Informal Finance and the Design of Microfinance

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Author's notes

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Introduction

Informal finance is defined as contracts or agreements conducted without reference or recourse to the legal system to exchange cash in the present for promises of cash in the future. In turn, *microfinance* is defined as formal schemes designed to improve the well-being of the poor through better access to saving services and loans. While both informal finance and microfinance serve poor, unbanked people, informal finance derives from the grassroots, bottom-up demand of the poor for appropriate financial services, whereas microfinance derives from donor-driven, top-down supply.

The common wisdom is that informal finance is a mine of lessons to inform the design of microfinance (*e.g.*, Ardener and Burman, 1995; Bouman 1995; Burkett, 1988; Caskey, 1994; Christen 1989; Graham 1992; Von Pischke 1992). In both rich and poor countries, work has looked at rotating savings and credit associations (RoSCAs), money-guards, hire/purchase stores, moneylenders, pawn shops, trade finance, check-cashing outlets, and loans among family and friends. This research has unearthed six basic virtues of informal finance:

- Slashed transaction costs
- Supply of not just loans but also savings and implicit insurance
- Services sensitive to constraints faced by women
- Substitution of confidence in character for physical collateral
- Socially enforced and/or self-enforced contracts
- Sequences of repeated transactions.

What can microfinance learn from informal finance?

Research on informal finance often suggests that microfinance acquire these virtues. In development practice, however, this is not very useful advice. Knowledge of the virtues of informal finance is necessary, but it is only the first step; the second step is to infuse microfinance schemes with these virtues. Most research fails to tell how to do this. Good policy recommendations must be much more than mere lists of desirable outcomes (for example, lower transaction costs). Rather, they are potentially feasible means to reach a goal (for example, joint-liability groups that tap into social capital).

Much research, overwhelmed by the discovery that poor people fashion their own financial instruments in the absence of formal services, has tended to overlook some important weaknesses of informal finance (Christensen, 1993):

- No deposit insurance
- No large loans
- No long loans
- No recourse to legal systems to enforce contracts.

Compared to no finance, informal finance is a good thing, and it will always have a place for both the rich and poor. Compared to effective formal finance, however, informal finance often falls short, especially for savings services. This rest of this note describes seven small ways for microfinance to acquire the virtues of informal finance.

Do not cap interest rates

The high interest rates (explicit or implicit) on loans from moneylenders, pawn shops, check-cashers, and hire/purchase stores are well-documented. Less well-known is that these high rates are needed to cover the cost of the supply of financial services to poor people. The poor are often very risky, and, compared to the small loans, the fixed costs of lending are high. Of course, all else constant, the poor benefit as interest rates fall, and some part of high rates may reflect the monopoly power of lenders who, unlike traditional bankers, are willing to get their hands dirty working with the poor. Like ration limits on groceries or other goods, however, legal caps on interest rates lead to sleight-of-hand to obfuscate the true cost of borrowing, and this only increases the likelihood that poor borrowers will get in over their heads. Likewise, legal caps reduce profits and decrease competition, which increases monopoly power and so increases the pressure to circumvent legal caps with even higher rates.

Do not outlaw informal finance

In a sense, this is an empty recommendation; informal finance, by its very nature, it outside the influence of formal laws. For example, laws probably have little effect on whether parents make loans to their children. Of course, some poor people do get trapped in vicious debt cycle due with unscrupulous lenders, but these lenders are unlikely to disappear by decree, and legal restrictions discourage mostly the fair lenders, weakening competition and strengthening the monopoly power of the predators. Probably the best course is what Meyer and Nagarajan (1992) call "benign neglect"; do not attempt to regulate or outlaw informal finance, because it would increase costs for the government and have little or no positive effect on financial services for the poor.

Allow people to form their own joint-liability groups

The first of two central innovations in microfinance is the joint-liability group in which all borrowers are liable for each other's debts. The success of such groups at the Grameen Bank in Bangladesh and at BancoSol in Bolivia has led to widespread replication. The clones usually are less successful than the models. Often, this is because staff of the microlender places members in groups (often with strangers) rather than letting groups form on their own. Although members may exclude the poorest, only self-selection can ensure that members screen for risk, trust each other, and believe that they have power to enforce repayment through social sanctions. Without self-selection, groups are mere façades.

Let loan officers judge risk

The second central innovation in microfinance is the use of loan officers who subjectively judge the risk of potential borrowers based on their sense of smell. In this way, the loan officer is like the local moneylender or store-owner who judges risk through their knowledge of the character and cash flows of a potential borrower. Loan officers belong on the street; microfinance requires written loan applications, but what makes or breaks an evaluation are visits by the loan officer to the borrower in her home and business.

Use collateral that is easy to repossess

Pawn shops and hire/purchase stores make loans without groups or loan officers because they take assets as collateral that are simple to repossess or—for pawn shops—pre-repossess at disbursement. Many poor people have small household items—black-and-white televisions, radios, tables and chairs, hand tools—that might back microloans. Repossession of these assets will not allow a lender to recoup losses from default, but the shame of repossession and the cost to replace an asset serves as powerful incentives to repay for the borrower. Of course, no one is happy when assets are repossessed, but the chance of loss of household items helps to ensure that borrowers carefully weigh the gains and risk of indebtedness. Lenders also have an obligation to judge risk well enough not to indebt people with high chances of default.

Go to where the poor are

Check-cashers and pawn shops are in the bad part of town; microfinance organizations should be there as well. When a deposit or repayment is small, transaction costs in terms of miles, money, and minutes are relatively high. To reduce these costs requires branches close to clients, and this requires a large number of branches. To control costs, branches must be small and simple, without the brass doorknobs and marbled floors of banks. Branches should also stay open on evenings and week-ends, the times when the working poor are more likely to be able to visit. The ultimate microfinance branch is a mobile collector that visits clients at their own homes and businesses, patterned after the money-guards of Africa and the RoSCA organizers all over the world. Such mobile collectors are especially valuable for women.

Provide deposit services

The emphasis of the microfinance movement on loans is misplaced. Some people want loans and are creditworthy, but all people want savings and are depositworthy. Although some people can exit poverty through the returns on assets purchased through loans, most people exit poverty through the return on assets purchased with their own savings. It is easy to make loans; all it takes is money, usually from donors. If borrowers default, the donors are still rich. It is difficult, however, to take deposits; deposit-takers must submit to regulation, and if they go bankrupt, they harm the very poor whom they meant to help. Thus, despite the important of deposit services to the poor, few microfinance organizations offer savings accounts. One way to improve is to convince donors to subsidize deposits and deposit-taking at traditional banks as much as they have subsidized loans and lending by non-governmental organizations.

An example from Bangladesh

*Safe*Save, a young microfinance program in the slums of Dhaka, Bangladesh, exemplifies many of the above points. Its design explicitly used insights from informal finance (Rutherford, 1998a and 1998b; Matin, Rutherford, and Maniruzzaman, 2000).

*Safe*Save offers both saving services and loans. Balances in its passbook savings accounts earn interest, and clients can make deposits or withdrawals at any time in any amount. Loans are collateralized by savings balances; clients can borrow up to 1.5 times their savings, and savings balances are frozen (pre-repossessed) until the debt is repaid. Like credit-card debt, debt from *Safe*Save does not have a fixed repayment schedule; as long as a borrower pays monthly interest and semi-annual fees, the loan is outstanding as long as the borrower wishes. Interest rates are high—3 percent a month on outstanding balances.

Employees at *Safe*Save work out of simple, one-room branches with minimal furniture and no motorcycles or other vehicles. As combination moneyguards/loan officers, employees visit each client each day in their home or business to transact deposits, withdrawals, disbursements, and repayments. Such home visits are especially important because most clients are women and because the custom of *purdah* severely restricts the movement of Bangladeshi women in public.

Conclusion

Informal finance has a lot to teach microfinance. Knowledge of the virtues of informal finance, however, does not imply knowledge of how to acquire those virtues. Policy advice must not only instruct microfinance organizations to imitate informal finance, but it must also say how to do so. *Safe*Save in Bangladesh is an example of how this might happen in practice.

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