INFORMAL MARKETS FOR FINANCIAL SERVICES IN SRI LANKA

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Introduction

Informal sector is a worldwide phenomenon. Efforts to ease problems associated with mismatch between resource endowments and needs encourage people to invent different methods leading to informal financial transactions and related institutions. With the evolution of societies more formal arrangements and institutions have been created. Overtime they have become sophisticated with advanced institutional arrangements and products. However, informal sector institutions and activities also exist along with formal sector developments. The formalization of informal sector activities depends mainly on infrastructure developments, policy adjustments and awareness of the benefits of formal sector facilities.

This paper intends to examine the nature and the operations of informal financial activities, with special reference to Sri Lanka. There is no clear and established definition for the informal sector, be it related to financial or any other types of activities. In this paper informal sector refers to the non-institutional or unorganized financial sources, which consist mainly of friends and relatives, moneylenders, traders, pawnbrokers, and landlords, engaged in lending activities and borrowings from such sources. Like in other countries, these informal activities operate in clusters throughout the country where the operations related to a particular cluster is limited to a particular geographical area or group of people most of the time. The operations of such informal financial systems move along with other services, which may have both formal and informal characteristics. Though the entry to the market as a supplier of such services is not restricted, the entry is not completely free of barriers, as the incumbents tend to resist new entrants at least at initial stages. Though anybody can be a lender, some kind of monopolistic characteristics could be seen in these markets. Similar services can be seen, in all such markets and prices of loan are almost similar.

This paper will consist of six sections. Section 2 is devoted to review of the theoretical and empirical literature on various aspects and issues associated with informal financial services. The salient features of informal financial transactions in Sri Lanka are discussed in section 3. Section 4 examines the extent of formal and informal financial activities in Sri Lanka at present. It also gives a summary of historical developments at the beginning. The Legal and Social factors that contribute to the existence of informal financial markets are discussed in section 5. Section 6 focuses on the costs and benefits of the formalizing informal financial activities. The final sections present major findings and conclusions.

2. Literature Review

The literature on the informal financial markets in Sri Lanka is limited to a few studies compared to them in the formal sector. However, the studies conducted in other countries can be used to shed some light in this regard, as the characteristics of informal transactions are quite similar across countries, worldwide

The existence of informal financial markets is a wide spread global phenomenon. However, the degree of their importance is largely associated with the degree of economic development. As was explained in the introductory chapter, informal financial markets play a very vital role in fulfilling financial needs of less advanced societies, especially in Less Developed Countries (LDCs). The size and the degree of informality of the activities in this sector differ among LDCs and also among different regions of a given LDC too.

According to a paper by ILO, an informal market consists of small-scale units in the production and distribution process of goods and services with the primary objective of generating employment opportunities and incomes to their participants not withstanding the constraints on capital, both physical and human and know-how. Jeganathan defines informal sector further as being outside the pale of the organized sector covering economic transactions of any type. Informal capital markets for credit in developing countries consist of two segments, the non-commercial sector and commercial sector. Non-commercial sector consists of friends and relatives, and generally they do not charge interest on loans. The commercial segment constitutes of a range of people like input dealers, crop buyers, landlords and moneylenders involving in financial activities, charging interest on loans (Padmanabhan). In addition, in most LDCs informal sources still meet 50–80 percent of the credit needs of the community though there has been a general decline in the importance of this sector with the expansion in the formal sector. General perception among masses including the governments about the suppliers of informal financial services is that they are "exploiters of helpless peasants". Despite this rather negative image, informal financial sector provides a vital and significant service to the masses to meet their financial needs through ways more convenient to them. Further, they adapt to the changing conditions compared to rigid rules and regulations that guide the formal sector financial transactions and have secured a higher rating among the poor, Padmanabhan emphasizes.

Following are the benefits that clients of moneylenders accrue from their transactions with moneylenders, according to Pathmanabhan

1. Proximity
2. Comfortable atmosphere
3. Quick credit
4. All-time access
5. Freedom of deployment
6. Repayment flexibility
7. Lower transaction cost

However, he admits that the above benefits are not free. Borrowers have to pay relatively higher interest rates. Especially for short-term funds the effective annual interest rates could well exceed 100 per cent. Further, sometimes consumption credits are available with some conditions where the borrowers are compelled to purchase their needs from the lender at relatively higher prices. This situation could hold them in a vicious circle of debt and poverty.

Referring to the market structure in money lending Padmanabhan explains that there is a considerable difference of opinion as to whether moneylenders enjoy monopoly profits in their lending operations. Most believe that moneylenders in informal sector earn high profits by virtue of monopolistic positions. Others, on the contrary, believe that the moneylender is a victim of unfair prejudice and that his income just covers the cost and risk associated with informal lending. Others argue that informal money lending is complementing the formal sector lending and there is no exploitative relationship between the informal lender and the borrower. Therefore there is no hard evidence of monopsonistic exploitation by informal lenders as the interest they charge include cost of capital, risk and administrative cost etc.

Padmanabha provides some important statistics on informal financial services and associated costs in India during 1980s. (Table 2.1)

TABLE 2.1 Costs and Interest Rates (%) of loans

Informal lender	Opportunity cost	Average administration cost	Risk premium	Average lending cost	Average nominal interest rate charged
Pawn shop	7	3	2.64	12.64	14.07
Shop keeper	7	3	2.64	12.64	16.38
Money lender	7	3	11.4	21.4	27.44
Rice Miler	7	3	5.3	15.3	11.74
Relatives	7	2	5.4	14.4	4.62
Friends	7	2	5.4	14.4	6.84

Source: Rural Credit, K P Padmanabhan

According to the above data the loans are available at relatively lower costs from relatives and friends. The moneylender is the highest cost source of borrowing.

The Rural Credit Survey of 1954 in India identified the following advantages of moneylenders in extending credit to rural people...

1. Moneylender plays a more supervisory role at all times.
2. Moneylender has different yardsticks to choose whom to lend. Least important

of all for him is the possibility of having recourse to the law and almost as unimportant is the possibility of acquiring debtor property.

3 It does not follow that he will not invoke the forces of compulsion the moment payment has become due. This is a matter on which, being unaffected by institutional codes, he can be as rigid or as elastic as realism dictates.

4 Having, in the light of all possibilities, decided on whether and how much he is going to lend on what terms, he is free to follow as flexible a procedure as he likes in regard to the actual operation of lending.

5. He is able to hand over the money promptly in order that some expenditure which brooks no delay may be met at once, without having to obtain another's sanction or authorization.

According to the 1986 report on the seminar on unorganized money market in the SEACEN countries, Chandravakar states that term "informal financial sector" or unorganized Money Market covers all financial activities outside the orbit of institutional and regular finance and this sector is highly heterogeneous since it covers lending and borrowing transactions involving varied types of individuals and intermediaries. Therefore, it is difficult to give an exact definition and description of the sector. But there are basic institutional and behavioural features of the sector that can be identified as follows.

1. The absence of regulation and presence of informality. There are no legal barriers in the sector
2. There is interlocking relationships among the credit, commodity, land, and factor markets. This implies that the interest rates on loans, which may be very high, are not determined by the market forces alone.
3. A quantity adjustment, that is the amount of credit available, is more important than price or interest rate adjustment. It is evident that in spite of the high interest rates, there continues to be credit rationing in the market
4. The working of the informal financial market exemplifies the Lemon principle in that the market requires complete knowledge of the borrowers' credentials and credit worthiness. This is in contrast to the lending in the formal market with relies mostly on collateral and incomplete information.

Further, Chandravakar states that there are useful and distinct services provided by this sector especially in the rural areas of the countries and they have existed long before the formal sector came into being. Even after the emergence of the formal sector the informal sector continues to exist. This to some extent, may be a response to the prevalence of financial repression in the formal sector and also emergence of the underground economy. More importantly, it may imply a very important and useful role that informal financial sector plays in financing micro, small and medium farmers who have no recourse to the formal financial sector. Furthermore, he states that informal financial sector probably reflects a stage of economic development in which the function of various sectors of the economy is not yet specialized.

The important factors influencing the interest rates in the informal financial markets can be grouped into behavioural and institutional components. The behavioral part refers to the pure rate of interest or liquidity preference, which is conceptually the price of parting with liquidity. There can be proxies by the interest rate of the longest maturity and most risk free securities such as treasury bills or in its absence, the saving deposits interest rate offered by the commercial bank. The institutional component comprises four major factors namely risk premium, administrative cost, opportunity cost of lender's capital and the profit.

According to Sandaratne, informal or non-institutional sources of credit continue to be perhaps the more dominant source of credit to small farmers, despite several improvements having been made in recent years in provision of institutional credit in Sri Lanka. He further states that the inability to recover loaned funds result in a declining number of creditworthy borrowers, which could in turn result in lesser inputs and lower production. But informal lenders were substantial in their lending and contributed a little less than half the credit borrowed by paddy farmers. The informal sector lends at interest rates ranging from zero to over 250 per cent per annum. In fact one third of informal credit was interest free, over 10 per cent at interest rates of 15 per cent. About 12 per cent of credit was borrowed at interest rate over 50 percent per annum and less than 1 per cent was above 150 per cent according to Sandaratne. He further explains that due to the presence of high interest rates of 150 per cent, informal lenders are branded as usurious. There are several other factors that account for the characterization of informal lending as usurious, which are as follows.

1. High Interest bearing loans
2. Interest rates based on causal investigations
3. Large number of loans are of short duration

Sandaratne describes that informal financial services are free of transaction cost and over 70 percent of informal lending was for production purposes during 1970s and 1980s. Cultivation purposes alone accounted for over half their volume of lending and 10 per cent of fund lends to the trading sector. Informal loans have a wide range of sizes and non-interest facilities are smaller sized but moneylenders grant somewhat larger loans. 93 per cent of the non-interest loans are unsecured but other lending covered by immovable assets, jewellery, durable consumer goods, machinery and equipment. Sandaratne further elaborates that informal lenders, like institutional sources had recovered only a small proportion of loans and moneylenders recovery is worse than non-interest charged lenders. In addition, he described that the importance of the informal sector's role in production credit may not have been adequately recognized owing to the fact that informal sources met the needs of consumption credit.

3. Sri Lankan Enviornmet of Informal Financial Services

With the introduction of formal financial institutions under the British rule in 1828 to facilitate the needs of the plantation sector informal markets appear to have grown in a small way to cater to the needs of the other sector of the economy. A community of Indian born money lenders emerged to finance the needs of indigenous persons in trade and consumptions. Pawn broking became the common method of finance and laws were enacted to protect pawned article owners and to implement anti usury policies.

The formal financial sector in Sri Lanka constitutes a system encompassing commercial banks, development banks, rural banks, credit societies, savings banks, finance companies, insurance companies, and contractual savings institutions. The opening up of the economy in 1977 paved the way for most of these institutions to expand and develop new products to cater to the growing needs. The exposure of these sector institutions to the practices of formal markets in advanced countries enables them to have advanced methods with sophistication. These developments led to both financial widening and deepening in the country. However, this sector could not cater to the all groups that sought financial facilities of different types due to lack of policy environment with required adjustments to the existing rules and regulations. Consequently, the informal sector has moved in par with the formal sector to cater to the groups which could not benefit from the formal sector institutions.

3.1 Structure of Informal Financial Markets in Sri Lanka

Informal financial transactions in Sri Lanka can be studied under three different categories, which are as follows.

1. Direct money lending includes professional and non professional money lenders, friends, relatives and private pawn brokers
2. Indirect money lending includes incorporate trade, marketing and commission agency and crop mortgage related credit
3. Voluntary credit groups includes single-purpose credit societies, multi-purpose saving and credit societies and Rotating Savings and Credit Societies (ROSCAS) and Accumulating Savings and Credit Associations (ASCAS)

3.1.1 Rural sector informal financial Market

Rural informal financial markets operate with other markets and consist of a wide range of financial transactions linked or tied to land, labor, voluntary credit societies, and informal saving associations such as ROSCAS and ASCAS. Economic activities, mostly agricultural activities, of the rural sector are tied with these financial transactions, as the penetration of formal financial institutions is weak. Though the presence of formal financial transactions in the rural sector has improved in line with the expansion of institutional financial sector with both financial widening and deepening, the informal financial transactions still play a dominant role in the rural sector. The existence a large number of small and landless farmers with irregular and unpredictable income, lack of awareness of facilities available with formal financial institutions, greater procedural requirements and seemingly unfriendly environment associated with formal financial institutions, have contributed to the dominance of informal financial sector.

Popular financing methods in rural Sri Lanka are as follows.

a. Pawning

Pawning is an arrangement where the borrower surrenders a valuable article, mostly jewelleries, as collateral against the borrowed money. The amount lent against such articles is always lower than the market price, so that the borrower has the incentive to service the loan and lender's interests are also secured in the event of a default by the borrower. Two types of Pawn Brokers are in operation: registered pawnbrokers and unregistered pawnbrokers. Unregistered ones are closer to the clients, as their needs are met at any time of the day with easy and simple procedures. Lending conditions and applicable interest rates in the informal pawning transactions can vary from person to person depending on the evaluation of the creditworthiness and the degree of relationship the borrower has with the lender. If borrower defaults, the borrower accepts that the ownership of jewellery is transferred to the lender automatically. However, repayment conditions in most of the cases are very flexible due to cultural practices linked with jewellery. At present, formal financial sector has come with strong competition for pawning but informal pawnbrokers continue to be attractive, possibly due to the flexible terms and conditions they maintain and also the long term association of the rural folk with pawnbrokers.

b. Trade credit

In this system borrowing takes place mostly in goods. Some times services also can be involved. Such transactions could involve either in consumption or investment. Households, that have irregular income sources and also do not have the capacity to purchase their consumer needs in bulk for a few days ahead, tend to purchase their daily requirements from a neighbouring retail store or a boutique. In most cases such purchases on credit are settled fully or partly at different frequencies such as daily, weekly, monthly or irregularly with harvests etc. Sometimes the same boutique owner can lend money in emergency situations, such as a family member falling sick. Similar types of borrowing takes place for production purposes as well. It is more predominant in agriculture activities where farmers borrow seeds, fertilizers, and chemicals etc at different stages of the production process. Repayment of loans could be with the harvest, a common practice, or in cash. Sometimes the lender collects his dues at the initial stage of harvesting, where the borrower has no alternative rather than to oblige.

The interests charged on these types of loans are not clearly identified. Most of the times the interests are hidden in higher prices for items sold to the borrower and lower prices paid to borrower in exchange for their harvest to settle loans. Further, most of the times trade credit becomes a rolling credit, where new borrowing goes to pay previous borrowing.

c. Crop mortgages

This type of credit is common in the rural sector in the country. Lender and the borrower enter in to an agreement, mostly verbal, before the facilities are granted. Borrowed funds used for the production purposes, especially for paddy production, are agreed to be repaid with the harvest or on mortgage of the harvest. Sometimes borrower agrees to pay half in goods from the harvest and balance in cash or pay in full with the harvest. In most occasions lender dictates the terms and conditions and borrower has to oblige due to weak bargaining power.

d. Single purpose credit services

This service, arranged by the group of people jointly , collects a fixed sum of money periodically to accumulate into a fund sufficient to grant loans to members to meet their emergency financial requirements, such as funerals, daughters attaining 'age' and weddings. The most common need of such nature is a funeral. Sometimes there are associations, called death donation societies where members of the society contribute to a relief fund to assist members in such situations. These societies provide single purpose loans too to members at an agreed subsidized rate decided by the society.

e. Direct Lending

Direct money lending bears the following main characteristics but it can differ from one centre to another centre due to various reasons.

1. Little or no collateral is involved
2. No documents or paper work
3. No specific purpose required for loans
4. High flexibility for important loan covenants

Under the indirect money lending, large portion of low-income groups borrow funds mostly for consumption activities. Shopkeepers and boutique owners are mainly involved in these types of fund transfer activities especially with rural sector in the country. Lender will dictate all the terms and conditions of the financial facilities and at the same time borrowers has much respect for the lender. Borrowers are always have much faith in the lender to be fair and just. Rolling over is a common feature in these types of transactions.If the borrower pays the loan in full, he can get a fresh loan again under the same terms and conditions. Most of the lenders keep their clientele for a reasonable period by using same contracts with the borrower. Sometimes some lenders waive off the last interest installment if a fresh loan is obtained with the same conditions. It can be seen that these types of credit arrangements are prevalent among the urban and estate sector.

Voluntary credit groups have also been in the rural sector and organized to certain extent or behave as semi formal financial institutions under cooperative concept. These credit organizations are characterized by unlimited liability, small area of operation and mutual knowledge among members. There is no any provision for dividends or any other return and are like welfare societies.

3.1.2 The Urban sector informal financial market

Urban sector is characterized by relatively more formal economic activities with relatively higher magnitude. Accordingly, the majority of the financial transactions are conducted with formal financial institutions. However, informal financial transactions too prevail to a considerable degree due to various reasons. Urgency of funds, unfamiliarity with formal institutions, lack of collateral, having defaulted with the formal sector, and tax evasions are possible reasons. Nature of business is also an important factor in this regard; people who are involved in illegal economic activities do not turn to formal institutions, as they cannot reveal the actual nature of their business. Using both formal and informal institutions to meet financial needs can also be seen among urban businesses.

Small enterprises tend to look for informal sources of financing at their early stages of business, possibly due to difficulties in meeting the requirements of formal financial institutions, lack of awareness and sense of uncertainty about the repayment of loans regularly.

Several types of informal financial markets can be seen in urban areas especially in metropolitan cities and regional marketing centers such as Colombo (Pettah) Dambulla, Marandagahamula and Meegoda. In these markets large transactions take place on daily basis with the involvement of traders and informal lenders. Informal lenders in these markets have a fairly accurate assessment of the creditworthiness of the borrowers and of ways of recovering their loans. Funds are readily available on request. In the event of a request for funds by a newcomer, it is common to obtain a verbal guarantee from a reliable client at the centre. Usually borrowers are businessmen or merchants engaged in all types of business activities in the metropolitan areas or trusted agents of the merchants. Documentation between lender and borrower generally do not exist. It is a simple, daily transaction where lenders maintain records or borrowers in their own way. All terms and conditions are verbal and exchanges take place based on the long established trust. The amount of the loans can vary from very small amount to millions of rupees. Sometimes, moneylenders use syndication type loans based on the trustworthiness of the borrower. All types of features in conventional syndication loans appear in informal syndication loans too but arranging fee is negligible. It is difficult to find information of the default rates, though such cases could prevail in these markets. Lenders tend to use various tools to recover a loan including physical harassment, especially when a default seems willful. Certain moneylenders maintain close relationships with law enforcement authorities to use their power indirectly to support their activities.

3.1.3 Estate sector informal financial market

Plantation estate sector inherits distinctive characteristics compared to both urban and rural sectors and clients in informal transactions are mostly from estate sector labourers. Their monthly income is only a salary from the estate that is sufficient to maintain a simple life. Therefore some of the estate workers get into activities such as animal husbandry, shop keeping, and some other micro or small-scale industries and they tend to rely on their lender for finance. Because of their living styles, citizenship problems, and work environment, it is difficult for them to link with the formal financial sector.

The common features of informal financial transactions at these market centres could be summarized as follows.

1. No written records of transactions
2. No collaterals or security for loans
3. Very few restrictions on transactions with someone who wishes to be involved
4. Short-term lending
5. Manageable rates to the borrower and different rate structure

3.2 Main characteristics/features of Informal Financial Markets in Sri Lanka

Although there are distinctive characteristics in informal financial transactions across sectors, there are common features as well.

3.2.1 Participants

It can be seen that wide range of participants takes part in the informal financial markets in Sri Lanka. They constitute people such as farmers, shop owners, professional and non-professional moneylenders, businessmen, and institution such as community-based organizations, voluntary credit groups and cooperative societies. Each party has different role in the market. One significant fact that the participation of certain parties in informal markets is an indication of the trust earned by these markets and participation itself generates more trust. This can be seen in the urban informal financial markets than rural financial markets.

3.2.2 Size of lending

The size of the loans granted in informal financial markets follow a somewhat generic pattern, which shows that the size is usually larger in urban sector than in other two sectors. In addition, size of the interest bearing loans are bigger than the interest free loans and small loans may be as smal as Rs. 500/= for street vendors and bigger loan as big as Rs. 5 million or more for organized businessmen in urban and metropolitan centers. However, majority of loans in the informal financial sector is small and spread in a wide range, depending on the economic activities.

3.2.3 Price of the Loans (Interest rates)

Price of the informal financial facilities range from zero interest to more than 100 per cent par annum or in certain cases could be extremely high. The zero rate facilities are mainly provided by friends and relatives and occasionally by voluntary organizations like ROSCAS and ASCAS for very small amounts. Daily basis rates are ranging from 2% to 5% depending on the activity. In most cases moneylenders charge specific amounts for Rs. 1000/= for small-scale borrowers on daily basis or grant loans on discount basis. For example, charging Rs.100/= per Rs.1000/= or releasing only Rs. 900/= for a loan of Rs.1000/=. Furthermore, the interests charged in these methods vary depending on the size of the loan, previous experience and relationship with the borrower, nature of the situation of borrowing and the lenders expected return. In certain cases the effective interest rate is not apparent, as they are charged in different forms.

3.2.4 Approval Procedures

Lender has sole authority of approving facilities for borrowers in the informal financial sector. Borrower does not have any authority to change the terms and conditions of the loan amount, repayment period, interest applicable, and other factors linked to the facility. Due to this reason, some argue that the lender exploits the borrower in an unfair manner and use it as a factor to justify regulating the informal financial sector. But if closely scrutinized, such claims could be seen to be exaggerations to a certain extent, as moneylenders provide an important service in the absence of formal sector facilities. Coexistence of informal money lending with formal lending activities in the economy itself testifies that the society benefits from their service. In certain cases money lenders provide multiple services, such as the link between the city centers and business clients, advisor and also enticer in certain economic activities. The clients receive such services free of charge in most cases.

3.2.5 Collateral/Securities

The informal lending or financial activities are not based on collateral or securities compared to formal sector lending of financial activities. This is the most important factor for survival of this industry all over world today in the presence of the sophisticated formal financial sector. In some countries both sectors work hand in hand. Informal financial sector emphasizes more on goodwill between the two parties than entering in to formal loan agreements. However, some studies revealed that some of the transaction are covered with some securities such as equipment, machinery, consumer durables and immovable assets. But there is no ownership transfer or registering of mortgages by the borrower or lender. In most occasions possession will be changed, but after the repayment borrower will take back the asset. Most of the loans are unsecured in the informal financial sector and this is another reason for the lender to charge higher interest rates for higher risk. Borrower's goodwill thus becomes the main collateral in most part of the country, with the future harvest of the borrower considered as the collateral.

3.2.6 Risk

Loans backed by intangible assets such as goodwill may create a vulnerable situation to the lender and therefore, the associated risk is very high. With the asymmetric information background, lender's selection of the borrower may be questionable. If the selection is poor, loan becomes doubtful and lender has a high risk of collecting his loan funds. But this is not valid for informal financial markets due to symmetric information situation in the market. However, informal moneylenders have diversified their ways of assessment of borrowers through their long experience. Lender knows the borrower well, and his network is capable of gathering most relevant information on the borrower. In other words, informal financial markets tackle this problem very cleverly by using all available sources of information and use credit scoring models very effectively.

Furthermore, the presence of the free rider problems is relatively less in the informal financial market compared to the formal sector. Therefore, most types of risks are mitigated substantially. If any defaults occur due to genuine reasons, he will make rescheduling arrangements with new loans to the borrower. This analysis shows that informal credit is less risky than formal credit most of the lenders provide facilities to known parties.

4. Distribution the Informal Financial Market Between the Formal and Semiformal Financial Sectors

The Consumer Finance and Socioeconomic Surveys conducted by the Central Bank of Sri Lanka (CBSL) at regular intervals have collected vital information relating to financial transactions of the household sector in the country between 1963 and 2004.The following information (Table 4.1) from the report for 2003/04 indicates developments with respect to formal and informal financial transactions over a eriod of around 50 years.

Table 4.1 Distribution of Number of loans by Formal and informal institutions

	Number of Loans %						
	1963	1973	1978/79	1981/82	1986/87	1996/97	2003/04
Formal institutions	7.6	11.5	10.7	9.7	16.6	43.1	45.0
Informal Institutions	92.4	88.5	89.3	90.3	83.4	56.9	55.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Values %						
Formal institutions	n.a	n.a	25.3	38.0	39.8	67.3	61.1
Informal Institutions	n.a	.n. a	74.7	62.0	60.2	32.7	38.9
Total			100.0	100.0	100.0	100	100
Source. CFS 2003/04 Report							

Source. CFS 2003/04 Report

Over this period the importance of the informal sector in meeting the financial transactions of the household sector in Sri Lanka has been in a decreasing trend. The two decades of 1980s and 1990s have experienced notable developments in this regard, where the shift from informal sources to formal ones has speeded up in 1980s while the intensity of this move has increased in 1990s. Liberalization of the economy paving the way for more private sector participation and consequent expansion in economic activities at all levels and the availability of facilities could have contributed to the developments in 1980s. Implementations of further liberalizing measures particularly in the financial sector, increased interest in both the private and the public sectors in extending financial facilities to rural areas.. The resulting expansion of micro-finance concept could have accelerated the process that gathered momentum in 1980s.

Chart 4.1 Formal and Informal contribution of Number of Loans (%)

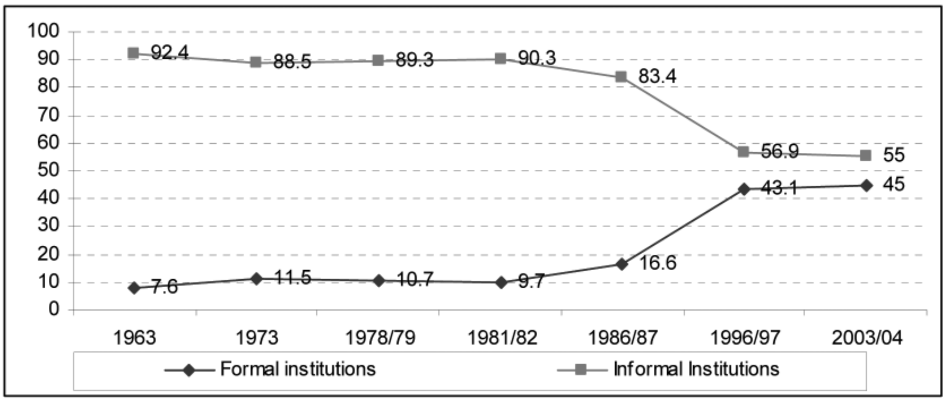
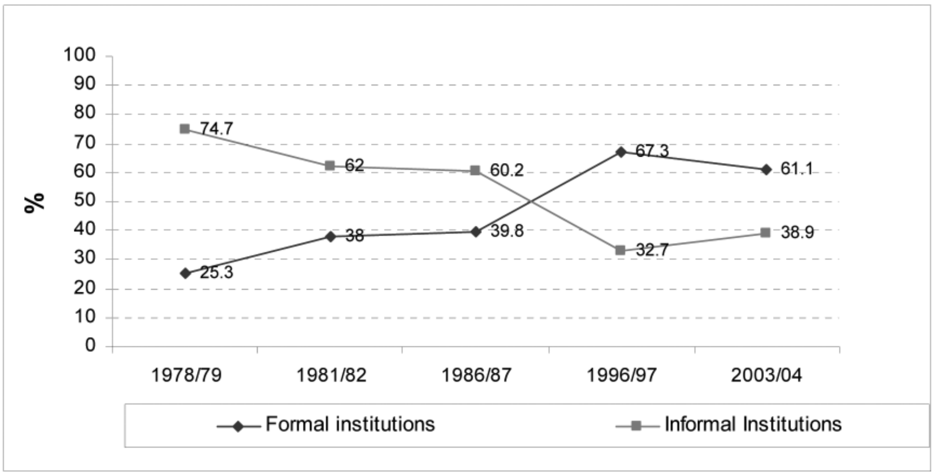


Chart 4.2 Formal and Informal contribution of Value of Loans (%)



However, the developments after late 1990s up to recent times indicate virtually a stagnant situation. The question arises whether the expansion has reached its maximum within the prevailing structural environment encompassing economic, institutional and legal dimensions. The availability of facilities in the formal sector is only one factor that encourages shift of financial transactions from informal institutions to formal and semi-formal ones, especially with respect to borrowing. Ability to meet the documentary and procedural requirements of the formal financial institutions and willingness, which is associated with the awareness and certainty of being able to repay according to the times-frames specified in institutional lending etc., also play an equal, if not greater, role in this regard. If these are the reasons for the observed stand still situation of the shift to the institutional sector, further institutionalization of the financial transactions may require an environment that would remove the above mentioned barriers.

4.1. Current Situation of Formal and Informal Financial Transactions

In addition to the above time series analysis, a cross section of the nature and the magnitude of financial transactions with formal and informal institutions would help understand the current situation. The CFS 2003/04 conducted by the CBSL provides comprehensive set of data for this analysis.

4.1.1 Purpose and Source of Borrowing

The distribution of the number of loans obtained by households during the reference period revealed that around 55 per cent of the loans are from informal institutions, while the balance 45 per cent is from formal institutions. Accordingly there is a tendency among households to turn to the informal sector for their financial needs. Further, the distribution of the amount of loans reveals another important characteristic. The share of the amount of loans from the informal sector is around 40 per cent, which indicates that the average size of a loan from informal sources is relatively smaller than that from formal sources Among formal sector institutions, commercial banks are dominant both in terms of its share in the number as well as the value of loans to the household sector. Development banks and Rural Banks also have played an important role particularly among categories of loan to industry and livestock.

The analysis of the loans only from informal sources reveals a high concentration of both the number and the amount of loans from friends and relatives. The relative share of this single source is around 75 per cent and 74 per cent for the number and the amount of loans respectively. The second highest share is associated with moneylenders for both the number and the amount of loans with respective shares of around 19 per cent and 21 per cent. Accordingly, around 95 per cent of the household financial transactions with informal institutions are with only two sources. The balance 5 per cent is distributed among NGOs and other sources, where the share of NGOs is relatively low at around 2 per cent for the number of loans and 1 per cent for the amount.

Among the two major sources of informal sector loans, friends and relatives have been dominant the dominant source for all purposes of borrowing, while within this category, consumption loans dominate. Convenience of arranging a loan with a fairly low or no interest payments could be the main reasons for this phenomenon. Relatively smaller size of a loan as suggested by the respective shares in the number of loan and amount is also important in this regard. According to the distribution of loans by purpose, the highest number of loans, around 57 per cent, is for consumption purposes. However, the relative share of consumption purposes in terms of the amount is only 18 per cent, which suggest relatively small size loans for this purpose. The average size of a consumption loan from all sources is around Rs. 3,111/=. The average size of a loan varied from Rs. 2,411/= from friends and relatives to Rs. 9,100 /=from commercial banks among specified sources. This range is much narrower within Rs 1,898 from non-specified sources to Rs. 3,397/= from moneylenders. Accordingly the household sector seems to turn to more informal sources of financing to meet their relatively smaller consumption loans.

Table 4.2 The Distribution of the Number and Amount (value) of Loans by Propose and Source 2003/04

Purpose	Source: Formal								Informal				Total
	Commercial Banks	Development Banks	Development Financial Institutions	Rural Banks/Co-operatives	Samurdhi/ Janashakthi	Loan Boards /Thrift Societies	Formal Sector Employers	Finance Companies	NGOs	Money Lenders	Friends and Relatives	Other	
Number of Loans													
Paddy Cultivation	33.3	10.3	1.1	6.9	5.7	9.2	1.1	-		4.6	25.3	2.3	100.0
Other Crops	22.5	7.0	-	4.2	8.5	1.4	-	-	1.4	9.9	38.0	7.0	100.0
Livestock	26.7	13.3	-	20.0	6.7	6.7	6.7	-	20.0	-	-	-	100.0
Industry	28.0	24.0	-	4.0	12.0	4.0	-	4.0	-	-	24.0	-	100.0
Business /Trade	28.9	8.4	1.7	3.8	3.8	1.3	0.4	2.5	0.8	8.4	35.1	5.0	100.0
Housing	29.5	8.6	4.5	5.7	4.1	3.7	4.5	0.8	1.6	8.6	28.3	-	100.0
Consumption	20.1	2.2	0.5	3.6	0.9	1.6	3.0	0.9	0.9	12.1	52.2	1.8	100.0
Ceremonial /Ritual	20.3	1.3	0.3	2.5	0.6	1.6	20.3	0.3	0.6	11.4	37.3	3.5	100.0
Settlement of Dues	32.1	7.0	2.3	7.9	3.3	2.3	0.9	0.5	0.5	14.9	26.5	1.9	100.0
Consumer Durables	20.0	4.2	-	7.4	1.1	2.1	12.6	4.2		9.5	34.7	4.2	100.0
Other	31.5	3.6	-	5.0	1.4	1.4	1.8	0.9		8.6	42.8	3.2	100.0
Total	23.9	4.3	1.0	4.4	2.1	2.1	4.7	1.0	0.9	10.8	42.4	2.4	100.0
Amount of Loans (Values)													
Paddy Cultivation	44.7	10.2	0.4	4.1	5	14.1	1.1	-		3.0	16.3	0.9	100.0
Other Crops	23.6	6.9	-	5.9	11.1	0.5	-	-	0.2	7.1	28.6	16.1	100.0
Livestock	30.5	32.7	-	14.6	0.4	1.5	12.8	-	7.4	-	-	-	100.0
Industry	38.7	9.9	-	3.4	5.2	0.6	-	0.8	-	-	41.3	-	100.0
Business /Trade	43.4	11.6	3.5	0.9	1.0	0.2	0.0	7.1	0.1	4.5	25.4	2.3	100.0
Housing	31.8	7.1	9.1	3.3	1.7	1.7	11.3	1.5	0.9	7.5	24.1	-	100.0
Consumption	28.4	4.2	1.5	3.5	0.6	1.6	3.7	0.9	0.9	13.2	40.5	1.1	100.0
Ceremonial /Ritual	24.4	1.4	0.5	1.7	0.4	4.2	7.1	0.2	0.5	14.5	43.6	1.5	100.0
Settlement of Dues	53.7	3.8	2.3	1.8	1.1	1.8	1.0	0.2	0.7	9.9	20.1	3.7	100.0
Consumer Durables	7.4	8.3	-	14.6	0.3	3.1	11.4	2.6	-	5.7	44.4	2.1	100.0
Other	45.4	10.8	-	1.2	1.8	0.3	1.9	0.3	-	11.3	25.5	1.7	100.0
Total	35.9	7.9	3.3	3.2	1.3	1.7	4.6	2.5	0.5	8.2	29.0	1.8	100.0

Source: CFS 2003/04 Report

4.2.2 Collateral

The data reveals that more than half of the loans are still with no security, a fact that testifies to the existance of informal financial transaction to a greater extent. Presence of asymmetric information and related problems, such as adverse selection in lending and moral hazards subsequent to borrowing, which increase the exposure of the lender to risk of higher defaults, make formal financial institutions to ensure the recovery of loans by backing it with personal guarantees, verbal or documented. This is one important factor that make majority of the households switch to informal sector borrowing as they find it difficult to offer acceptable securities to the formal sector institutions

Table 4.3 Distribution of the Number and Amount of Loans by Collateral

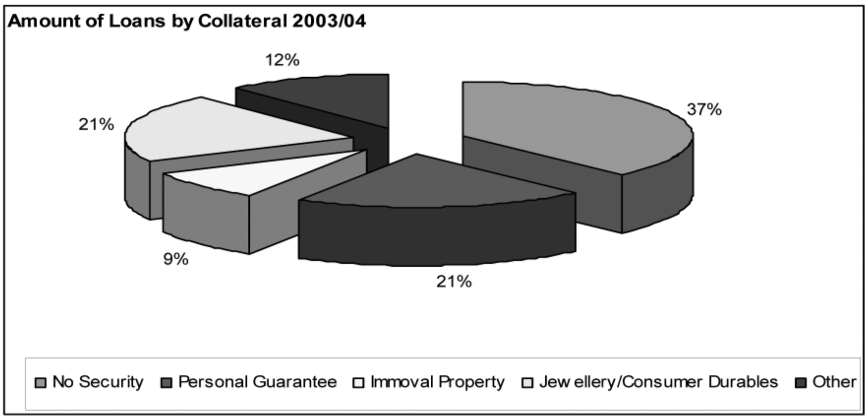
Type of Collateral	Number		Amount	
	1996/97	2003/04	1996/97	2003/04
No Security	57.8	54.5	35.5	37.7
Personal Guarantee	6.7	9.9	10.4	20.8
Immovable Property	1.6	1.2	30.6	9.1
Jewellery/Consumer Durables	31.2	31.0	11.9	20.8
Other	2.7	3.4	11.6	11.6
Total	100.0	100.0	100.0	100.0

Source: CFS 2003/04 Report

Around 58 per cent of the loans taken during the reference period have been with no security or collateral. The situation during the previous survey too is similar with around 55 per cent of loans being with no security. However, the share of the amount of loans with no collateral has been 36 and around 38 per cent respectively in two survey periods. These patterns of the distribution of the shares suggest that the size of loans with no securities has been relatively small. Around 31 per cent of loans during both survey periods have been supported by collateral such as jewellery or consumer durables. However, its share with respect to the amount of loans has almost doubled from 12 per cent during the previous to around 21 per cent during the current survey, indicating an increase in the relative size of a loan in this category. Appreciation of the value of gold and consequent increase in the amount that could be borrowed against jewellery could have contributed to this increase. One important phenomenon with respect to borrowing against collateral is the significantly low share of number of loans against immovable property which is mainly land. One important feature about the land ownership among households in Sri Lanka is that in most cases, clearly identified ownership with documentary support is rare despite their ownership of land according to family norms and traditions. Therefore, informal sector lenders too are reluctant to lend against lands with unclear titles. This is an area where programs to formalize informal financial transactions should take in to consideration. Personal guarantees have been used for around 10 per cent of loans to support around 21 per cent of the amount of loans. It is an improvement both in terms of the number and the magnitude of loans compared to the previous survey.

Chart 4.2

Chart 4.3



5. Factors that influence the activities in the Informal Financial System

The factors that affect the existence and the activities of informal financial transactions can be classified into three areas: (i) Legal and Regulatory factors (ii) Economic and Social factors (iii) poor property rights.

5.1 Legal and Regulatory Factors

Public confidence is the main pillar on which the existence of the financial institutions rest. The government and the agencies that carry out functions to facilitate government activities are responsible for maintaining an effective , credible payment and settlement system. The effectiveness and the efficiency of such a system depend mainly on the financial soundness of institutions that do business by providing various financial services to the society. Hence, governments maintain supervisory and regulatory systems with legal support.. Accordingly, a fair number of acts and regulations relating to financial sectors can be identified. The primary focus of most of those acts and regulations to reduce the exposure of formal institutions to risk of having high defaults has limited their area of operations. This situation has deprived prospective borrowers from access to formal sector institutions. Accordingly, they have left room for informal markets to emerge, due to the demand arising from those who cannot comply with the rules and regulations that govern formal financial institutions and high-level regulation imposed by authorities from time to time.

The Monetary Law Act (MLA) specifies the main functions and responsibilities of the Central Bank of Sri Lanka (CBSL), which is entrusted, with the duty of ensuring price, economic and financial system stability. Under the latter responsibility, the CBSL imposes minimum requirements and guidelines coupled with on -site and off-site supervision to ensure compliance. The Banking Act and Finance Companies Act are examples of regulatory requirements for specific areas. In addition, there are individual institutional acts to govern the operations of individual financial institutions. Bank of Ceylon Act, Peoples' Bank Act and National Savings Bank Act are a few examples. The Securities Exchange Commission (SEC) and Insurance Commission are examples for other types of regulatory bodies in the formal financial sector. In addition, there are large numbers of legislations that successive Governments, since independence, have enacted to secure and safeguard the peoples' interests in different areas of their activities..

5.2 Social and Economic Factors

During the last fifty years, Sri Lanka has maintained a moderate economic growth path to reach the threshold of the lower middle-income country standard, based on the crude measure of per capita income. However, the incidence of poverty is still prevalent across the country, and in certain areas, it has even increased. Data collected by Socio-Economic Surveys revealed that the income disparity has increased with more concentration of wealth, among high-income households. Further, the pattern of economic expansion in the country also indicates high concentration of economic activities in certain areas, particularly in the western province, has denied fair distribution of opportunities for people to involve in economic activities across the country.

Experience in other countries has shown that the availability of opportunities is a key factor that empowers people to generate more income and accumulate assets over time. Higher income and associated accumulation of wealth, with an environment of more opportunities, gradually encourage people to deal with formal sector institutions and adjust their behavior in line with the operations of such institutions. With such an environment activities, behaviours and attitudes change and become advanced and sophisticated. On the contrary, societies that do not have opportunities tend to stay poor and under developed with majority of their activities being primitive, unorganized and informal.

Unequal distribution of opportunities across different regions in the country and poor infrastructure particularly in rural areas, where the majority of the poor live, have kept the poor in poverty, while developed regions have adjusted with increasing globalization. Basically, all economic agents, be they formal advanced units or informal primitive units, are mainly driven by the profit motive. Accordingly, most of the formal sector institutions including financial sector ones have focused their attention on more developed regions while neglecting the needs of other regions. Establishment of state owned financial intermediaries of various types from time to time have failed to address this adequately, since they also have finally been enticed by the profit motive. Further, politically motivated popular schemes to write off loans from the public sector financial intuitions have led to a higher ratio of non performing loans. Bad precedents set by such actions at macro level have made certain development loan schemes utter failures finally depriving even genuine borrowers having access to cheap funds. A large majority of the income earners in the country, particularly in the rural sector and the urban poor, has seasonal or irregular pattern of receiving income. This irregularity is also a constraint for borrowing from the formal sector institutions, which demand regular service of loans. Hence, even creditworthy and genuine borrowers' turn to informal financial sector for their needs. Lack of familiarity, with formal sector environment due to their remoteness geographically, and awareness of the procedures also encourage people to find help from the informal sources. In certain societies borrowing especially for consumption purposes is considered as disgraceful.. That makes them avoid formal financial institutions and secretly find shelter in the informal sector

5.3 Poor Property Rights

Poor property rights are another factor that forces people to turn to the informal sector. As stated earlier, even the poor own immovable properties but have no documentary evidence of title. Hence their inability to borrow from the formal sector, even though they possess necessary skills for productive activity. Thus they are compelled to sell their skills cheaply to other entrepreneurs, who exploit them. The skills of the poor can be used to develop themselves and the economy, if there was a way for them to establish the title to the immovable properties they own

6. The cost and benefits of the formalizing these activities

The available information presented in chapter 3 above reveals that the informal sector financial transactions still dominate the overall financial transactions of households in Sri Lanka. This situation when compared with advanced economies suggests that Sri Lanka has a long way to go in this area. As was mentioned earlier, the relative share of the formal financial transactions is closely associated with the level of economic development and accordingly, the progress in economic development could transform informal financial activities to more formal ones and reduce the share of the informal market in the financial sector. However, direct intervention for this purpose could expedite the process to a certain extent. Providing institutional infrastructure to suit needs of the prospective clientele with an effective awareness program would be an important step in this regard.

Formalization of any activity gives its usage recognition and enables such activities to move parallel with other formal sectors of the economy. Therefore, formalizing the informal sector may be desirable, but it will need a comprehensive programme to meet the multidimensional needs of the poor. Also the growth of informal economy or informal financial market can often be traced to inappropriate, ineffective, misguided, or badly implemented macroeconomic and social policies, often designed and implemented without proper consultation with the actual stakeholders.

There are different views on the normalization of informal financial markets. However, there is general agreement that whatever measures implemented to formalize this sector, they should not be perceived as alien by the people at grass-root level who are the net beneficiaries of such measures. Accordingly, a blend of both the formal and informal characteristics would help a smooth transition of certain informal transactions into a formal environment. In other words, it needs to be a semi-formal environment, which is already there, in association with certain rural sector development programmes in operation.

6.1 Benefits of Financial Deepening

The incidence of relatively high interest rates associated with the informal financial sector is a common phenomenon identified in almost all economic systems. They reflect different types premiums for risk and convenience that the formal sector institutions have failed to provide to the needy sections of the society. If formalization provides acceptable alternatives, the society would benefit by reduced cost of funds, and enable them to utilize relatively higher share of their income for consumption and productive investment.

Further, formalization would provide clear and documented terms and conditions to the client so as to reduce the risk of unexpected terms and conditions under informal transactions. It could provide the legal protections for the less privileged people. Since formalization removes certain barriers that people find when dealing with formal sector institutions, it provides them with the opportunity of selecting institutions of their choice in a competitive environment, so that they can enjoy the benefits of competitive prices. Further, people can enjoy the benefits of non-financial services that are offered by the formal institutions.

In addition to such individual benefits the whole society can reap benefits from a more formal environment due to increased availability of information for effective policy making. Since data collected from established formal institutions is more accurate, it could help more accurate assessments about the performance of the financial sector as well as the entire economy. Accordingly, formalization of informal financial institutions and their operations could create a more efficient financial environment, while enhancing both efficiency and effectiveness of policies for development and poverty reduction.

6.2 Costs of formalizing informal financial markets

Formalization will require the providers of financial services to maintain a given set of standards. This requirement would force some players out of business in which case a certain segment of the market/society on the demand side would lose a service they have been enjoying to meet their needs. Not only suppliers, but also some users of informal services may also be marginalized, if they cannot have formal arrangements to deal with the formalized system. Under formalization process, it is necessary to convert informal financial units into formal ones. In this process of formalization the introduction of new rules and regulations and the establishment of new institutions to facilitate the effective implementation of the process will entail considerable financial cost to the government. Supervision of the operating institutions and their activities to ensure that required rules are observed properly will also bring on added costs to the government.

In addition to such direct and measurable financial costs, the society would encounter both direct and indirect economic costs in the process. If the marginalized segment of the market, to be arbitrarily formalized is relatively large, the economic costs in terms of loss of output and employment opportunities will be considerable. If the arbitrarily formalized institutions do not provide avenues alternative to the informal ones, society will still have to rely on the informal sources for their financial transactions at relatively higher prices compared to the situation before arbitrary formalization, as providers of informal services will have to bear an additional cost to hide their transactions from official scrutiny. Such developments could even lead to social unrest.

Intervention by the government through regulations to formalize informal financial activities could create distorted markets due to the complexity of the causes for the existence of informal markets. Regulation is to protect players in the business. It has a cost but borrowers could gain by lower interest rates and savers also will gain with more certainty and less risk. Designing a policy package to address all related issues in this regard would be an extremely difficult task. The ability, availability, and the willingness are three main factors that encourage people to engage in activities with formal institutions. Direct regulations can do only very little to address those issues. However, facilitating the penetration of formal institutions into needy areas will be more practical. A campaign to increase awareness of the advantages of the benefits that people can accrue through formal sector transactions would complement the facilitating process.

7. The major Findings and Conclusions

Sustainable economic growth and fair distribution of resources and opportunities are prerequisites for quality economic development. Increased investment and commensurate increase in savings to finance that investment have been identified as basic requirements for economic growth. As resources and skills are unequally distributed among different segments of the society, an effective system is required to mobilize resource from surplus units to deficit units. This service is provided by both formal and informal financial institutions in an economy. Country experiences have proved that the relative importance of the share of informal financial transactions is closely associated with the level of economic development and hence varies from economy to economy. In advanced economies the formal sector is very significant, while on the contrary, the informal sector dominates in less developed economies. However, in developing economies too, the formal sector dominates in certain areas, particularly in urban business sector. The characteristics of informal markets are common in most of the countries. Poor institutional infrastructure resulting in lack of facilities, more formal procedures, inability to meet documentary support for borrowing from the formal markets, irregularities in income receipts and associated uncertainty of repayment of loans, lack of awareness, involvements in illegal economic activities, and tax evasion are among the major reasons for people to turn to informal financial market to meet their needs.

Informal financial markets provide a very important service in meeting financial needs of especially less privileged segments of the society who find it inconvenient or uncomfortable in dealing with the procedures in a formal environment with formal financial institutions. As such, informal financial markets provide an array of services to their clientele, but at relatively higher prices.

The available evidence indicates that informal financial markets in Sri Lanka played an important role until early 1970s, which the introduction of open economic policies and deregulation led to an expansion of the formal institutions. This was significant particularly after the introduction of policies to liberalize the financial sector. However, the process has slowed down during the last two decades. Informal financial markets still play a relatively higher role in the economy. Further, such transactions involve fairly small amounts. There are a large number of factors attributable for the existence of informal financial markets. A comparison with advanced economies indicates the Sri Lanka has potential to have more formalized market in the financial sector transactions. Correct policies in this regard could bring about more formal activities into the financial sector for overall benefit to society. However, formalization of informal financial markets should be done after consideration of the impact of such moves on the real stakeholders, which was not the case in the past. However, direct intervention by the government in the formalization process would be difficult and costly in many ways. Provisioning of facilities for formal markets to take over informal market activities could minimize the cost of formalization and deliver benefits to society to achieve Parato improvements.

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