

### **13. Informal financial market services in Sri Lanka (Special Reference to Rural Areas)**

A.M.P. Adikari, Lecturer, Department of Social Sciences, Rajarata University of Sri Lanka, E- Mail:[priyangani.adikari@yahoo.com](mailto:priyangani.adikari@yahoo.com)

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#### **ABSTRACT**

An effective financial system is required to mobilize resource from surplus sector to deficit sector. This service is provided by both formal and informal financial markets in an economy. Informal financial markets provide very important service in meeting financial needs of units who do not deal with the process of formal financial markets. Characteristics of informal financial services in Sri Lanka can be studied under Rural, Urban and Estate sectors. This study examines the informal financial services in Sri Lanka with special reference to rural areas. Primary data as well as secondary data are used for this study. The data say that Majority of the respondents are engaged in financial markets, formal as well as informal financial market, while total of 23% respondents are engaged in informal financial sector. Pawning, trade credit, crop mortgages, single purpose credit services and direct lending are identified as informal credit services in the research areas. Direct lending service is the most utilized financial service by the respondents. As evidenced in data, most of the respondents' reason for preferring informal financial services is closeness and personal relationship. The research reveals that informal financial services are still remaining in rural areas.

It is recommended that integrating informal financial market with formal financial market will increase the scope of the financial transactions and create people's confidence in the system thereby encouraging those in the informal sector to patronize the formal sector.

**Key Words:** Crop mortgage, Direct lending, Financial market, Informal financial service, Pawning, Trade credit.

## **Introduction**

The financial system in an economy plays a considerable role in stimulating economic growth via the process of directing funds from surplus sector to areas of need. Historically, developing countries including Sri Lanka have been experiencing financial dualism, formal and informal sector. An informal (Unorganized) market serves the needs of the informal finance while Currency Board or the Central bank, Commercial banks, savings institutions, co-operatives and the share market serve as the sources of formal (organized) finance. On the other hand, it was the money lenders, indigenous bankers, pawn-brokers, traders and merchants, landlords, friends and relatives act as intermediaries in the informal credit market. And also, informal financial sector is a key source of credit supply, especially among parties which are limited access to formal financial sector. The opening up of the economy in 1977 paved the way for most of institutions to the practices of formal markets in advanced countries enable them to have advanced methods with sophistication. The informal sector has moved in far with the formal sector to cater to the groups, which could not benefit from the formal sector institutions. With advantages of unregulated money supply, easy accessibility, easy liquidity, low administrative and procedural costs, little or no collateral/ mortgage requirements, flexibility in interest rates and repayments schedules, informal credit markets are ideally suited to cater to the lower income groups and informal sector's requirement of credit. (Srinivas, 2008)

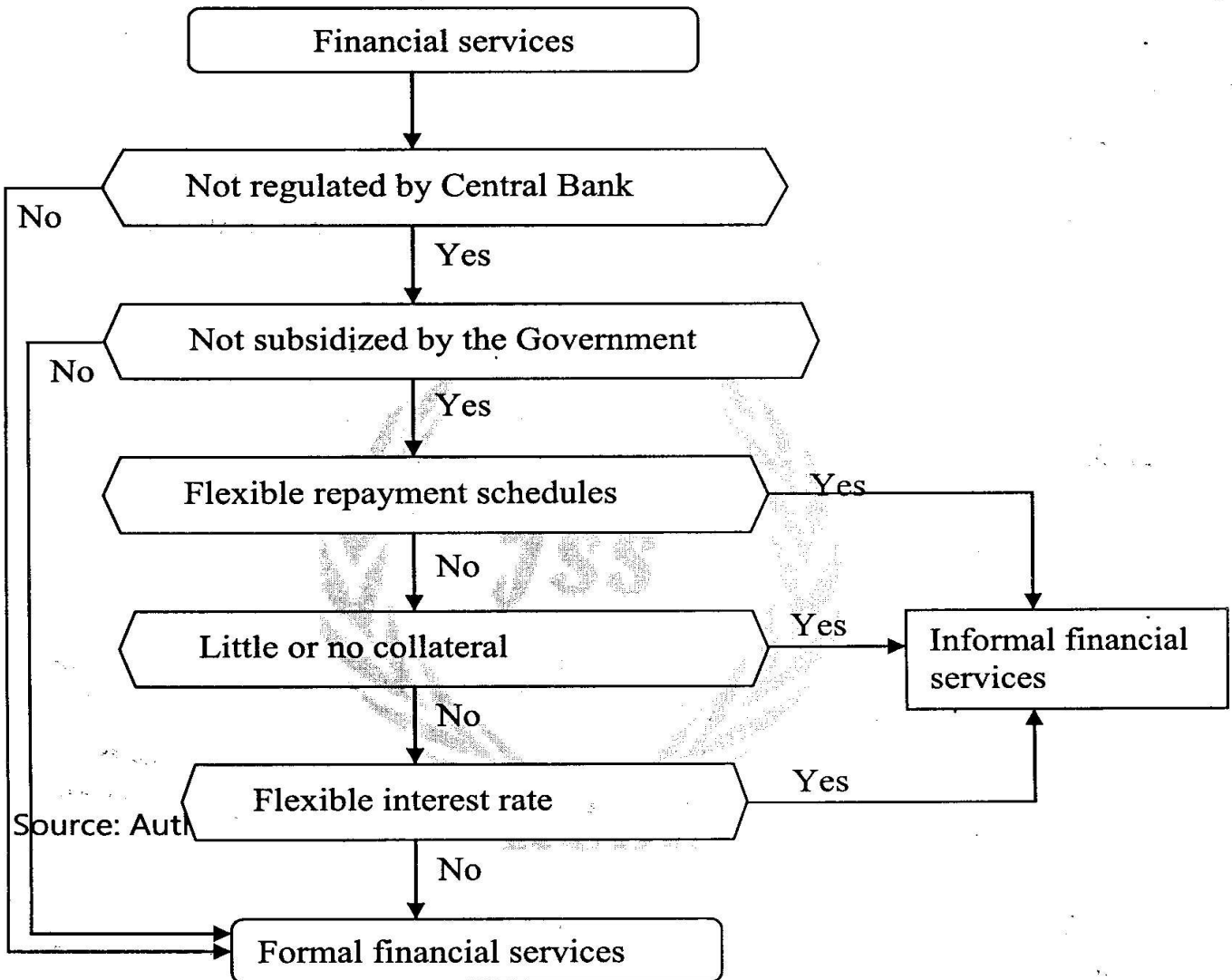
Informal financial services are heterogeneous with a wide variety of operators, services, including lending and borrowing using wide variety of debt instruments. Characteristics of informal financial services in Sri Lanka mainly can be studied under three different sectors which are,

1. Rural sector informal financial market
2. Urban sector informal financial market
3. Estate sector informal financial market (Karunagoda,2007)

There are distinctive characteristics in informal financial services across sectors; there are common features as well. As there is no clear and established definition for the informal financial services, based on the

characteristics discussed, the following flow chart helps to identify and define informal financial service operations.

Figure No: 01 Informal financial service operations



The operations of informal financial systems move along with other services, which may have both formal and informal characteristics. The research intends to examine the characteristics and operations of informal financial activities in Sri Lanka with special reference to rural sector.

### Problem of the study

Sri Lanka is experiencing financial dualism, as formal and informal sector. The existence of informal financial market is a wide spread global phenomenon according to literature. The degree of their importance is largely associated with the financial development. On the basis of financial operations and characteristics, informal financial services in Sri Lanka can be studied under three different sectors, which are Rural, Urban, and Estate sectors. And also, informal financial transactions in, Sri Lanka can be studied under three different categories 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 group includes Single-purpose credit societies, Multi-purpose saving and Credit societies, Rotating savings and Credit societies (ROSCAS) and Accumulating savings and Credit associations (ASCAS) (Karunagoda, 2007).

The consumer finance and socioeconomic survey (2003/2004) conducted by the Central Bank of Sri Lanka indicates developments with respect to formal and informal financial transaction over a period of 50 years. The table 1 indicates formal and informal financial transaction from the report.

Table No: 01 Distribution of Number of Loans by Formal and Informal Institution

Number of loans as %							
Year	1963	1973	1978/79	1981/82	1986/87	1996/97	2003/04
Formal institution	n.a.	n.a.	25.3	38.0	39.8	67.3	61.1
Informal institution	n.a.	n.a.	74.7	62.0	60.2	32.7	38.9
Total			100	100	100	100	100

Source: Central Bank of Sri Lanka/ Annual Report 2010

Through the presence of formal financial transactions in the rural sector has improved in line with the expansion of institutional financial sector, the informal financial transactions also still play a dominant role in rural sector. The research intends to examine the characteristics and operations of informal financial activities in Sri Lanka with special reference to rural sector. In this research, informal sector refers to the non- institutional or unorganized financial sources, which consist mainly money lender, traders, pawn brokers, friends and relatives and landlords. Pawning, trade credit, crop mortgage, single purpose credit services and direct lending are considered as financial services in informal financial services in rural sector. Therefore, this research is set out to examine informal financial services in Sri Lanka with special reference to the rural sector.

### **Objectives of the study**

This research was undertaken to examine informal financial services in Sri Lanka with special reference to the rural sector.

The specific objectives of the research were to

- Identify the structure of informal financial services in Sri Lanka.
- Examine different informal financial sources in rural areas of Sri Lanka.
- Identify the reason for preferring informal financial services in rural areas.

### **Methodology**

Primary data and secondary data were used in this study. Secondary data were extracted from the documentary sources. Primary data were gathered through questionnaire conducted with a random sample of 100 household drawn from the list of household available with Grama Niladhari. This sample was selected from purposively selected villages namely Deyyanwela, Arama and Aranayake that are located in three different Grama Niladhari divisions of Aranayake Divisional Secretariat area. A sample size 100 household as 40 Deyyanwela, 30 Arama, and 30 Aranayake were selected. The collected data were analyzed and evaluated by using descriptive statistical method.

## **Literature Review**

The concept of informal financial market has been defined in various ways in the literature. Chandavarkar, (1985) the informal financial market refers to the non institutional financial market that covers all financial activities outside the armpit of the institutional finance. He described the financial as being a heterogeneous residual sector comprising of different entities such as money lenders, traders, landlords, pawn brokers, friends and relatives. The informal rural financial markets consist of "unorganized money lenders" and "informal lenders", "non institutional sources" and "unorganized sources", which operated largely outside the banking system, which are mainly unregulated, and loosely monitored than formal sources. Adeyemo (1981) defined the informal financial market is an indigenous system of saving in varying forms, which can be broadly summarized as a situation, in which a group of people come together, contribute fixed amount at fixed intervals and assign the total amount contributed to an individual member on rotational basis or after credit to members and share their accumulated savings at certain time in the year rather than on rotation. Udry (1997) defined; informal finance refers to all transactions, loans and deposits occurring outside the regulation of a central monetary authority, while the semi formal sector has the characteristics of both formal and informal sectors. Udry pointed out that there are three types of informal units in Africa savings mobilization units with little or no lending; and lending units that do not engage in any savings; and those units that combine deposit mobilization and lending. The types of informal financial units vary mainly because they are purpose oriented and mostly developed to meet the demand for specific financial services, responding to the demand of a distinct clientele, defined by them using various socio economic criteria. According to Ghatak S. (1976) the unorganized money markets in less developed countries deserve some elaboration as they are quite, complex and heterogeneous. Money lenders and indigenous bankers are the two major sources of credit, but there is a variety of other sources, which can be quite important in some less developed countries. There are a large number of non-professional groups of people, who provide credit to the rural sector. Landlords, pawnbrokers, merchants, traders' commission agents, even

friends and relatives all act as sources of credit in varying degrees of importance. One of the chief sources of credit in the rural economies is the money lender. Hence, the nature of his activities deserves special consideration. The primary business of the money lender is money lending and banking. Their activities are usually not open to public examination. They sometime mix money lending with other types of economic activities and lack of specialization is the hallmark of their operation. Landlords, trader and merchants also act as money lenders and they provide a significance proportion of the total supply of credit to the rural economy even today.

Ghatak, S. (1976) pointed out the main features that differentiate the informal financial market from the organized market as;

1. Flexibility in loan transactions
2. Personnel dealing with borrowers
3. Simple and some crude system of maintaining accounts
4. Blending of money lending with other types of economic activities
5. Informal dealing with customers
6. Utmost secrecy about financial dealings.

Padmanabhan, (1996) in most less developed countries informal financial sources still meet 50 – 80 percent of the credit needs of the community through there has been a general decline in the importance of informal sector with the expansion in the formal sector. General perception among masses including the government about the supplies 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. Padmanabhan pointed out following benefits that clients of money lenders accrue from their transactions with money lenders.

1. Proximity
2. Comfortable atmosphere
3. Quick credit
4. All time access
5. Freedom of deployment

6. Repayment flexibility
7. Lower transaction cost

According to Sandarathne (1980) there are several improvements formal credits, informal sources of credit continue to perhaps the more dominant source of credit to small farmers. Further, he states that the informal sector lends at interest rates ranging from zero to over 250 percent per annum. Due to the presence of high interest rate, informal lenders are branched as usurious. He points out the following factors that account for the informal lending as usurious.

1. High interest rate bearing loans
2. Interest rate based on the casual investigations
3. Large number of loans are short duration

In addition, Sandarathne (1980) 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.

Srinivas (2008) informal credit operations are highly heterogeneous with a wide variety of operations and services including information lending and borrowing using wide variety of debt instruments. The common element, which runs through all of them, is their "informality, adaptability and flexibility of options". This reduces their transaction costs and gives them comparative advantage and economic rationale over formal finance. The "informality" in informal finance is characterized by the following:

1. Unregulated and non-subsidized
2. Easy accessibility
3. Loan availability in very small size and for short periods
4. Low administrative and information costs
5. Little or no collateral
6. Flexible and variable interest rates (from very high to no interest)
7. Highly flexible transactions and repayments tailored to individual needs.



As a result of the above characteristics, flexibility dominates Informal Credit Market operations, which enable them to reach borrowers beyond the profitable reach of the formal sector with lower transaction costs.

Chandravakar (1977) states that term informal financial sector covers all financial activities outside the orbit of institutional and regular finance and this sector is highly heterogeneous as it covers lending and borrowing transactions involving varied types of groups such as individuals and intermediaries. Further, he pointed out institutional and behavioral features of the sector as "

1. The absence of regulation and presence of informality There are no legal barriers in the sector
2. There is interlocking relationship 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 along
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 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 an contrast to the lending in the formal market with relies mostly on collateral and incomplete information"

According to the Chandravakar (1977), very important and useful role of informal sector is financing micro, small and medium to farmers, who have no help from formal financial sector.

Though, there are improved formal financial market services at present, this review which is a collection of volume of research on informal financial market services is still remaining as a being evident.

## **Characteristics of Informal Financial Services in Rural Areas**

Rural, urban and state sectors included informal financial transactions in Sri Lanka can be studied under three different categories.

1. Direct money lending
2. Indirect money lending
3. Voluntary credit groups

Direct money lending includes professional and non professional money lenders such as friends, relatives and pawn brokers. Indirect money lending includes crop mortgage related credit, incorporate trade, marketing and commission agency. Single-purpose credit and savings societies are included in voluntary credit groups.

With the expansion of formal financial services in all areas, the formal financial services have spread in rural areas too. But, the informal financial transactions still play a major role in the rural areas. Rural informal financial markets consist of a wide range of financial transactions linked to land labour and voluntary credits societies. The factors that the farmers, who are small and land less, with irregular income, lack of awareness about financial institutions have contributed to the dominance of informal sector in rural areas. Pawning, trade credit, crop mortgages, single purpose credit services and direct lending are popular financing methods in rural areas in Sri Lanka. Pawning is very popular financing method among informal financial services. But, at present formal financial sector also has come with strong competition for pawning. Interest rates in the informal pawning services are varying from person to person. It depends on the relationship between borrowers and the lenders.

Trade credit borrowing occurs in goods and services. This type of services involve for consumption or investment. Similar types of borrowing takes place for production purpose as well (Sandarathne 2007)

“In most cases such purchases on Credits are settled fully partly at different frequencies such as daily, weekly, monthly or irregularly with harvest etc... it is more predominant in

agriculture activities where farmers borrow Seeds, Fertilizers and chemicals etc... at different stages of the production process. Repayment loans could be with the harvest, a common practice or in cash. Sometimes the lender collects his dues at the initial stage of the harvesting, where the borrower has no alternative rather than to oblige”.

Crop mortgages are common financial services in the rural sector. Borrowers' funds are used by the lender in an agreement. Especially the funds are used for the production purpose. Borrower agrees to pay half in goods from the harvest out the rest in cash or pay in full with the harvest.

Single purpose credit services are arranged by the group of people to collect a fund to grant among members to fulfill their financial needs, specially funerals, weddings and other welfare occasions. Arranging as a society or group, they provide single purpose loans to its members at a subsidized rate.

## **Results and Discussion**

### **Respondent involvement of financial market**

Respondents were asked about the financial markets that they are involved in their financial activities. Majority of the respondents are engaging in both financial markets, formal as well as informal financial market, while total of 23% respondent engage in informal financial sector.

Table. No. 02 Respondent involvement of financial market

Financial market	Frequency	Percentage (%)
Formal	33	33%
Informal	23	23%
Both	44	44%
None	0	00%
Total	100	100%

Source: field survey 2011.

### Informal financial services in research area

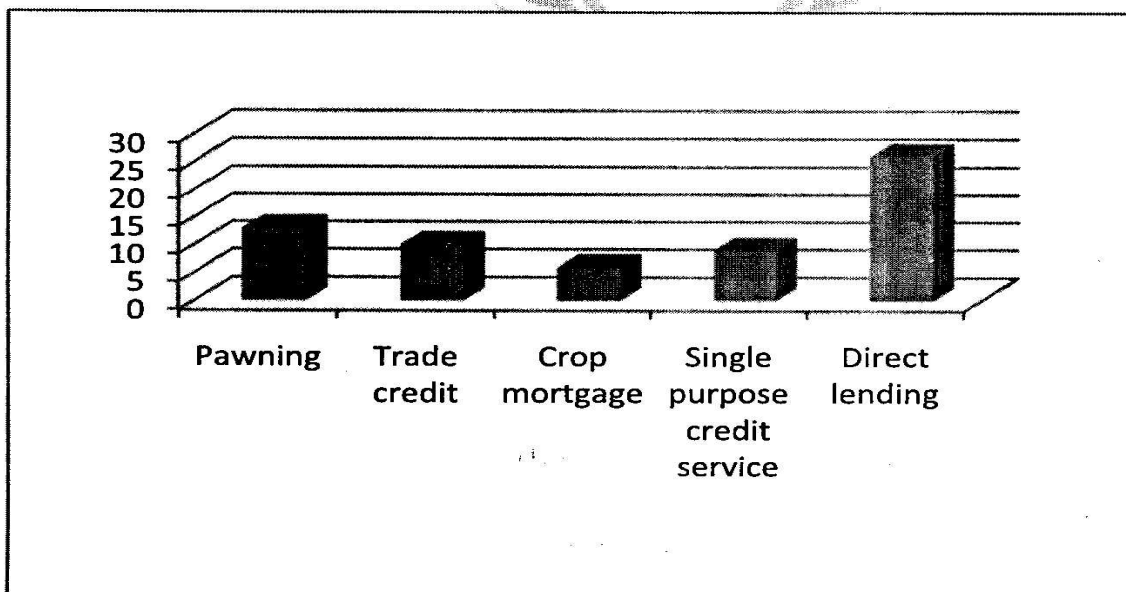
Pawning, trade credit, crop mortgages, single purpose credit services and direct lending are identified as informal credit services in the research areas. Respondents were asked about the credit services nearest to them in terms of proximity because some of respondents expressed that they are engaged in both sectors to obtain financial services. Therefore, researchers asked the nearest financial services that they obtain. Direct lending service was the most used financial service by the respondents.

Table. No. 03 Informal financial services in rural areas

Financial Service	Frequency
Pawning	13
Trade credit	10
Crop mortgage	06
Single purpose credit service	09
Direct lending	26

Source: field survey 2011.

Figure No. 02 financial services in rural areas



According to the data, 26 respondents have used direct lending service for their credit requirement. 13 respondents have given pawning as their financial service to obtain credit and 10 were single purpose credit service and 6 were crop mortgage.

### Participants of Informal financial transactions in rural services

It can be seen that wide range of participants takes part in the informal financial market in the rural areas. Respondents answered the following groups which take part in their areas as participants of these financial services.

- Farmers
- Government and private sector job holders
- Businessmen
- Professional money lenders (address him as Polee Mudalaali)
- Credit societies (welfare societies).

Table. No. 04 Respondents' reasons for preferring informal financial services

Reason	Number of respondents	Percentage (%)
Closeness and personal relationship	23	36.51%
Easy access to borrowing	16	25.40%
Family ties	11	17.46%
Easier to operate	13	20.63%
No formal services facilities in area	00	0.00%

Source: field survey 2011.

As evidenced in Table. No. 03 most of the respondents' reason for preferring informal financial services 36.51% was closeness and personal relationship, 25.4% was easy access to borrowing, 17.46% was family ties and 20.63% was easier to operate as reasons for preferring informal financial services. The special reason hidden this data informal financial facilities are available in

this areas. Because, none responded to their preference as absence of formal financial services in this area.

## **Conclusion and Recommendation**

According to literature in advanced economies, the formal sector is very significant while, the informal sector dominates in less developed economies. But, informal finance markets provide a very important service in supporting financial needs of the groups, who have less access to also there are large number of reasons for preference of informal financial services. The sample household data set has confirmed what the literature tells us. However, the degree of financial market importance is largely associated with the degree of economic development. Providing facilities for formal financial services could avoid disadvantages of informal financial services.

The research reveals that informal financial services are still remaining in rural areas. It is recommended that integrating informal financial market with formal financial market will increase the scope of the financial transactions and create people confidence in the system thereby encouraging those in the informal sector to patronize the formal sector.

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