus may exist for a number of years. However, all members and organisers interviewed stated that they use the fund immediately. They do not save the money from one cycle for the next cycle, as described above. Although this is regarded as a weakness of ROSCAs, it has to be taken into account that short-term credits are an important service that is not provided by lenders from the formal financial sector, though it is one needed by SSEs.

4.2.4.2 No Legal Enforcement

Peer monitoring appears to work very well in ROSCAs. Nevertheless, there is a certain risk that an organiser may exploit members, since he has the fund under his control and may abscond with the money. However, it is not only the organiser who poses a risk, members who receive the fund at an early stage may also disappear with their fund or not return to pay their regular contributions.[176]

Since ROSCAs operate in the informal financial sector, members and organisers have very few means available to ensure regular payment, apart from trust-based relationships and member selection. To ensure regular contributions, ROSCAs may divide the fund into two parts, with a potential defaulter obtaining part of the fund at the beginning, but having to wait until the end before he receives the second part of his fund. He may also be put at the end of the rotation cycle, and thus be the last member to receive the fund.[177] Other ROSCAs require other forms of protection. Their members are required to provide some form of collateral or a guarantor who inspires confidence and assumes a payment obligation in the event of default. In some ROSCAs, even the guarantor has to deposit collateral. However, these types of risk management appear to be used only very rarely.[178]

Even though ROSCAs operate in the informal financial sector, it would be possible for organisers and members to sign a contract making it possible to apply legal sanctions in the event of default. In some countries, such contracts are covered by special legislation, in others regular legislation provides sufficient security for both the association and its members.[179] Since ROSCAs are mainly based on trust, it has to be questioned how many organisers really use a kind of legal basis for their ROSCA.

The hypothesis that ROSCAs have limited means of legal enforcement was largely confirmed by our empirical findings from Sri Lanka. Although the risk of default is minimised by a very confidential relationship between organiser and members or by means of inquiries into members, as described above, there is nevertheless a certain risk of default. Since ROSCA organisers are always required pay the contributions of defaulters or make up for delayed payments, the fact that they have no means of legal enforcement is a problem for them. Organisers are responsible for the proper functioning of the ROSCA, and are therefore required to compensate for default. Although most organisers stated that they do not perceive this as a problem, means of legal enforcement would provide relief for them.

We interviewed some ROSCAs in which the organiser requires a certain kind of collateral or a guarantor to insure himself against default.

175 Bouman (1995), p. 378.

176 See GDRC.

177 See Ardener (1964), p. 217.

178 See Germidis / Kessler / Meghir (1991), p. 164.

179 See Ardener (1964), p. 217.

Table 9: Strengths and Weakness of ROSCAs	
Strengths	**Weaknesses**
Low default rate - due to trustful relationships - due to inquiries about members	No legal enforcement - active in informal sector - mainly based on knowledge of members
Low interest rate - lot ROSCAs pay no interest - the auction mechanism results in moderate to low interest rates	No long-term credits - credit is restricted to the duration of one cycle (13 months)
Flexibility - auction mechanism - organisers offer a variety of services that lead to flexibility - in lot ROSCAs members show mutual flexibility	
Low transaction costs - no bureaucracy - low transport costs - low information costs - compensation costs for defaulters are borne by the organisers	
Source: Authors' compilation	

However, since ROSCAs operate in the informal sector, they are not based on a contract, and thus so no legal recourse is available. It is more a preventive method that aims at protecting against default or delayed payment.

One ROSCA member we interviewed told us that the organiser concerned has a method to ensure regular payment. This ROSCA has a kind of statute that is put into legal form by a lawyer. This entails fixing the dates for contributions and disbursement as well as the amounts involved. LKR 25 per day are charged for delayed payments. This statute not only protects the organiser against default, it also provides members with a measure of certainty that they will be able rely on one another. This may be a good example for other ROSCAs in Sri Lanka. Contracts would allow ROSCAs to become semi-formalised and provide them with more effective means to cope with defaulters.

In Sri Lanka, ROSCAs have been formally subject to legal regulation since 1936. Seetu Ordinance No. 61 provides for registration and control of ROSCAs. The regulation requires every ROSCA to be formed by means of a written agreement between organiser and members. ROSCAs that operate with an amount below LKR 50 are exempt from this provision. This regulation ignores the fact that ROSCAs operate in the informal financial sector, and that it is their informality that makes them attractive for many people. If ROSCAs were formalised and made subject to official legislation, they would lose their informal character.[180]

However, with the exception of one organiser, none of our interviewees had ever heard of the Seetu Ordinance. This interviewee stated his unwillingness to be registered under the law, because registration would entail an obligation to pay taxes. The fact that hardly any interviewees were familiar with the ordinance may indicate that it is quite unimportant to ROSCAs, which have no interest formalisation.[181] Nevertheless, many ROSCAs would be better off

180 See Fernando (1986), pp. 28-29.

181 It is also possible that knowledge of the Act has decreased during the ensuing decades, and now nobody is familiar with it.

operating on a contractual basis, since this would provide both organisers and members with reliable means of legal enforcement.

Summing up the findings of our empirical research in Sri Lanka, we can observe that ROSCAs in Sri Lanka display characteristics similar to those analysed in the literature. Despite their weaknesses, ROSCAs are a very attractive method to obtain easy and fast credit, and one that forces members to save. For most of their members, the strengths of ROSCAs are more important than their weaknesses. They are therefore very popular in all strata of Sri Lankan society. Even many small entrepreneurs prefer ROSCAs to other sources of finance. Their incentive to participate is their need to obtain credit for their businesses. Nevertheless, the weaknesses of ROSCAs cannot be denied.

5 Conclusions and Recommendations: Financial System Integration

This chapter addresses the question under study and summarises the study's main results, interpreting them and providing recommendations on improving the supply of credit to SSEs.

5.1 Summary of Findings

In Sri Lanka, there is a gap between the credit supplied by both informal and formal providers to SSEs, which use both sources of credit depending on their respective conditions and purposes for which credit is needed.

The Sri Lankan financial system is marked by a dualistic structure, i.e. the financial sector breaks down into formal and informal financial markets. In developing countries such as Sri Lanka, the reason why financial dualism arises is that the formal financial sector is underdeveloped, a fact which is reflected in an inadequate credit supply of formal financial actors, in particular banks, to SSEs. Informal financial suppliers partly compensate for this lack of financial services. However, the financial services provided by informal suppliers are also inadequate (Table 10).

On the one hand, formal financial actors, such as banks, provide relatively large credit volumes for long periods at moderate interest rates, but the procedures take time and formal collateral or guarantors are required. The supply of long-term bank credits to SSEs is thus limited. In addition, the supply of short-term credits by banks is restricted because transaction costs are high. On the other hand, informal financial actors, such as

Table 10: Strengths and Weaknesses of Credit Suppliers

Financial Needs:	Moneylender	ROSCAs	Banks
Short-term credit	+	+	?
Long-term credit	?	?	+
Small credit volume	+	+	?
Larger credit volume	(?)	+	+
Quick disbursement	+	(+)	?
Flexible collateral	+	+	?
Simple procedures	+	+	?
Moderate interest rates	?	+	+

Source: Authors' compilation

moneylenders and ROSCAs, provide quick and easily accessible credit for short periods, and these suppliers are more flexible as regards collateral requirements, though conditions are insecure and interest rates are high. Although the strengths and weaknesses of formal and informal credit suppliers complement each other (Table 10), credit needs of SSEs in Sri Lanka are not adequately satisfied.

5.2 Closing the Gap

Two approaches are available to narrow the gap. On the one hand, formal actors could adopt the strengths of informal actors as far as this is possible: the **downscaling approach**. Informal financial actors have certain strengths which formal actors could learn from in order to improve their credit supply for SSEs. On the other hand, infor-mal actors could be integrated as far as possible into the formal system: the **modified upgrading approach**.

Since this gap between the formal and the informal financial sectors cannot be closed on the basis one of these approaches alone, a bridge has to be built from both sides, aimed at meeting in the middle and integrating the two sectors, or, in other words, what is called for is a combination of a **downscaling** approach and a **modified upgrading approach**. The result would be a less strict division between the formal and informal markets. In addition, this would mean more competition between different suppliers. The answer to our research question is that (at least for the medium-term) adequate access to credit for SSEs in Sri Lanka can be improved only through more competition between the suppliers in an integrated financial system.

The following sections provide recommendations for closing the gap. The first part of the bridge has to be built from the formal sector. Recommendations to banks aim at improving their credit supply to SSEs. The second part of the bridge has to be build from the informal sector. These recommendations address policy-makers and aim at an integration of the informal sector into the formal economy. They amount to a modified upgrading approach.

5.2.1 Potentials of a Downscaling Approach

In the long-term, for Sri Lanka the **downscaling approach** is more important than the **upgrading** or the **linkage approach**. Banks have adequate institutional and financial capacities to provide large volumes of credit for investment needs of SSEs. However, banks provide only a limited amount of loans to SSEs. In addition, most Sri Lankan banks have difficulties in providing small and short-term loans. The overhead and transaction costs involved in providing small loans are nearly identical to those for larger loans. Consequently, there is no incentive to provide small loans. Therefore, banks need to reduce their costs and increase their revenues.

Downscaling of banks would imply that banks enlarge their target groups to include smaller clients who mainly obtain loans from informal suppliers of credit. In this way banks could adopt the strengths of informal credit suppliers.

First of all, banks could reduce costs by simplifying procedures for small loans without leaving the formal framework. Clearly, banks cannot operate as flexibly as moneylenders because they are obliged to abide by formal regulations and procedures which imply costs. However, this does not mean that banks should alter their overall banking practice, although they could offer more schemes for small loans. In Sri Lanka, the process of downscaling has already started. The People's Bank, for example, has established a microfinance unit and successfully implemented the Rural Banking Innovation Project (RBIP) programme (Box 8).

There are a number of Sri Lankan banks, such as the People's Bank, the Bank of Ceylon, the Seylan Bank and the Hatton National Bank, which have the advantage of a large network of branches and a broad outreach. This network could facilitate

Box 8: Making Microfinance Profitable – The RBIP Project

With an eye to refocusing the People's Bank's activities in lending to micro-, small, and medium-sized enterprises, the GTZ in 1996 embarked on a co-operation project (Rural Banking Innovations Project RBIP) with the bank in Kandy. The objective of the project is to make these lending procedures viable for the bank and to meet the needs of customers. The programme is designed in the following way.

Borrower profiles: Borrowers have to be older than 18 and younger than 55 years, permanent residents of the area in which the People's Bank branch is established, should not have defaulted at the People's Bank before, and should have a savings and an investment savings account with the bank.

Enterprise profiles: Enterprises should be "viable" and operate in compliance with environmental laws

Disbursement: Credits should be released within ten to fourteen days after application.

Credit volume: Loans for movable assets and working capital cannot exceed LKR 1 million.

Borrower contribution: For a loan between LKR 25,000 and LKR 50,000, borrowers have to contribute 10 % of investments either in kind or in cash, and for a loan above LKR 50,000 they have to contribute 10 % of investments either in kind or in cash.

Collateral: Credits up to LKR 25,000 require two guarantors, credits between LKR 25,000 and LKR 100,000 require two guarantors and movable assets (if possible), and credits of over LKR 100,000 call for two guarantors and movable assets, or a mortgage on immovable assets.

Interest rate: The interest rate amounts to 22 %.

Repayment period: In determining the repayment period, the bank considers borrower's the repayment capacity, but the repayment period should not exceed three years. In exceptional cases, borrowers are allowed to prolong the repayment period by three months. A repayment period of five years is possible only if immovable assets are provided as collateral.

Field Officer Approach: By linking the bank with the client, the field officer establishes a closer relationship between these two actors. This approach has two objectives: first, to establish a better understanding of the clients' financial situation and repayment capacity. Second, to enable the bank to expand its services to the client (marketing, business planning, management training, etc.). The field officer should talk to the client once or twice per month.

Geographic Information System (GIS): The GIS is a computer-based spatial information programme. Its purpose is to improve services to clients and the bank's performance, e.g. by identifying areas with a lack of banking services, establishing information about the bank's market share among various target groups etc.

Management Information System (MIS): The MIS is a widely used tool to expand the information available to make sound business decisions. It includes information about collection ratios, portfolios at risk, trend charts, etc. Within the RBIP Project this instrument is linked to other tools like the GIS or impact monitoring. This makes it possible to develop a deeper understanding of the target market.

Source: See Charitonenko / de Silva (2001), p. 39; Hofmann et al. (2000), pp. 2-7 ; RBIP (2001), pp. 1-2

downscaling of banks and could make banks more accessible for more clients. The People's Bank and the Hatton National Bank have successfully used the downscaling approach. An alternative approach would be to introduce credit cards for SSEs which was done by the Seylan Bank (Box 9).

Second, like moneylenders, banks could accept a wider range of collateral because SSEs often lack the collateral required to obtain regular bank credits. Banks could investigate what kind of items might be included as potential collateral, such as vehicle papers or valuable private household goods or guarantors other than civil servants or persons employed in public institutions.

Third, bank officers could approach customers, as in the so called "Field Officer Approach," which is used in the Rural Banking Innovation Project (RBIP) of the People's Bank / GTZ (Box 8) and also by the Hatton National Bank. With this approach, the field officer establishes a closer relationship to the customer by linking the bank more closely to the client. Banks could implement more personalised relations to their SSE clients and could better check their customers. On the one hand, this would lower default costs because banks would be better able to evaluate the financial capacity of their clients. However, on the other hand, this would mean higher transaction costs for banks.

Box 9:	**The Seylan Bank's Govisarupatha Credit Card for Farmers**
The Seylan Bank was the first financial institution to introduce the credit card in the microfinance sector. This card enables a farmer to purchase a specified amount of inputs (seeds, fertiliser, pesticides) from selected merchandisers. The volume of credit obtainable adapted to the customer's specific needs. There is also an extra-budget for emergencies. The card is valid for one year and therefore can be used for two growing seasons. The loan has to be repaid before the beginning of the next season. Farmers who have dealt with the bank for at least nine month are eligible to receive the card. By introducing this card, the bank was able to reduce its administrative and operating costs. There is just one application process and therefore paperwork has been tangibly reduced. Interested farmers have to approach the bank only twice a year, instead of applying for each individual credit. In addition, this approach makes it possible for them to supplement their cash flow according to their needs.	
Source:	Interview with the Chief Manager of the Development Banking Division

Fourth, banks could increase interest rates for small loans in order to realise profits, as is illustrated in the example of moneyshops (Box 10). The current credit supply of moneylenders shows that SSEs are able to pay very high interest rates for flexible and quick credits.

Even though banks cannot be as flexible and as fast as moneylenders, they should be able to operate with lower interest rates than moneylenders. Thus the small loan products of banks can be competitive as compared to moneylenders. Currently, there is a vast gap between moneylenders' interest rates and the typical interest rates charged by banks (typically 60-120 % p.a. compared to 22 % p.a.). Therefore, banks could more than double their interest rates for small loans with a view to becoming profitable. In this case, they would still be in a position to offer loans at considerably lower rates than moneylenders.

Box 10:	**Moneyshops in the Philippines**
In 1973, the Philippine Commercial Bank and Industrial Bank established moneyshops at public markets. In market stalls these moneyshops offer daily credits at interest rates amounting to 40 % per annum. These interest rates were quite high compared with bank rates, which ranged between 14 to16 % in the Philippines. However, these interest rates are much lower than those required by moneylenders. Due to this additional credit supply of moneyshops, interest rates in these markets declined substantially from 20 % daily in 1973 to 5-10 % monthly in the early 1980s. This example illustrates that the gap between interest rates of formal and informal suppliers narrowed considerably. Between 2 and 4 persons work at moneyshops, daily collecting credits, as informal suppliers do. Contacts to customers are thus intensive: collectors know their clients very well and are able to evaluate their financial situation. Apart from lower interest rates, another main advantage of this approach is that it provides clients easy access to bank credits without complex procedures. In addition, moneyshops open early in the morning, when their customers need money. Although there was a high default rate, moneyshops expanded considerably in the Philippines. The establishment of moneyshops show that banks are able to adopt lending techniques of informal credit suppliers and that banks are able adapt their lending techniques to their clients' businesses.	
Source:	See ADB (1991), p. 209; Germidis / Kessler (1991), p. 227

Policy-makers could contribute to the process by establishing a legal framework to enable banks to implement the recommendations for downscaling. **Development organisations** could promote banks in developing microfinance programmes. One successful example is the above-mentioned RBIP project of the GTZ and the People's Bank.

The history of pawnbroking in Sri Lanka (Box 11) and moneyshops in the Philippines (Box 10) serve as illustrative examples of how and where banks have successfully adopted lending techniques of informal credit suppliers.

Box 11: Pawnbroking in Sri Lanka
In the first half of the 20th century pawnbroking was a purely informal business. However, today two types of formal actors dominate the business, with informal pawnbrokers remaining only a marginal phenomenon. First, there are pawning centres of banks, which started out by copying the techniques of pawnbrokers. They charge much lower interest rates than informal pawnbrokers and offer legal security. Second, there are lcensed pawnbrokers. These are mostly jewellers who obtain an official license for pawning and offer pawning services to their clients which are more flexible (higher credits for an item and longer opening hours) and faster than the those offered by banks. However, these pawnbrokers demand higher interest rates. On the one hand, both types of pawnbrokers act within the legal system. On the other hand, the main advantage of pawnbroking is low transaction costs for both the borrower and the lender, e.g. such transactions usually take about five minutes. In addition, they also make available small credits at relatively low interest rates.
Source: See Grashof (2002)

Nevertheless, downscaling of banks (in the short- and medium-term) is not sufficient to provide adequate credit access for SSEs.

5.2.2 Potentials of an Upgrading Approach

Upgrading informal financial sector actors means a transformation towards more formality and professionalism of informal financial transactions.

Moneylenders have no incentives to formalise their businesses. The moneylenders interviewed were reluctant to register their moneylending business, since this would mean having to pay taxes and because registration would not mean any advantage to them. However, the negative aspects of informality suggest that a **modified approach to upgrading** moneylenders could contribute to a better credit supply for SSEs.

This approach includes at least some degree of formalisation of moneylenders' businesses. The **Mediation Board**, which has a mandate to settle loan disputes between moneylenders and their borrowers in a semi-formal way, is one solution to this problem. The Mediation Board reduces the moneylenders' risk and provides more security for the borrower. In cases of informal loan disputes, mediation is possible if both parties agree to mediation, or if there is a written contract.

Since the Mediation Board is not very well known in Sri Lanka, information on this mediation service should be improved. The Mediation Board could be promoted more extensively as an institution for the settlement of informal loan disputes. Sri Lankan policy-makers could promote the establishment of Mediation Boards throughout the country.

ROSCAs do not have much potential to upgrade their activities, either. The majority of ROSCA organisers reported that they would not be interested in a more professional approach to organising one or even more ROSCAs. This is due to the risk and responsibility involved in the organisation of a ROSCA. Some organisers perceive this responsibility as a burden and are not interested in upgrading their ROSCA. Similarly, enlargement of the group was not attractive for most ROSCA members. The particular social character of their ROSCA would suffer if too many people entered it. In addition, the larger the groups, the less foreseeable the risks and the more likely are delay and default. The only promising approach to a **modified upgrading** of ROSCAs would be to adopt some legal measures aimed at minimising the risks of delay and default for members, as well as for organisers.

On the one hand, introduction of formal documentation for transactions in ROSCAs would clash with the informal nature of a ROSCA. On the other hand, introduction of contracts between members and the organiser would give the basic rules of ROSCAs a legal form. Such contracts could be used in court in cases of default to recover at least part of the money concerned.

Sri Lankan policy-makers could promote a better legal integration of ROSCAs. Our interviews have shown that ROSCAs are an important instrument of SSE liquidity management. However, ROSCAs face risks of default and fraud despite the trust-based and personal relations that generally reduce the chance of default. Due to lack of legal enforceability, loss in cases of default may be high.

5.2.3 Potentials of a Linkage Approach

According to our analysis, the linkage approach appears unsuitable to improving the access of SSEs to credit. The linkage approach consists of linking informal or semi-formal financial actors with formal institutions, i.e. of co-operation between informal and formal actors. This makes it possible for them to complement their respective strengths and improve services to their clients. Since in Sri Lanka the most important informal credit suppliers are moneylenders and ROSCAs, linkage of these two credit suppliers with banks will be analysed.

In theory, **linkage between moneylenders and banks** appears to be an appropriate solution[182], but in practice it is difficult to realise, a fact which is illustrated in Box 12. Even if the approach is designed in a more market-oriented manner, the following critical issues have to be taken into consideration.

First, moneylenders in Sri Lanka already have access to other sources of credit. Accordingly, any linkage approach would have to compete with these sources, especially in terms of flexibility of conditions and quick availability. Second, it is questionable whether such linkage would lead to an increase of the credit supplied by moneylenders to SSEs, because the bank is unable to monitor whether moneylenders in fact use bank credits to provide credits or the persons to whom moneylenders lend on these additional credits. In the late 1980s the Bank of Ceylon launched a scheme aimed at linking moneylenders and banks in Sri Lanka failed (Box 12).

Similarly, the potential for linking ROSCAs with banks is low. The majority of the ROSCAs interviewed are not social self-help groups but autonomous associations whose main purpose is group lending and saving, which appear to function well. Thus the demand for a linkage approach is low. The main argument for linking self-help groups with financial NGOs and banks is to enlarge both funds and the credit supply of participants. Since borrowers in Sri Lanka have a wide range potential of credit sources, this major argument for linkage is not valid for Sri Lanka.

Measures to Adjust the Legal and Institutional Framework

In addition to these approaches, the legal and institutional framework could be adjusted. Due to their lack of adequate collateral, SSEs often cannot obtain large volumes of credit from banks. To improve this situation, assets of SSEs could be formalised. In particular, SSEs cannot use land properties as collateral because there are no clear regulations on how to prove property rights, and land titles are not registered. Although solving this problem would amount to a time-consuming and costly process, policy-makers should promote the registration of land titles.

Since SSEs are often highly indebted, the following steps could be used to avoid high SEE indebtedness or to help solve the problems of highly indebted SSEs. First, policy-makers could establish an advisory board for highly indebted SSEs. Second, policy-makers could support a fair and transparent insolvency process for SSEs by building a semi-formal institution which regulates insolvency processes. SSEs which use new loans to service outstanding loans need to break out of this circle, which is their only chance to start out again with a new business.

182 See Germidis / Kessler / Meghir (1991), p. 236.

Box 12: Linking Moneylenders and Banks in Sri Lanka

In 1988, the Bank of Ceylon tried to establish a scheme to improve the credit supply in rural financial markets in co-operation with moneylenders. The objectives were to lower administrative and transaction costs for the bank, to reduce interest rates in informal lending and to help the poor. The bank's approach consisted of three steps: First, to select "Community Credit Facilitators" (CCFs), second, to establish separate current accounts with certain overdraft limits for CCFs and third, to monitor their performance.

Selection of CCFs was based on certain eligibility criteria. For example, a CCF had to have a current account at the Bank of Ceylon and had to provide collateral. Furthermore, he or she must not have defaulted on previous loans. At the same time, the CCF had to have previous experience in informal lending, and be able to conduct simple accounting and "command respect." Each division of the regional structure had to select a maximum of three CCFs. Before the separate current account was established, the bank calculated the overdraft limit on the basis of the CCF's collateral. Once the Bank opened the account, the moneylender could obtain money within the limits of his overdraft for on-lending. The interest rate was 18 % p.a.

Criteria for reviewing the moneylender's activities included the nature of his collateral, fluctuations in his overdraft and guidelines describing the functions and responsibilities of CCFs. If the result of the review was positive, the overdraft limit was renewed; if not, it was reduced. The guidelines mainly described the desired activities of CCFs. They were to provide quick credit with low formal barriers in small doses to the poor in order to reach a maximum number of borrowers. In addition, they were to encourage productive borrowing, to demand "*a more reasonable rate of interest*" and "*to maintain secrecy [...] in order to preserve the client's reputation and dignity.*" The only guideline concerning the relationship with the Bank of Ceylon was that it was to bear the full credit risk.

The results of this linkage were disappointing, and the objectives were not met. An analysis of the failure can provide a clearer idea about the appropriate design and necessary conditions for a linkage approach with moneylenders. First, the Sri Lankan approach relies on a mechanism setting standards for moneylenders. Setting standards is problematic if the formal financial provider cannot control these standards. In addition, it is difficult to set standards in line with market conditions. In this case the bank was not able to monitor the moneylenders, who regarded the funds as their own money. As a result, the funds were "misused" for investments rather than for extending microcredits. The underlying problem was that the funds were subsidised. Moreover, even if moneylenders had increased their lending activity, it is unlikely that they would have passed on the subsidy. The goal of "a more reasonable interest rate" cannot be achieved by subsidies.

Second, the situation was aggravated by the political backing of some moneylenders. Knowing that they would not be forced to repay the funds, they were not obliged to abide by the stipulations agreed upon with the bank. Third, the goal of "*maintain[ing] secrecy[...] in order to preserve the client's reputation and dignity*" is a laudable one. However, social pressure is one important mechanism used by moneylenders to sanction default and to realise high repayment ratios. There is a trade-off here between social and economic goals. Fourth, development of competition depends very much on how many moneylenders are eligible for funds from a formal financial institution. Concerning this issue, there is a trade-off between increased costs for dealing with many moneylenders and the danger of creating monopolies by dealing only with a very limited number of moneylenders. The optimal solution will depend on specific market conditions.

Source: See Bank of Ceylon (1988)

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Annex

6 Research Design

6.1 Research Area

Figure A 1: Map of the Negombo Area

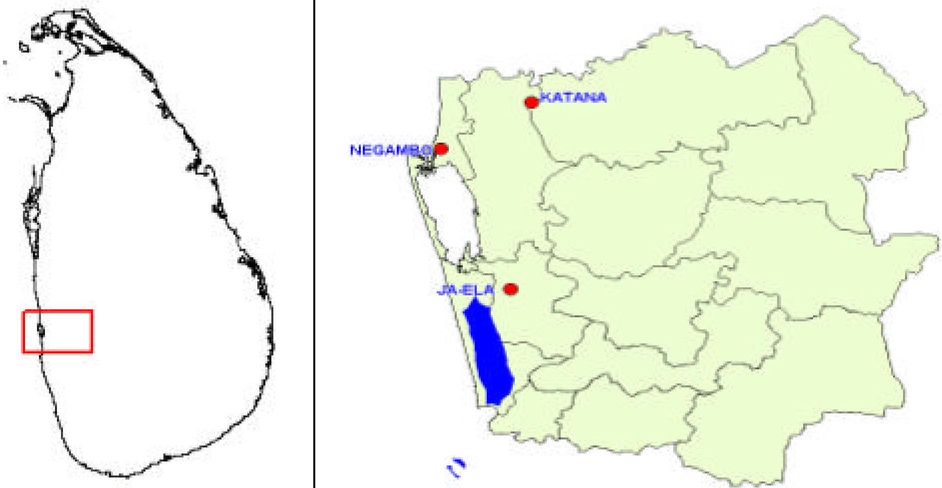
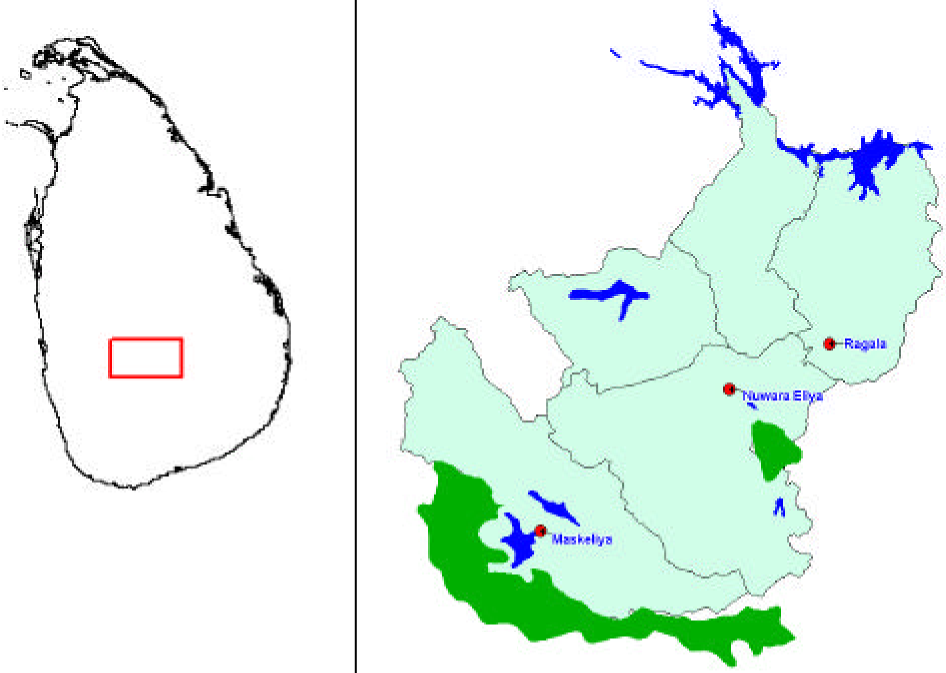


Figure A 2: Map of the Nuwara Eliya Area



Source: RBIP Kandy

6.2 Schedule of Field Research

The schedule of the field research in Sri Lanka was as follows:

17.02.-18.02.02	Colombo: meeting with People's Bank, German Embassy, GTZ
19.02.-01.03.02	Kandy: presentation of the preliminary report, pre-tests of questionnaires and adaptation
02.03.-16.03.02	Negombo: interviews in the field and a short evaluation of interviews
17.03-31.03.02	Nuwara Eliya/Maskeliya: interviews in the field and a short evaluation of interviews
01.04.-28.04.02	Evaluation of interviews, expert-interviews, writing of final report
29.04.-04.05.02	Presentation of results to counterparts and experts as well as discussion of input from the workshop

6.3 List of Expert-Interviews

Having interviewed the practitioners, we also interviewed some Sri Lankan and international experts, especially branch managers of banks and experts working in research departments of Sri Lankan banks, national and international research institutes and members of the donor community active in the field of financial development. Furthermore, we interviewed some NGOs involved in microfinance.

Mr. Udo Gärtner	GTZ
	Project manager EIP (Enterprise Information Project)
Dr. Nimal Sanderatne	University of Peradeniya
	Visiting Senior Fellow, Postgraduate Institute of Agriculture
Mrs. Shenuka Chanmugan	Asian Development Bank, Colombo
Mr. Chandrarathna, D. Vithanage	The Ceylon Chamber of Commerce
	Assistant Secretary General Programme Manager
Mr. Sarath Hewagama	Sarvodaya Economic Enterprise Development Services (SEEDS)
	Chairman
Mr. Saliya J. Ranasinghe	Sarvodaya Economic Enterprise Development Services (SEEDS)
	Chief Executive
Mr. Sikila Wijewardena	Sarvodaya Economic Enterprise Development Services (SEEDS)
	Deputy Managing Director

H. M. Ranasinghe	Small & Medium Enterprise Developers (SMED) Project Manager Management Service Division
Mr. Dulan De Silva	Consultant
Prof. M.D.C. Abhayaratna	University of Sri Jayewardenepura, Colombo Department of Geography
Mr. D. V. Sonnadura	Industrial Development Board Director
Mrs. Amara Liyanage	Industrial Development Board Assistant Director
Mr. W.M. Rathnayake	Industrial Development Board District Manager Nuwara Eliya
Mr. Mervin Perera	People's Bank Branch Manager, Negombo
Mr. Karunatilake	Business Promotion Officer (BPO) of the People's Bank, Maskeliya
Mr. Ranasinghe	People's Bank, Kandy
Mr. Sumane Rathnasuriya	Seylan Bank Chief Manager, Develpment Banking Department
Mr. M.H.M. Razik	Hatton National Bank, Kandy
Mr. D. Wijesundera	Hatton National Bank Senior Deputy General Manager (Development Banking)
Mr. Richard Gant	Consultant
Mr. Gunaratne	Mediation Board Maskeliya
Dr. Hemamali Palihakkara	SANASA Director General SANASA Education Campus Ministry of Industries
Mr. T. B. Weerasekara	Chairman of Industrial Development Authority
Mr. Lionel Jayaratne	U.S. Agency for International Development Mission to Sri Lanka Senior Project Management Specialist