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Saving for Development:
A Linkage Model for Informal and Formal Financial Markets

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1. Subsidized Ruin of the Economy

In the past two decades, financial policies directed to the promotion of small-scale agriculture and of small-scale craft industries have been based on three premises:

- Small producers are poor.
- They are unable to save.
- They need cheap credit for investments.

The imputed inability of small producers to self-help and self-reliance had far-reaching policy consequences. Development banks limited their business to credit, ignoring savings mobilization. In most rural areas, possibilities for opening savings accounts hardly exist.

Another important policy consequence was subsidized credit. The government sets ceilings to interest rates way below market rates and cost price. As a result, formal sector financial institutions were unable to serve the masses of small producers. Instead, small numbers of large loans went to medium- and large-scale agriculture and industry.

Peasants who could not obtain bank loans became the target group for governmental and non-governmental development agencies who offered free or cheap loans. However, the masses of small peasants and craftsmen in the informal sector and even the small industrialists in the formal sector were beyond the reach of any credit program.

The masses of small producers had only access to the financial institutions of the informal sector. The loans offered on informal financial markets were uncontrolled by the state. Interest rates were market rates, usually a multiple of the controlled rates, among private money lenders as well as in financial self-help organizations.

Micro-economically, credit programs without a savings mobilization component led to poor repayment morale. Frequently, the choice of loan recipients was politically motivated, and loans were considered as free gifts. Reimbursement rates of 50 per cent and below were no exception. On the outside, this seemed to confirm the underlying premise: farmers and craftsmen are too poor to pay back their loans. Frequently, the remaining debts were waived, which further demotivated the clients, and new credit programs were initiated, with a seemingly limitless supply of money from the international market.

Macro-economically, subvention led to misallocation of production factors. This was one of the Factors contributing to increasing external debts without corresponding increases in productivity. To the contrary, food production stagnated; in Africa per capita food production rates even declined. On the whole, *state intervention seems to have done more to prevent than to promote development*.

2. Self-Help Organizations: Indigenous or *Alien?*[1]

In a new approach to development, emphasis was given to self-help and self-reliance. Development assistance was to promote, not replace, self-help and personal effort. For practical reasons such assistance could not be given to individuals but only to groups or organizations. This led to the introduction of self-help organizations which were to activate their members.

Early concepts of the promotion of self-help and self-help organizations still bore the marks of the poverty premise: small producers do not possess functioning self-help organizations; if they did, they would long have solved their own problems. Therefore, self-help organizations were initiated from outside, usually by the management of a development project. The resulting organizations were alien to the local population. Some were accepted and succeeded, most failed, as local institutions and indigenous processes of group formation and social control were ignored

There is a new tendency now to acknowledge the widespread existence of *indigenous self-help organizations*, described since the 1930s by authors of very different leanings such as *Westermann* (1935, 43) and *Strickland* (1934, 14).

These are organizations of local origin, some ancient and some of a more recent date, invariably morphogenetically influenced by the changing external social and economic conditions. They are certainly not traditional in the sense of static.

3. Financial Self-Help Organizations: Savings and Credit Associations

The most important and most widespread financial self-help organizations are savings and credit associations, among them *Bouman´s* (1979) RoSCAs (rotating savings and credit associations)[2] . There are four main types:

Type 1: Rotating Savings Association:
Each member pays a fixed amount on a fixed day. On each contribution day, one member receives the total amount. A cycle is ended when each has received the total once.
Type II: Rotating Savings and Credit Association:
Functioning as in type I; in addition, there is a fund for emergency or insurance allocations and/or for loans to members.
Type III: Savings Association:
Members make regular contributions which are kept by a collector or treasurer or paid into a bank account. At the end of a specified period, each contributor receives his money back.
Type IV: Credit Association:
Members make regular contributions to an insurance and loan fund Usually interest is charged for loans, with differing rates for members and nonmembers. There is no rotating element in types III and IV.

[1] Cf. H.D. Seibel, Landwirtschaftliche Entwicklung in Afrika: Durch Einführung moderner oder Modernisierung traditioneller Genossenschaften? Zeitschrift für ausländische Landwirtschaft 7, 1968, 219-232.
[2] For a review, cf. Seibel & Damachi, 1982.

These associations are usually referred to as *informal financial institutions* because they are part of *informal financial markets* Financial markets are defined as formal when they fall under the control of state credit laws; they are defined as informal when they operate outside of such control. Yet savings and credit associations are usually *formal organizations* as defined by most organizational theorists. For they are permanent organizations with a specified structure; they are headed by an elected committee, consisting of chairman, secretary, treasurer and other committee members, they have by-laws and keep books and records. Thus, they are *formal organizations within an informal financial market.*

In addition to self-help organizations with primary savings and credit functions, there are numerous voluntary associations with secondary savings and credit functions, such as unions of craftsmen, traders and market women, friendly societies, ethnic unions; school associations, improvement associations, and the like. Many of them practice saving and credit along the lines of one of the four types described above.

All these associations are the authentic self-help organizations; by institutionalising self-help, their members have taken the solution of their problems into their own hands.

Yet there are many problems they cannot financially solve. Operating outside the formal sector and barred from access to banks and outside credit sources, consultancy services and most other systematic modern inputs, they tend to keep a near stationary economy going rather than rapidly modernizing it.

As long as informal and formal, indigenous and modern institutions – such as savings and credit associations and banks – keep apart, far-reaching development-processes arc unlikely to result[3].

4. Linking Formal and Informal Financial Institutions

The following proposal is based on a variety of experiences, most from West Africa: Liberia, Nigeria, Togo and Cameroon. It shows how financial institutions of the informal sector, such as indigenous savings and credit associations, may be *linked* to financial institutions of the format sector ("banks"). Rural and urban financial infrastructures are being developed *from below* by establishing a *group credit system based on the mobilization of personal savings of target groups*, especially small producers, organized in indigenous savings and credit associations. The proposal is equally applicable to other indigenous self-help organizations with savings and credit functions, such as craft unions, ethnic unions, or friendly societies.

The principal tenets of the model are:

(1) The indigenous savings and credit association chooses an appropriate legal form, such as co-operative society, registered society, etc.[4]
(2) The association enters into a business relationship with a bank, which may be a co-operative, a private or a state bank.
(3) Liabilities of the association vis-à-vis the bank are regulated by the status and legal norms. Usually, it will be a joint and several liability.

[3] For a presentation of the state-of-the-art, cf. Kessler & Ullmo, 1985.
[4] There are circumstances were legal registration would be unwise. In this case, a written contract between the bank and the association may suffice.

(4) The association obtains group loans for on-lending to its members.
(5) The amount of credit is determined by the association’s savings with the bank.

5. Savings and Credit Associations as Credit Groups

The linking of savings und credit associations or other types of voluntary associations as credit groups to banks may proceed along the following lines which may have to be locally modified between the contracting parties:

(1) The number of members of a credit group is optional. Each group determines in own size. lndividuals may belong to several groups.
(2) Each group determines both contribution cycle (daily, weekly, monthly or otherwise) and amount; alterations of cycle und amount are possible.
(3) The total amount of savings of each saving day is paid into a bank account by the treasurer of the credit group within a fixed period, e.g. 3 days.
(4) Each group keeps two accounts: a saving und a current account. Opening and maintenance of the accounts correspond to the general terms of business of the partner bank (interests, fees etc.). There are no preferential terms.
(5) The savings of the group are paid into the savings account; this deposit serves as security for the bank. Withdrawals am only permitted if u member of the group terminates its membership or if the credit group is liquidated.
(6) The bank gives out a savings book, recording all payments.
(7) The current account is used for the payment und repayment of credits und the crediting of the loans und interests. The bank issues account statements after each transaction or payment.
(8) Any withdrawal from the savings or current account requires the signature of three designated committee members of the credit group in the presence of a bank manager.
(9) lnterest rates for savings und loans correspond to market rates. lnterests on savings are credited to the savings account, interests on loans are charged to the current account.
(10) Both accounts are group accounts. The group keeps individual accounts for its members. The individual member cannot freely dispose of his savings. Termination of membership is possible if the member has paid back all his debts to the group.
(11) Each credit group ha to adopt written by-laws; a copy has to be forwarded to the partner bank.

    The by-law have to specify:
    - the name of the group
    - the amount of contribution
    - the cycle of contribution
    - the committee members (president, vice-president, secretary, and treasurer)
    - the nomination of three committee-members who are entitled to enact the group´s business.

    Optionally, the by-laws regulate:
    - the number of members
    - the conditions of membership
    - the expulsion of members
    - conditions and consequences of membership termination
    - loan conditions
    - kind of loan payment (cash or kind)
    - sanctions and fines
    - changes in contributions and cycle

- changes in by-laws
- modalities of electing officers, duration of office and possibility of reelection
- liabilities of committee members and control of transactions
- multiple membership
- liquidation of the credit group and termination of the connection with the bank.

(12) Simple book-keeping is required. All payments of a member must be documented in transaction books.

(13) The group is required to inform the partner bank about:
- changes in contributions and cycle
- changes in committee membership
- any termination of individual memberships
- liquidation of the group

(14) Loans are only paid to the group, not to individual members. The credit group is liable to the bank, thus taking the risk of defaulting. The loan period is limited to 12 - 15 months, unless otherwise stipulated.

(15) The amount of loans issued by the bank depend on the actual group deposits.

(15.1) The first loan may not exceed twice the accumulated savings of the group at the end of the last month before the loan application.

(15.2)The second loan equals three times the groups deposits, provided
- the preceding loan including principal and interests has been paid back fully and in due time, and
- the fixed contributions of the group have been paid regularly into the bank account during the last 6 months.

(15.3) Subsequently, the loan may be further increased according to conditions to be negotiated.

(16) Loans for a period exceeding 12 to 15 months require a special agreement between the bank and the credit group.

(17) Loans are issued for investments only. The feasibility of a loan is examined by the group not the bank.

(18) In case of defaulting, the bank is entitled to increase rate by 1% per month up to a maximum of 25% per year. Additionally, the maximum credit limit for the following year drops to twice the amount of the deposit.

(19) Each member of the credit group is jointly and severally liable for the total amount of loans issued to the group.

(20) The group decides the date, when a loan application shall be submitted.

(21) Each member is entitled to obtain a loan. The group decides the individual circumstances of the on-lending (borrower, amount, interest rate, loan period and loan purpose).

6. The Dynamics of Savings and Loans in Credit Groups Linked to Banks

The following table gives three hypothetical examples of credit groups of farmers, craftsmen and traders. As group size and contribution amount will be fixed by each group and as there are national, regional and local differences in disposable incomes, the actual figures may differ from these examples[5].

[5] For empirical data on the financial strength of savings and credit associations, cf. Seibel, 1984.

Table 1: Savings and Loan Accounts in Three Hypothetical Groups of Farmers, Craftsmen and Traders over Five-Year Period

	Example 1: Farmers	Example 2: Craftsmen	Example 3: Traders
Balance of savings account			
1st year	1.100	22.000	40.000
2nd year	2.970	54.000	128.000
3rd year	5.764	98.000	275.000
4th year	9.667	156.000	490.000
5th year	14.900	231.000	780.000
Total amount of loans			
1st year	3.300	66.000	120.000
2nd year	8.910	162.000	384.000
3rd year	17.290	294.000	825.000
4th year	29.000	468.000	1.470.000
5th year	44.700	694.000	2.367.000

Example 1: A group of 20 farmers.
Weekly contributions arc $ 1.- during the first year.
They are increased by $ 0.50 each following year, until they reach $ 3.- during the 5th year.

Example 2: A group of 20 craftsmen.
Weekly contributions are $ 20.- during the first year. They are increased by $ 5.- each following year, until they reach $ 40.- during the 5th year.

Example 3: A group of 20 traders.
Daily contributions are $ 5.- during the first year.
They are increased by $ 5.- each following year, until they reach $ 25.- during the 5th year.

Balances of the group accounts und total amounts of credit are given in table 1 for the first five years of each group.

Interest on savings is assumed to be 5 %, interest on loans 15 %, of which 5 % accrue to the group und 10 % to the bank. Interest added to the group account is calculated on the basis of mid-year accounts.

7. From Growth to Development: The Role of Consultancy Services

In a first phase of linkage between formal und informal financial institutions, loans tend to be small, und borrowers are likely to carry out their already existing plans for investment und business expansion. The effect of the program is likely to be *growth,* which is a quantitative change in production.

In a second phase, loans increase to an extent where they supersede the borrowers' capacity for investment decisions. From this point on, a consultancy service oriented towards different target groups will be needed. This service may be financed through members' contributions, interest rates, or external sources. In this phase, the program may lend to *development,* which is a qualitative change in production und living conditions.

8. Guiding Principles for Developing Financial Markets

The development of financial markets in Third World countries may be guided by the following principles emerging from current national und international discussions:
(1) The financial system in Third World countries develops *from below:* from indigenous self-help organizations with primary or secondary savings und credit functions as well as indigenous financial intermediaries in rural und urban areas.
(2) Savings und credit associations und other self-help organizations with such functions build up a *credit system based on savings* mobilization.
(3) For refinancing, they *link up with existing financial institutions* of the formal financial sector.
(4) If formal sector financial institutions are locally or regionally not available, they may be extended downwards through *decentralization.*
(5) Between formal und informal financial institutions functions are delegated to the lowest level possible.
(6) Financial self-help organizations join together to form local or regional umbrella organizations.
(7) *Unions* of financial self-help organizations present the *level of intervention* for development projects.
(8) If no unions exist, individual self-help organizations or *informal associations of such organizations* may present the level of intervention.
(9) Project activities are designed to assist self-help organizations and their unions to build up and improve a system of *services for members* or member organizations and to promote the linkage between formal and Informal financial institutions.
(10) A strong union of financial self-help organizations *develops its own formal financial institutions.*

Summary

The policy of development through subsidized credit has largely failed. Development policy is presently being reoriented towards savings mobilization supplement by credit programs based on personal savings.

Formal financial markets are ineffective in mobilizing savings in Third World countries as they reach but a small proportion of the population. Most of the rural and urban masses have only access to informal financial markets. The most prominent financial self-help organizations are savings and credit associations, which particularly widespread in West Africa: formal organizations on an informal market.

The effectiveness of both formal and informal financial markets is greatly enhanced by linking savings and credit associations to formal financial institutions. The associations are formed into joint and several liability credit groups obtaining group credit for lending to members. After an initial phase of quanitiative growth, they offer consultancy and other services to their members, possibly with the assistance of an aid project, thus contributing to a qualitative development process.

Zusammenfassung

Nach dem Scheitern einer finanzwirtschaftlichen Politik subventionierter Kredite findet zur Zeit eine entwicklungspolitische Umorientierung auf Ersparnismobilisierung und ersparnisabhängige Kreditvergabe statt.

Formelle Finanzmärkte eignen sich nur in beschränktem Maße für eine Ersparnismobilisierung in Entwicklungsländern, da sie nur einen geringen Teil der Bevölkerung erreichen; den ländlichen und städtischen Massen sind weitgehend nur informelle Finanzmärkte zugänglich. Die wichtigste finanzielle Selbsthilfeorganisation ist der Spar- und Kreditverein (SKV), der besonders weit in Westafrika verbreitet ist: eine formelle Organisation auf einem informellen Markt.

Die Wirksamkeit formeller und informeller Finanzmärkte lässt sich erheblich steigern, indem SKV an formelle Finanzinstitutionen angebunden werden. Die Vereine wandeln sich in Kreditgruppen mit gesamtschuldnerischer Haftung um und erhalten einen Gruppenkredit, den sie an die Mitglieder durchleiten. Nach einer ersten Phase quantitativen Wachstums tragen sie durch Beratungsdienste und andere Leistungen für ihre Mitglieder zu einem qualitativen Entwicklungsprozess bei, gegebenenfalls mit Unterstützung eines Entwicklungsprojektes.

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* For a bibliography cf. *Seibel*, 1984.