Overseas Development Institute



# FINANCIAL INTEGRATION AND DEVELOPMENT IN SUB-SAHARAN AFRICA: THE FORMAL AND SEMI-FORMAL FINANCIAL SECTORS IN MALAWI

C. Chipeta
and
M. L. C. Mkandawire

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# Preface

As part of Structural Adjustment Programmes, many governments in Sub-Saharan Africa initiated a large scale restructuring of the financial system in the 1980s. Emphasis in these programmes was placed on the need to i) adopt financial liberalisation measures, and ii) enhance regulatory and supervisory functions to ensure prudence of the financial institutions. Special Financial Sector Adjustment loans have been taken up to uphold reform measures and to restructure and strengthen distressed financial systems in several African countries. An improved regulatory environment with enhanced supervision is underscored in these operations, while the recent literature on the subject points to the need for careful design of the sequence, pace and timing of financial liberalisation and the importance of its coordination with changing macroeconomic conditions.

However, financial reform has at best had limited *developmental* effect in the region so far. It has been increasingly recognised that adoption of financial liberalisation policy alone has not been sufficient to generate a strong response in terms of increased savings mobilisation and intermediation through the financial system, wider access to financial services, and increased investment by the private sector. Fragmentation of financial markets persists, impeding efficient resource mobilisation and financial intermediation.

Given this background, a research project, 'Financial Integration and Development in Sub-Saharan Africa' has been undertaken at ODI, with financial support from the World Bank and SIDA, to examine the performance of financial systems for resource mobilisation and intermediation for economic development in Sub-Saharan Africa. The field work has been conducted in Ghana, Malawi, Nigeria and Tanzania, based on common questionnaires addressed to formal, semi-formal and informal institutions and borrowers. The main objectives of research were to:

i) investigate the nature and degree of fragmentation and segmentation of financial markets in Sub-Saharan Africa;

ii) examine the sources of segmentation against several theoretical paradigms and evaluate the conditions under which linkages between segments utilise the comparative advantages of each, and obstacles to such linkages;

iii) examine operational constraints facing formal financial institutions and informal associations/lenders;

iv) evaluate the effects of financial liberalisation on the whole financial system; in particular, to provide understanding of the impediments to financial deepening in Africa and the extent to which they can be relieved through financial liberalisation and through active policies of positive interventions, technical assistance and infrastructure that support market development by facilitating information flows and lowering transaction costs and risks;

v) help the design of long-term policies towards financial sector development and evaluate which policy and institutional measures can most effectively accelerate the financial system's ability to mobilise resources and intermediate between saving and investment for broad-based development in Africa.

This present paper is one of a series that will provide initial presentation of results of the country case studies. It presents the *Malawian* case study, reporting the results of the field work on the behavioural characteristics of *formal* financial organisations/agents and the operational constraints in urban and rural areas.

Machiko Nissanke
May 1995
(Project Coordinator)

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# 1. Introduction

## 1.1 Background

It is widely believed that fragmentation or lack of integration between segments of the financial sector in Africa impedes mobilisation of financial resources and intermediation. Lack of integration is attributed to repressive financial policies and to structural and institutional factors which reflect the low level of economic and financial development. Through reforms in the financial sector attempts have been made in many African countries to reduce direct government controls on the sector. But the impact of these efforts in terms of widening and deepening financial systems has generally been limited. However, not much systematic research has been done on this issue in Africa and even less on the structural and institutional bottlenecks, whose removal is said to be necessary for achieving more interaction among the formal, semi-formal and informal segments of the financial sector.

This study of the formal financial sector is part of a larger study on the financial sector in Malawi. Similar studies are currently under way in Ghana, Nigeria and Tanzania to facilitate inter-country comparisons. The aim of the project is to investigate obstacles to financial market integration and improved intermediation in sub-Saharan Africa and to explore how these obstacles can be overcome by through policy, structural and institutional reforms. The project is based on the premise that a well-integrated financial market is needed to facilitate development through more effective mobilisation and allocation of resources. Because of structural and institutional imperfections, financial market integration will not occur merely by liberalising the formal financial sector. Structural and institutional bottlenecks must be dealt with first.

This particular study focuses on structural and institutional constraints to closer interaction between different formal financial market units, on the one hand, and between formal and semi-formal and informal segments, on the other. The objective is to evaluate alternative policy interventions that would assist in expanding and accelerating the intermediation process through closer integration among different segments of the financial sector.

The conceptual origins of the study lie in various explanations of financial dualism. Among these are the financial repression hypothesis (McKinnon, 1973; Shaw, 1973; Fry, 1988) of how restrictive interest-rate policies and credit controls shift the allocation of resources away from the market to the government and thereby create parallel markets; and structural factors, including the recent discussion of fragmentation in terms of imperfect information (Hoff and Stiglitz, 1990), according to which differences in the costs and characteristics of different types of transactions may lead to specialisation within financial markets.

## 1.2 Immediate objective

In this part of the study we want to gain better understanding of the fragmentation problem from the perspective of the formal and semi-formal financial sectors. We shall describe and analyse the operations of the formal financial sector with a view to highlighting the factors which explain fragmentation within the sector itself and between it and the semi-formal and informal financial sectors. The fragmentation problem, in other words the absence of linkages or the existence of only weak linkages between the financial sectors and within individual sectors themselves, is reflected more generally in the sub-optimal intermediation of financial resources from economic sectors which are in surplus to those which are in deficit. Of particular concern here is the inadequate supply of investible funds to enterprises with high growth potential, especially the small and medium-scale enterprises. The ultimate objective therefore, after identifying the factors behind fragmentation, is to be in a position to come up with policy recommendations on how an economy at Malawi's stage of economic development can promote integration within and between the financial sectors, and enhance financial intermediation in general and the supply of financial credit to small to medium-scale enterprises in particular.

It is important to examine fragmentation within the formal financial sector itself before examining the fragmentation between the formal and the semi-formal and informal financial sectors. For if there is fragmentation between formal financial institutions or segments in spite of the fact that they share a number of similar characteristics, how much more fragmentation is there between them and the informal financial sector? Legally, each segment of the formal financial sector is controlled and regulated by the same legislation; for example, commercial banks and a few other financial institutions come under the Banking Act. Furthermore, they are, from time to time, subjected to the same financial/monetary policy measures. Secondly, their premises are located close to each other as they usually share the same streets in urban areas. Thirdly, and related to the second attribute, their knowledge of one another and their potential access to related information is much greater than that between them and the informal financial institutions or segments. Informal financial institutions, in contrast, are not subjected to legal control and regulations; because of the lack of publicity about them and the degree of secrecy surrounding their transactions (especially moneylenders) there may be very little access among them to information about one another and their clients.

The structural factors have resulted not only in segmentation but also in dualism, and the extreme form of fragmentation into formal/semi-formal and informal financial sectors with different relative prices and barriers to flows between them. This study will investigate the consequences of this dualism as well as the weak intermediation within the formal and semi-formal units and the limited impact of financial liberalisation in expanding the formal and semi-formal sectors. Lack of integration among segments because of transaction costs, risks and incentives makes it essential to ascertain such costs and incentives and to assess the lenders' measurement of the risks. Other explanations of financial dualism focus on institutional factors according to which fragmentation is the result of weaknesses inherent in complementary institutions as well as in the financial system itself. In particular, it is asserted that the inadequacy of the legal infrastructure affects the costs and risks associated with enforcement and hence lenders' perception of risk.

## 1.3 Hypotheses

The study is carried out by testing a number of hypotheses which focus on (i) the origins of segmentation; (ii) why interest rates do not clear markets; (iii) the persistence of fragmentation between segments; (iv) the persistence of fragmentation among formal, semi-formal and informal units; and (v) how integration might increase. Where appropriate, these have been classified into their policy-based, structural and institutional aspects.

Under the origins of segmentation, it is hypothesised that semi-formal units were stimulated by financially repressive policies to mobilise savings and provide credit to those who lack access to the formal financial system. In terms of the policy-based aspects of this hypothesis, under a repressive regime, interest rates will diverge from those of the formal system and converge when the regime is liberalised. In terms of structural origins, different approaches to and practices in screening loan applications, monitoring and enforcement of contracts should result in different transaction costs.

On the persistence of fragmentation between segments, it is hypothesised that funds do not flow from formal to semi-formal segments because lack of information and perception of high risk and high transaction costs do not motivate banks to expand lending activities to semi-formal financial institutions for on-lending to small borrowers and informal units. It is important therefore to establish the type of information used by semi-formal lenders, to ascertain their perception of risk and to measure their transaction costs for purposes of comparison.

It is also hypothesised that semi-formal units remain fragmented because they are each limited by the scope of their mandates, the availability of funds and the limited nature of their information about markets. They cannot lend more than they can mobilise or receive in grants. For integration to increase, the hypothesis being tested is that semi-formal units will need greater access to formal credit to enable them to expand their lending operations.

# 2. Financial background

## 2.1 Formal institutions

Modern financial institutions in Malawi comprise the following:

*Formal institutions:*

| | |
|---|---|
| Central bank | Reserve Bank of Malawi |
| Commercial banks | National Bank of Malawi (NBM)<br>Commercial Bank of Malawi (CBM)<br>Indebank Financial Services Ltd |
| Development finance | Malawi Development Corporation institutions (MDC)<br>Investment and Development Bank (INDEBANK) |
| Corporate banks | Finance Corporation of Malawi (FINCOM) |
| Finance houses | Leasing and Finance Company of Malawi (LFC)<br>National Mercantile Credit (NMC)<br>CBM Financial Services Limited |
| Savings institutions | Post Office Savings Bank (POSB) |
| Building societies | New Building Society (NBS) |

*Semi-formal institutions:*

| | |
|---|---|
| Development finance institutions for small to medium-sized enterprises | Investment and Development Fund INDEFUND)<br>Small Enterprise Development Organisation of Malawi (SEDOM)<br>Malawi Union of Savings and Credit Co-operatives (MUSCCO)<br>Malawi Rural Finance Company (MRFC) |
| Credit Unions | Savings and Credit Co-operatives (SACCOs) |

In addition, there are a number of insurance companies and brokers and several pension and provident funds. The formal and semi-formal financial institutions that were sampled or are in one way or another relevant to this study are described below.

*Reserve Bank of Malawi (RBM)*

The RBM was established in 1964 and performs the customary roles of a central bank: supervision of commercial bank operations, overseeing the soundness of the financial system, management of foreign-exchange reserves and the exchange rate, setting of the bank rate, acting as banker to the government, statutory bodies and commercial banks, and collecting and disseminating economic and financial data.

The RBM's supervisory role was strengthened by the revised Banking Act of 1989. In theory, any financial organisation must be registered by the RBM, and any institution collecting deposits from the public must be registered as a bank or as a credit co-operative. However, at present, this applies fully in practice to the formal financial sector only. It will gradually be extended to the semi-formal operations of, for example, non-governmental institutions over the next 5–10 years.

*Commercial banks*

There are three commercial banks in the country. Indebank Financial Services Ltd is the newest and smallest of the three and, at present, largely serves the corporate sector. We shall concentrate on the NBM and CBM, as these two dominate the formal financial sector, providing all the usual commercial banking services in savings, deposits, credit and lending, foreign exchange, leasing and factoring, and transaction clearing. They are becoming increasingly mutually competitive but still operate a number of anti-competitive agreements, such as dividing between them the routing of mobile agencies and the location of sub-branches. Both banks are profitable and stable, with combined total assets of MK1,382 million at 31 December 1991 (NBM MK920 m. CBM MK462 m.). Both have a high reputation in the mainstream Malawian business community.

The National Bank of Malawi was established on 1 July 1971 by amalgamating Standard Chartered Bank Ltd and Barclays Bank DCO, following an agreement between the two expatriate banks and the Malawi Government. Initially the two foreign banks held 51% of the equity and the balance was held by two local entities, Press (Holdings) Ltd (now Press Corporation Ltd) and the Agricultural Development and Marketing Corporation (ADMARC). The total shareholding of the Standard Chartered and Barclays Bank was reduced to 20% in 1977, when, by agreement with the local shareholders, the two foreign banks became service companies of the National Bank of Malawi. On 31 December 1982, Barclays Bank sold its shares to Standard Chartered whose shareholding consequently rose to 20%. The present shareholders of National Bank are Press Corporation Ltd 38.4%, ADMARC Investment Holding Company Ltd 31.15%, South African Mutual Life Assurance Society 10.0% and Standard Chartered Bank Africa plc 20.45%. The latter continues to be the service company providing managerial expertise, advice and other professional banking services through the Head Office of the Standard Chartered Bank in London.

The Commercial Bank of Malawi began operations on 11 April 1970. The initial shareholders were Banco Pinta and Sotto Mayor of Mozambique 60%, Press Holdings Ltd 20%, and Malawi Development Corporation (MDC) 20%. The Portuguese/Mozambicans sold all their shares to Press Holdings and ADMARC in 1974, when Bank of America also came in with a holding of 30%. Bank of America sold its shares to the Malawi Government on 31 December 1983, and ADMARC sold its shares to MDC in January 1985. The present shareholders are Press Corporation 40%, MDC 20%, National Insurance Company 10% and the Malawi Government 30%.

The banks' main branches are limited to the larger urban centres such as Blantyre, Lilongwe, and Zomba. In addition, both banks operate a network of permanent static agencies and mobile units to extend the coverage of their services throughout the country. The former are sub-branches open for restricted periods and staffed by the mobile units. Typically, there will be a building rented or owned by the bank used for this purpose only and able to provide routine collection and withdrawal of deposits, and, in some cases, buying of foreign currency. They do not usually provide credit assessment for loans, or other more elaborate services; clients requiring such services have to visit the main branches.

The mobile units are secure vans used to service the static agencies and also to provide routine banking services at stopping points. Each will be staffed by a cashier and a driver from the bank, and a policeman hired for the day. The time spent at a stopping point can be as short as 30 minutes depending on the expected level of business. Typically, several points will be covered in a day, but the vans may be idle for at least part of the week. The vans usually act as net collectors of funds; by the end of the month this can amount to as much as K250,000.

The NBM has 14 branches, 20 static agencies and 27 mobile unit stopping points. The CBM has 14 branches, 10 static agencies and 41 points. In consultation with the Reserve Bank of Malawi, the banks co-ordinate their static agencies and stopping points to avoid duplication. Both maintain that a number of these agencies and stopping points make a loss but that they are obliged to operate them by the RBM. Thus, if their operations were not co-ordinated and controlled, their outreach into the smaller trading centres would probably decline.

*Non-bank financial institutions*

The Malawi Development Corporation was established in 1964 as a first development corporation, with equity participation of the international financial institutions. It is a limited liability corporation, now wholly owned by the Malawi Government. It provides equity and loan finance to business projects in areas where private initiative is lacking. It relies on foreign and local sources of finance.

The Investment and Development Bank (Indebank) provides equity finance as well as medium- and long-term loans for new and existing industries and agricultural ventures. Since its establishment on 30 December 1972, its resources have comprised share capital and loans; it began accepting deposits only in the early 1990s through its newly established commercial banking wing Indebank Financial Services. Indebank's shareholders are ADMARC and four foreign organisations, namely the Netherlands Development Finance Company, the Commonwealth Development Corporation of the United Kingdom, the German Finance Company for Investment in Developing Countries and the International Finance Corporation (IFC), an affiliate of the World Bank. Through these foreign shareholders Indebank has considerable access to foreign finance.

Indebank Financial Services was set up in 1991 as a commercial banking branch of Indebank, and on 1 April, 1993 it was established as a subsidiary wholly owned by Indebank. It accepts term deposits but not savings deposits, and it does not offer checking account facilities. It provides fianncial assistance to the commercial and industrial sectors as well as the agricultural sector. It also handles foreign trade transactions.

The Leasing and Finance Company of Malawi Ltd (LFC) provides leasing finance for the acquisition of capital equipment of various kinds for agricultural, industrial and commercial enterprises. It also intends to start offering hire purchase finance in the near future. It was incorporated on 28 April 1986, its shareholders being Indebank, FINCOM, Old Mutual and four foreign entities, namely the German Development Company, the IFC, EDESA S.A. of Luxemburg and UDC Ltd of Zimbabwe which was given a management contract for several years. These foreign shareholders should be able to facilitate LFC's access to foreign capital. The LFC accepts fixed deposits of varying maturities at high rates of interest but does not intend to accept savings deposits. Its total assets now exceed K60m.

National Mercantile Credit Ltd finances hire purchase transactions as well as capital leasing activities and block-discounts commercial trade debts. It was formed in 1958 by a group of businessmen who wanted a facility for providing lease-hire finance, and is registered under the Banking Act. It does accept deposits of varying maturities at high rates of interest. There is only one branch, located in Blantyre. Total assets as at end-1988 stood at K5.1m., having grown from K1.1m. in 1975.

The Finance Corporation of Malawi (FINCOM) provides import-confirming and export debt factoring services; it also acts as a foreign buying agent. Established in 1976, it is a wholly owned subsidiary of ADMARC and is managed by Balfour, Williamson and Company Limited which belongs to the Lonrho Group.

The New Building Society (NBS) provides mortgage finance to businesses and individuals. It started operations in March 1964 as a successor and merger of three separate building societies. Its shareholders are the Malawi Government, Protea Assurance Company Ltd and Lonrho (Malawi) Ltd.

The NBS is open about the same length of time per week as the Post Office Savings Bank, has a low minimum deposit balance requirement as well as several deposit instruments of varying maturities up to 24 months. However, it places restrictions on the amount of savings withdrawals and has a more limited range of branches, serving only 5 urban and 3 other centres.

The present Post Office Savings Bank began operating as a government-owned institution in January 1964 when it succeeded a similar institution which had operated before independence. The savings deposits it collects via its hundreds of offices throughout the country were wholly invested in government obligations in the past. Having been transformed into a private bank, the POSB will soon start lending to other sectors.

It has a large network of branches and agencies (257 in 1983). Interest on its deposits is exempt from taxation, and it enjoys security and safety. A low minimum deposit balance is required and withdrawals are allowed at any Post Office. However, withdrawals are limited to K20 within three days; larger withdrawals require one or more months' notice. In addition, customers must furnish proof of identity. Since its clientele consists mainly of small savers, it does not have as much money in deposits as the commercial banks.

## 2.2 Semi-formal institutions

SEDOM is an organisation that had built up a good reputation in financing small-scale enterprises (CSEs) till the late 1980s. In recent years it has been facing considerable structural problems. SEDOM provides a variety of financial assistance instruments, but not grants to SSEs:

- mini loans, which range from MK1,000 to MK5,000 (the limits are adjusted with an inflation factor)
- term loans, ranging from MK5,001 to MK100,000.
- other financing such as equity finance, leasing, guarantees, and workshop finance.

SEDOM's technical team gives advice to both existing and potential entrepreneurs in all areas essential for a successful business, such as production management, selection of suitable machinery, business management, financial control, maintenance and quality control. The technical assistance team also develops so-called products promotion and rural business creation programmes, usually in co-operation with other development institutions.

According to SEDOM's internal evaluation, it has become evident that a growing number of projects are facing problems. Many projects have failed completely in the past and many surviving projects are performing only marginally with further failures likely. This has affected the arrears performance of SEDOM's loans portfolio (along with other complex factors). The arrears situation represents a major problem warranting strong responses in terms of stern recovery action and, where situations are hopeless, write-offs. In general the extension and advisory programme has not worked well; it has been under stress for many years and has not lived up to initial expectations.

While poor performance is partly related to problems of staff and resources, there are other considerations. Many of the reasons for project failure and many of the problems experienced by ongoing projects are simply not amenable to easy solution by way of simple extension advice. SEDOM needs to undergo a reorganisation in order to be in a position once again to render adequate services, especially to smaller entrepreneurs.

The wide spread of SEDOM's scarce human and financial resources over a broad range of non-core activities places considerable pressure on its capacity to perform major functions efficiently. Some examples of efficiency problems include:

- administrative systems for loan approvals and disbursements are slow and cumbersome and warrant upgrading to modern approaches;
- decision-making arrangements for chronically sick accounts, both with regard to recovery action and, where hopeless, write-offs, are also slow and sometimes lacking in consistency;
- collection of repayments from clients has been very costly, frequently involving the use of a driver and a professional officer. Agency arrangements, lower-cost staff and other alternatives need to be explored in detail.

Improving administrative efficiency needs to be addressed on a number of fronts, including the appropriate recruitment and deployment of staff, and the development of more efficient credit systems for approvals/arrears management, combined with expenditure restructuring which will allow diversion of scarce resources from fringe activities to concentration on SEDOM's core objectives.

*Malawi Union of Savings and Credit Co-operatives (MUSCCO) and SACCOS.*

MUSCCO was established as a non-governmental institution in 1980 with the objective of developing financially sound local savings and credit co-operative societies (credit unions) throughout Malawi. As an apex organisation, its specific role is to promote and expand the number of savings and credit societies and develop a financially viable national association of societies. MUSCCO also aims to increase the management skills and creditworthiness of its member societies, their members, and the national association.

MUSCCO has its headquarters in Lilongwe, with regional offices in Mzuzu, Lilongwe and Blantyre. MUSCCO promotes the development of new credit and savings co-operatives through education and organisational assistance to self-help and employee-based groups interested in forming a SACCO. Study groups are set up to train potential SACCO members in credit union objectives, organisation and management, and to mobilise the savings required for the initial share capital. The study groups usually operate for three to six months before applying for registration as a SACCO. Nine out of ten study groups go on to register as a SACCO. Once the SACCO is formed, MUSCCO staff continue to provide management assistance and training to strengthen its financial and organisational capacity. In addition, MUSCCO provides central finance in the form of short- and long-term loans to the SACCOs for liquidity, investment in fixed assets, and to re-lend to members.

By the end of 1992, MUSCCO represented 115 SACCOs with 18,000 members and 21 study groups, and had a waiting list of groups interested in forming SACCOs. This represents a 130% increase in the number of SACCOs and a 29% increase in the number of members between 1985 and 1990. One-fifth of the member societies are urban-based and four-fifths rural-based.

SACCO members interested in developing or expanding their business are referred to the Development of Malawian Traders Trust (DEMATT), whose staff assist with the preparation of a business plan and, if a loan is granted, with monitoring and business assistance.

MUSCCO has experienced rapid growth in both the number of loans and the amount of loan funds disbursed to SACCOs each year. Short-term loans have been used by the SACCOs for liquidity and to on-lend to members. By contrast, business loans have been targeted on crop and livestock production (52%), trade (28%), manufacturing (15%), and service activities (3%). The average business loan amounted to MK6,450, and ranged from MK790 for ox carts to MK12,000 for maize mills. Figures were unavailable on the gender distribution of these loans but, according to staff, a majority of the funds went to men.

The SACCOs now have 75% of their assets in loans and 15% in investments, with the remainder in fixed assets. As the apex organisation, MUSCCO needs to reconcile its goal of financial sustainability with its role of providing credit funds to the SACCOs. As with most organisations established to perform social objectives, the solution is not without pitfalls. Clearly, MUSCCO must either achieve financial self-sufficiency or be dependent upon donor or other funds. The achievement of this objective will depend upon either the willingness of its SACCOs to increase their interest rates or the willingness of donors (USAID, in this case) to, in effect, provide funds to endow MUSCCO with the financial capability to meet its developmental objectives. The SACCOS use the income for their administrative expenses and do not pay dividends to their members.

MUSCCO's rapid growth has created related organisational stresses common in such situations. A significantly higher level of technical skills is needed to operate an increasingly sophisticated financial institution. MUSCCO seems to be planning for this transition quite systematically. It has an extensive staff development programme, with a formal, in-house training session for field officers, managers, and assistants for one week each year. Also, as part of the performance evaluation system, appraisals are undertaken of all staff in January each year. MUSCCO is at present not in a position to add new programmes to its ongoing activities without comprehensive external support (technical assistance as well as financial/capital injection).

*INDEFUND* operates offices in two locations, with the headquarters and southern branch office in Blantyre and the branch office for the central and northern regions in Lilongwe. The 26 member staff includes the general manager, 2 branch managers, 3 accountants, 8 project and Business Advisory Service (BAS) officers, 2 agricultural officers, 2 legal officers, and 8 support staff.

INDEFUND's current structure consists of:

- project officers who assist clients during the preparation of their business plans and then appraise the projects;
- monitoring officers who are responsible for training the entrepreneurs in bookkeeping and other record-keeping systems, as well as for monitoring the business to ensure that adequate records are kept and monthly reports submitted, and that attention is given to any problems that may arise;
- investment officers who monitor loan payments and are responsible, together with the branch managers, for debt collection; and
- staff who provide specialised assistance – a legal officer who advises on legal matters, and an agricultural adviser who supervises agricultural sector projects.

INDEFUND is, of necessity, involved in providing training and assistance to its clients in the preparation of business plans (both the technical and business aspects), in setting up bookkeeping and other record-keeping systems, in reporting on the status of the business, and in solving business and technical problems. It provides some of these services itself and co-operates with other organisations to obtain other services.

The monitoring and Business Advisory Service/Technical Advisory Service (BAS/TAS) functions are critical to INDEFUND's success. The strengthening of its internal monitoring capacities and the separation of appraisal, monitoring, and debt collection functions to allow monitoring officers to concentrate on their single responsibility are important. Similarly, INDEFUND's linkages with DEMATT in both business promotion and monitoring of rural businesses are encouraged. Group training for entrepreneurs in bookkeeping, but also in special topics, is also important to INDEFUND's success.

*Malawi Mudzi Fund (MMF)*

This Grameen-type experiment follows the recent establishment of a grass-roots banking institution, known as the Malawi Mudzi Fund, to serve the credit needs of the rural poor who certainly do not have access to formal and semi-formal financial institutions and probably do not have access to informal financial institutions either. Modelled on the Grameen Bank in Bangladesh, the Fund's customers are organised into small groups. The Fund mobilises resources through small but regular deposits from its customers. The first borrowers in each group are required to make several regular payments on their loans before other group members can borrow. An interest rate of 16% per annum is paid on deposits and 18.5% per annum is charged on loans. These interest rates are administered. No collateral security is required.

So far, the MMF has operated on a pilot basis in two districts, Chiradzulu and Mangochi. The initial popularity of the MMF has encouraged the government to extend it to other districts in the country, not through the MMF, which is to be disbanded, but through the Malawi Rural Finance Company.

## 2.3 Issues in financial development

In the light of the foregoing examples of attributes common to the formal financial institutions, why have the linkages between them been weak, as reflected in the inadequate flow of resources between them? Firstly, for historical and other reasons, segments of the formal financial sector have tended to specialise, particularly on the lending side of their businesses. This is not inherently undesirable; after all, specialisation promotes efficiency through the quality and quantity of the service provided. The adverse effect of specialisation, however, has been that the financial institutions in a particular segment of the formal sector have tended not to explore business opportunities beyond their traditional confines.

A good example is the fact that commercial banks have for too long focused on short-term lending, which historically has largely served the needs of foreign trade and large enterprises, while there has been a persistent unsatisfied demand for medium- and long-term capital finance on the part of both large and small-scale enterprises. And yet it is the commercial banks which have had a larger share of deposit resources than non-bank financial institutions. Because of their perception of inadequate opportunities of profitable lending to enterprises, the commercial banks have retained excess liquidity which has been invested in central government local registered stocks and Treasury bills, as well as holding large balances at the Central Bank. The commercial banks' excess liquidity was particularly evident in the 1980s. It resulted from the inadequate supply of foreign exchange which constrained the bank's expansion of credit to importers.

While the commercial banks have concentrated on short-term lending, with only a small proportion of their lending being of medium- to long-term maturity, non-bank financial institutions have concentrated on the provision of medium/long-term capital finance with little short-term lending (Chipeta and Mkandawire, 1991). If the linkages between these segments were strong, part of the excess liquidity of the commercial banks could have been lent to non-bank financial institutions, some of which have been experiencing shortages of loanable funds. This need for lending between financial institutions is also applicable among the commercial banks themselves as well as among non-bank financial institutions (including development finance institutions) when some of them accumulate excess investible funds.

Secondly, the development finance institutions have mainly relied on foreign sources of capital funds even when some other domestic financial institutions have had excess loanable funds. For several decades the commercial banks, before being localised, relied significantly on their head offices overseas when in need of additional funds. Since localisation they have continued to seek assistance (though on a reduced scale) from international banks including their former head offices, now called associate banks; typical assistance has been in the form of pre-export financing of tobacco purchases from the local auction floors. This has not been conducive to the promotion of linkages between local financial institutions, especially during periods when some of them have excess liquidity.

Thirdly, as required by its legislation, the single Post Office Savings Bank has, since its inception, invested all its loanable funds in central government securities. In terms of mobilising domestic financial savings on a broad-based geographical scale, the POSB is better placed than any other deposit-accepting institution, especially in the rural areas. Indeed since its formation in 1911 it has primarily been intended to serve lower-income savers, the majority of whom live in the rural areas. But it has served these low-income people only by collecting deposits from them and not by lending to them, nor by lending to other institutions which lend to enterprises and individuals in rural and urban areas. And this has not been conducive to the promotion of linkages between financial intermediaries. Legally, the commercial banks and some non-bank financial institutions have had to invest in government paper, due, apart from other considerations, to the inclusion of such paper in the definition of liquid assets for the purposes of meeting the liquidity ratio requirements. This has been because of there being hardly any alternative liquid assets in the country, apart from deposits at the central bank.

Fourthly, there are the underdeveloped money and capital markets. It can be argued that the simultaneous occurrence of pockets of excess liquidity with some financial institutions and liquidity deficits with others could have been minimised or avoided if the domestic money and capital markets were well developed. But this can be partly countered by the fact that the factors discussed above as responsible for the weak linkages between financial institutions are among the very factors which have hampered the development of vibrant money and capital markets. One of the other major factors has been the lack of appropriate financial instruments as well as participants, such as commercial paper and discount houses in the case of the money market, and securities of medium- and long-term maturity and a stock exchange in the case of the capital market.

The underdeveloped money market, or the lack of linkage between financial institutions through resources mobility, has been reflected in the fact that, even after having been localised, the commercial banks have seldom borrowed from the country's own central bank, the Reserve Bank of Malawi, as the lender of last resort; and when they have done so, it has been in small amounts. This has been due to at least three factors. Firstly, the long standing reliance on overseas banks, as mentioned earlier. Secondly, the fact that the commercial banks have for a considerable period been holding liquid assets well in excess of their statutory minimum requirements. Thirdly, the interest-rate structure, which has diminished any incentive to borrow from the central bank. During the whole period to May 1983, the Bank Rate at which the commercial banks could borrow from the central bank was higher than the interest rates paid to depositors by the commercial banks on savings deposits and on some of the term deposits of up to five months maturity. The reverse prevailed for a short period from June 1983 to March 1985, but from then until early 1990 the Bank Rate was again higher than the interest rates on savings deposits and short-term deposits requiring up to 30 days notice of withdrawal (Chipeta and Mkandawire, 1991).

Existing links between the formal financial institutions are in the form of the deposits of non-bank financial institutions at the commercial banks and the central bank, most of them maintained as working balances in current accounts. The largest of these are the deposits of insurance companies at the commercial banks. It seems that for a long time only a small proportion of the deposits of insurance companies have been held for meeting their transaction requirements and the rest has been treated as investment, illustrating the perceived scarcity of other investment opportunities. And yet the country's insurance companies and pension funds are the institutions with loanable funds of long enough maturity to meet part of the existing demand for medium- and long-term credit, little of which is satisfied especially among small and medium-scale enterprises (SMEs), which are of particular concern here. Paradoxically, the commercial banks, where the insurance companies and pension funds deposit their medium- and long-term maturity funds, have, in turn, not been keen to provide medium- and long-term loans.

The other link has been in the form of commercial banks' deposits at the central bank, while the flow of resources from the central bank to the commercial banks has been negligible and infrequent. These deposits have several times risen to very high levels, particularly in the 1980s. For a good part of that decade, a significant proportion of these deposits reflected the banks' liabilities in the form of the amounts paid in by importers and other transactors in local currency but awaiting externalisation because of inadequate foreign exchange. The commercial banks could have lent to SMEs a good proportion of their large balances at the central bank after setting aside the proportion needed for their daily operations, i.e. dealing in foreign exchange with the central bank, clearing cheques among the banks, and acquiring local currency for their cash requirements from the central bank.

Formal and semi-formal financial institutions have to some extent assisted SMEs. In the agricultural sector smallholders, who form the majority of the country's population, have received hardly any direct credit from the commercial banks and non-bank financial institutions. A few of them have received commercial bank credit indirectly through the seasonal overdrafts granted to the owners of burley tobacco estates, part of which they on-lend to tenants on their estates mainly in the form of farm inputs such as fertilisers. Institutions providing direct assistance are the Smallholder Agricultural Credit Administration (SACA), the newly established banking institution the Malawi Mudzi Fund, and the Savings and Credit Co-operatives (SACCOS) that operate under the direction and control of the Malawi Union of Savings and Credit Co-operatives (MUSCCO).

Non-agricultural SMEs have received financial assistance from two small development finance institutions, and to a lesser extent from other financial institutions and the commercial banks. However, it is generally agreed that this institutional credit to SMEs in both the agricultural and the non-agricultural sectors has been inadequate (Malawi Government/USAID, 1987). Indirectly the commercial banks also assist smallholders via lending to the Agricultural Development and Marketing Corporation (ADMARC) for the purpose of purchasing smallholder crops; ADMARC is the single largest purchaser and seller of smallholder crops.

## 2.4 Financial liberalisation, widening, deepening

In the wake of financial liberalisation from the late 1980s, some new formal and semi-formal financial institutions have been established and others are about to be established; also some existing financial institutions have started to diversify their activities in terms of sources of loanable funds and/or lending. It is not clear, however, if all this has led to financial widening in terms of a significant increase in the number and range of savers as well as in the number and types of borrowers, especially SSEs and small-scale agricultural enterprises (SSAs) which are of particular concern here.

It is rather early to assess the impact of the activities of the infant Malawi Mudzi Fund. Whether Indefinance depositors and borrowers have been wholly attracted from existing financial institutions or some of them are newly-found clients is not clear, as is the case with Leasing and Finance Company, which was established earlier. The old POSB, recently renamed the Malawi Savings Bank, has started to diversify its investment portfolio away from government paper into deposits with other financial institutions, but has not yet begun to lend to ultimate borrowers in the real sector.

As for financial deepening, paradoxically the data do not show that there has been further deepening with the introduction of financial liberalisation. The nominal stock of broad money supply as a percentage of GDP at current market prices in the early 1990s was no larger than in the 1980s; it was 19.2% in 1993 compared with 22.4% in 1987 and 18.1% in 1983. The nominal stock of identifiable domestic credit extended by formal financial institutions plus the non-financial sector's holdings of government paper as a percentage of GDP at current market prices was no larger in the early 1990s than in the late 1980s, and clearly lower than in the early 1980s; it was 35.1% in 1993 and 39.7% in 1992 compared with 43.2% in 1987 and 50.2% in 1983 (Table 1).

**Table 1 Domestic credit, money supply, gross domestic product (1983-93) (Km.)**

| Year | Gross domestic credit stock[a] End Dec (1) | Money Stock[b] (M2) End Dec (2) | GDP at current market prices (3) | Col (1) as % of Col (3) | Col (2) as % of Col (3) |
|---|---|---|---|---|---|
| 1983 | 721.4 | 260.5 | 1,436.9 | 50.2 | 18.1 |
| 1984 | 744.1 | 351.3 | 1,707.7 | 43.6 | 20.6 |
| 1985 | 853.3 | 351.4 | 1,944.9 | 43.9 | 18.1 |
| 1986 | 995.6 | 435.1 | 2,197.7 | 45.3 | 19.8 |
| 1987 | 1,129.5 | 586.2 | 2,614.0 | 43.2 | 22.4 |
| 1988 | 1,136.7 | 694.1 | 3,417.9 | 33.3 | 20.3 |
| 1989 | 1,408.6 | 732.1 | 4,388.2 | 32.1 | 16.7 |
| 1990 | 1,568.3 | 822.5 | 5,069.9 | 30.9 | 16.2 |
| 1991 | 1,987.7 | 1,000.5 | 6,105.5 | 32.6 | 16.4 |
| 1992 | 2,652.5 | 1,218.6 | 6,673.8 | 39.7 | 18.3 |
| 1993 | 3,161.5 | 1,728.4 | 9,010.5 | 35.1 | 19.2 |

(a) Gross claims of central bank, banks and other financial institutions on the private sector, parastatals and government, plus domestic non-financial sector's holdings of government paper.

(b) Currency circulating outside banks plus private sector demand, savings and time deposits at commercial banks.

Source: Reserve Bank of Malawi, *Financial and Economic Review*, quarterly.

The paradox of the lack of increase in the ratios of monetary aggregates to GDP since the late 1980s can be partially explained. A good part of the increase in the money stock up to the mid-1980s was due to the acute shortage of foreign exchange; but as the supply of foreign exchange improved considerably from the late 1980s because of balance-of-payments aid, a considerable part of the money stock was used to pay for imports, thereby contributing to the stagnation of the ratio of M2 to GDP. The stagnation in the ratio of identifiable formal domestic credit to GDP may, to some extent, be due to an increase in informal financial sector credit, on which there are, however, no time series. An earlier survey showed that in 1988 the amount of credit extended by the informal sector was almost as large as that extended by the formal sector (Chipeta and Mkandawire, 1991).

Following the liberalisation in 1990 of interest rates at formal financial institutions, one of the major developments on the interest-rate front has been related to the Treasury Bill rate, whose level since 29 September 1992 has also been influenced by the prices at which bidders are willing to purchase the Bills. Recently 30-day, 61-day and 182-day Bills have been introduced in addition to the traditional 91-day Bill. And lower denominations, as low as K1,000, have also been introduced to encourage small savers. By November 1994 yields of Treasury Bills rose to as high as nearly 40% when the reserve Bank Rate was 30% and the minimum lending rate at commercial banks was also 30%. In the following month the Bank Rate was raised to 40%, as was the minimum lending rate at one of the two major commercial banks, while at the other it was raised to 41%.

It is debatable whether the timing of the liberalisation of interest rates in May 1990 was appropriate or not, because, in terms of sequencing, those economic reforms which were rightly initiated earlier appear not to have run to their optimum levels. We refer to reforms which had the capacity to create a suitable environment for liberalising interest rates, particularly in terms of helping to keep real interest rates positive through price stability at low inflation levels. One of them is the reform of the exchange rate which was overvalued for a long time. The policy of depreciating the Kwacha in stages was begun in April 1982. By May 1990 or even twelve years later in early 1994 it was not clear that its external value had reached optimum levels. On 7 February 1994 the Malawi Kwacha was floated. Given the large share of imports in the national supply of goods and services, the inflationary effect of the sharp depreciation of the kwacha has been substantial. Another policy measure has been that of reducing the central government's large budget deficit, and more specifically the need to reduce deficit financing through borrowing from the Central Bank which has been rising continuously to uncomfortably high levels since the early 1980s.

The foregoing inflationary developments have been taking place amidst a policy of price decontrol which was also under way in the early 1980s. From the mid-1980s further inflationary pressure was exerted by the involuntary use of much longer trade routes from the seaports following the closure of the traditional shorter ones. Thus, by 1990 the rate of inflation was still in two digits and, with the exception of 1991, has continued at such levels, reaching over 35% by the end of 1994. In such an inflationary environment real interest rates have hardly been positive, and have therefore not served the functions of encouraging financial savings and allocating them amongst competing investments in the real sector.

# 3. Methodology

## 3.1 Introduction

The present study has made use of two primary sources of information as well as several secondary sources. Interviews with headquarters staff of formal and semi-formal financial institutions: commercial banks (NBM and CBM) the Leasing and Finance Company; the New Building Society; the Malawi Union of Savings and Credit Co-operatives; the Small Enterprise Development Organisation of Malawi; the Malawi Mudzi Fund; the Investment and Development Fund and the Investment and Development Bank, constitute one primary source of information. An unstructured questionnaire was used in these interviews. The main primary source of information was a detailed survey of these same formal and semi-formal financial institutions. The rest of this section is devoted to that survey.

## 3.2 Description of questionnaire

Information on the formal and semi-formal financial sectors is based on a long questionnaire, with 205 questions grouped into several sections. There is a section on the deposit characteristics of bank branches and non-bank financial institutions: this covers numbers of depositors and amounts of deposits by enterprise sector, defined on the basis of size of enterprise, namely small-scale enterprise sector, large-scale enterprise sector, small-scale agricultural sector, and other. Also covered are depositors from the informal financial sector so as to measure the degree of deposit linkage between the informal and other financial sectors.

The bulk of the questionnaire is devoted to lending operations, which is the main focus of the study. A section on characteristics of borrowers covers numbers of loan (including overdraft) applications and approvals broken down by gender, thereby helping to determine the extent to which loan demand is satisfied. Also captured is the average distance to bank branches covered by borrowers who do not live close to branches, which is relevant to the determination of transaction costs. Numbers of borrowers coming from the informal financial sector are also sought here, in an attempt to measure the degree of credit linkage between the formal/semi-formal and informal financial sectors Then there is a section on the allocation of responsibilities between bank branches and head offices with regard to loan processing and decision-making on the basis of loan sizes. This is followed by a section which covers terms and conditions of lending and other loan characteristics, including maturities, security, interest rates and other charges.

It has been hypothesised that a major constraint to the development of effective linkages between financial sectors is inadequate information and high transaction and other costs. There is, therefore, a section in the questionnaire which deals with the type of information and how it is gathered and other factors which are taken into account when screening loan applications. Data are also sought on the administrative costs associated with loan screening, monitoring and contract enforcement, for it is into these three areas that the various activities of lending fall respectively. The costs captured are on salaries, stationery and transport, disaggregated into borrowing sectors, thereby facilitating the estimation of the average administrative cost per each Malawi Kwacha lent out to each enterprise sector. There are also sections which deal with loan monitoring and loan repayment trends including methods of ensuring loan repayments, causes of default and remedial measures.

## 3.3 Techniques employed in the administration of the questionnaire

Use was not made of any scientific technique of sampling banks, non-bank financial institutions (NBFIs) and their branches. Given the small number of formal and semi-formal financial institutions and their branches in the country, the sample size targeted at the planning stage of the study represented almost the entire number of branches. The sample which was targeted is tabulated below against the actual number of respondents to the questionnaire.

| | | Numbers | |
|---|---|---|---|
| | Location | Sample targeted | Actual respondents |
| *Formal financial institutions* | | | |
| Commercial banks: | Urban | 18 | 11 |
| | Rural | 11 | 3 |
| Development bank: | Urban | 1 | 0 |
| | Rural | - | - |
| Building Society: | Urban | 2 | 1 |
| | Rural | 1 | - |
| Leasing Company: | Urban | 2 | - |
| | Rural | - | - |
| Subtotal | | 35 | 15 |
| *Semi-formal financial institutions* | | | |
| Savings and Credit | Urban | - | 5 |
| Co-operatives: | Rural | 13 | 11 |
| Development finance | Urban | 7 | 2 |
| Institutions: | Rural | - | 1 |
| Subtotal | | 20 | 19 |
| TOTAL | | 55 | 34 |

The highest number of branches of formal and even some semi-formal financial institutions is in the Southern Region of the country, followed by the Central Region and lastly the Northern Region.

Initially the study was introduced and the questionnaire presented to head offices of banks and NBFIs. The general reaction was as expected, namely, that the questionnaire was so long that the very busy staff in the branches would hardly find time to complete it. Nonetheless, some institutions were a little more willing to assist than others. Some of the latter, in particular one of the two commercial banks, had to be persuaded by emphasising the fact that the study has been sponsored by the World Bank and refusal to assist would not reflect well on the image of the institution, given the international status of the World Bank, and also the fact that some of its loanable funds are being channelled to borrowers under special schemes through the very same commercial banks.

For NBFIs the questionnaire was mainly administered at their head offices, as they felt that little additional useful information would be collected from their few branches. For the commercial banks, after obtaining approval from the head office, the questionnaire was administered at their branches by research assistants, who discussed the purpose of the study and the contents of the questionnaire with the branch manager and/or his deputy. This took an average of one and half hours. In most cases it was initially agreed that the questionnaire would be completed in one to two months. After a few weeks, follow-up visits were made to NBFI head offices, commercial bank branches and savings and credit co-operatives to check on progress in overcoming problems encountered in the completion of some parts of the questionnaire. In some cases such follow-up visits had to be repeated as many as four or even seven times before the completed questionnaires were collected. After discovering the problems SACCO officials were encountering, the research assistants resorted to completing the questionnaire themselves while interviewing the officials.

## 3.4 Respondents' reactions to questionnaire administration

As expected, respondents found the questionnaire very long. But as the work was in progress they discovered that some questions did not need much time to answer, thereby allowing time for them to retrieve raw data from their files, as called for in the questionnaire.

A few managers of commercial bank branches expressed the view that they had found completing the questionnaire a useful exercise; some of them even kept a copy of it.

## 3.5 Response time for questionnaire

The time it took to finish completing the questionnaire, ready for retrieval, was generally as long as three months, i.e. longer than the initially agreed period of one to two months. The delay was attributed to the fact that, because of the pressure of their normal workload, the staff assigned to complete the questionnaire found difficulty in doing so during their normal working hours. Extra time outside normal hours had therefore to be put in, particularly at commercial bank branches.

Difficulties encountered in completing the questionnaire mainly arose from the fact that the quantitative information called for by some questions had to be reconstructed from the raw form in which it was kept by the respondents. A typical example was that of reconstructing information on deposits and credit into sectors of small-scale enterprises, large-scale enterprises, small-scale agriculture and 'other'. Another typical example was the difficulty of allocating time spent on screening loan/overdraft applications, monitoring, and contract enforcement by loan officers at commercial bank branches where these officers discharge several other responsibilities. Also the reliability of answers to some questions seeking information on earlier years was considerably dependent on the continuity of service of loan officers in the same branch' a good example being information on the numbers of loan applications and approvals by sector. These and other difficulties explain the non-response to several questions by some respondents and the variation in the quality of answers among them. In other cases, the questionnaire was not even completed.

## 3.6 Survey coverage

As shown above of the 34 respondents, 15 were from the formal and 19 from the semi-formal financial sectors. Of the 15 from the formal sector, 14 were commercial bank branches and one was the head office of the only New Building Society in the country. Of the 15, 12 were in urban areas and only 3 (all commercial bank branches) in rural areas. Of the 19 respondents from the semi-formal financial sector, 16 were savings and credit co-operatives (SACCOS), only 5 of which were in urban areas. It is clear therefore that for the formal financial sector a good deal of the analysis will be based on data for commercial banks in urban areas, while for the semi-formal financial sector the analysis will be largely based on SACCOS in rural areas.

The average number of years respondent branches had operated in their areas was 20 for commercial banks, with those in urban areas having clocked nearly 22 years and those in rural areas 14. However, this information needs qualification: some branches of the National Bank of Malawi (NBM), one of the two fully-fledged commercial banks, had already operated for several years as branches of Barclays Bank DCO and Standard Bank before the two merged to form NBM in 1972. The urban branch of one of the respondent development finance institutions had operated for 7 years. The average number of years of existence for respondent SACCO branches was 6, with those in rural areas having existed for nearly 8 years compared with only 2.4 for those in urban areas.

The average number of other bank branches in the rural district of the respondent branch was 6 and the average was the same for its town. This average was grossly exaggerated by the city of Blantyre where about a third of all commercial bank branches are concentrated. In fact, there are several districts which do not have a branch and are therefore served only by commercial bank agencies, static and mobile . For respondent savings and credit co-operatives the average number of other SACCOS in a district was about 5.

## 3.7 Data analysis

Frequency distribution, proportions and means of relevant variables, and other descriptive statistics are the main tools used in analysing the data. To test for significance of differences in proportions or means of comparable variables drawn from different samples, use has been made of the t or the chi-square test.[1] Correlation between each type of formal or semi-formal financial unit, location of the unit and other relevant variables were also established by means of cross-tabulations. Lastly, two way analysis of variance, using the F test, has been used to compare several means of the same variables relating to types of lenders and different locations. The formula that has been used is:

$$F = MSTR/MSE = \frac{\{\Sigma\Sigma_{ni} (Y_{ij} - Y)^2\}/k-1}{\{\Sigma\Sigma\Sigma(Y_{ijk} - Y_{ijk})^2\}/N-1-k}$$

where MSTR = Mean Square Treatment
MSE = Mean Square Error

and where $Y_{ijk}$ is the kth observation of the ith level of the first factor (type of lender) and the jth level of the second factor (location of lender - rural/urban);

$Y_{ijk} = \Sigma Y_{ijk}/n$ is the mean for the treatment corresponding to the ith level of the first factor (type of lender) and the jth level of the second factor; $Y = \Sigma\Sigma\Sigma\, Y_{ijk}/N$ is the grand mean.

[1] This and all other tests have been made at the 5% level of significance

# 4. Deposit characteristics

## 4.1 At commercial banks

The questionnaire for the formal financial sector focused on deposit characteristics of banks and non-bank financial institutions, with deposits broken down into the small-scale enterprise sector (SSE), large-scale enterprise sector (LSE), small-scale agricultural sector (SSA) and other. Table 2 shows that the average number of depositors by enterprise sector per respondent commercial bank branch increased significantly for all enterprise sectors during the three years 1990–92: SSEs increased by 100%, LSEs by 66%, SSAs by 36%, 'other' by 31%, and the overall average number of the four sectors per respondent branch rose by 43%. Over the same three-year period the average amount of deposits by enterprise sector per respondent branch grew for all enterprise sectors except the SSA; average deposits of SSEs grew by 86%, LSEs by 565%, and 'other' by 60%.

**Table 2 Commercial bank deposit liabilities and depositors by size of enterprise sector**

| *Enterprise sector* | *Year* | *Average No. of depositors per respondent branch* | *Average total in Kwacha per respondent branch* |
|---|---|---|---|
| SSEs | 1990 | 233 | 941,459 |
| | 1991 | 217 | 1,447,571 |
| | 1992 | 465 | 1,754,064 |
| LSEs | 1990 | 35 | 1,313,770 |
| | 1991 | 45 | 6,539,821 |
| | 1992 | 58 | 8,740,911 |
| SSAs | 1990 | 317 | 824,953 |
| | 1991 | 303 | 478,979 |
| | 1992 | 430 | 753,484 |
| Other | 1990 | 2,521 | 14,323,356 |
| | 1991 | 3,060 | 19,620,222 |
| | 1992 | 3,293 | 22,854,138 |
| Total | 1990 | 4,056 | 17,403,538 |
| | 1991 | 5,652 | 28,386,573 |
| | 1992 | 5,790 | 34,102,597 |

*Source:* Calculated from survey data.

These results need some qualification, however. Data at commercial bank branches are not kept on the basis of size of enterprise sector as sought by the questionnaire and therefore compiling the raw data into the required format was quite difficult. Thus, the principle of whether an SSE or LSE is in manufacturing, service sector, commerce, mining or any other economic activity could hardly be applied. The guiding principle was therefore whether an enterprise was an SSE or LSE, regardless of its type of economic activity as classified by the ISIC codes. The SSA sector caused little difficulty. Slotting some accounts into the given sectors was to some extent arbitrary: for example, for personal accounts, some of which serve SSE or SSA operations apart from serving purely personal needs which fall into the category of 'other'. Further, since data on the number of employees are not readily available at branches especially for SSEs, the distinction between SSEs as those employing up to 10 persons and LSEs employing more than 10 persons was difficult to make in some cases.

Data on a quarterly basis are, however, available from commercial bank branches on deposits and lending broken down according to type of economic activity sector. These are processed by computer using ISIC codes, and are sent to the central bank for aggregation and publication. Our first study (Chipeta and Mkandawire, 1991) demonstrated some interesting results about which economic activity sectors have been net savers or net borrowers when their deposits at, and borrowing from, commercial banks are netted out. This was done for the private sector. It revealed that the agricultural sector had swung from a net saver up to the early 1970s to a net borrower from the mid-1970s to the 1980s, and persisting into the early 1990s. Some sectors, such as the manufacturing and the wholesale and retail trade sectors, have fluctuated from a net saver to a net borrower position. Others, such as the construction and civil engineering sector, the community, social and personal services sector and in particular the household sector, have consistently been net savers with the commercial banks.

In terms of distribution between the private and the public sectors, the private sector accounts for the bulk of total deposits at the commercial banks, followed by the parastatals and non-residents other than banks. Up to the mid-1970s, as noted in the earlier study, the proportion of deposits of parastatals was rising, largely because of the considerable growth in profitability and liquidity of the large parastatal which markets the crops of small-scale farmers. Since the late 1970s their profitability and liquidity deteriorated because of adverse factors external to the economy and in some cases weak management. Consequently the proportion of the deposits of parastatals decreased; in fact, they turned round from being net savers during most of the earlier years to net borrowers from the banking system during the greater part of the 1980s.

The earlier study also noted a compositional shift in deposits in favour of interest-bearing types, particularly time deposits, apparently because depositors are becoming increasingly knowledgeable and prudent in the management of their finances, thereby tending to minimise their holdings of non-interest-bearing demand deposits. For the larger of the two commercial banks, the share of demand deposits in total deposit liabilities was as high as one-half in the mid-1970s but decreased to a third by the mid 1980s. Over the same period the share of term deposits increased from less than a third to more than one-half, while that of savings deposits was relatively stable. This is because savings deposits are distributed among many more depositors and in smaller amounts per depositor than demand and term deposit liabilities. The rise in the share of term deposits has tended to raise the average cost of funds over the years.

Since 1992 interest rates on term deposits of 24 months have been set at a slightly lower level than for those of 12 months and the rest of the shorter maturities; term deposits with maturities of 13 to 23 months have not been offered by commercial banks in the early 1990s, as also term deposits of over 24 months since 1987. Since May 1990 interest rates for deposits and lending are determined by banks and NBFIs on the basis of market forces, with appropriate signals being given by the Reserve Bank of Malawi through changes in the Bank Rate. In such a liberalised-environment where changes are frequent, there is the adverse possibility of a deposit-taking institution contractually binding itself to a sizeable amount of long-term deposits at high interest rates, even when the interest rates, including lending rates, have generally decreased thereby narrowing its average interest margins.

With this adverse possibility it seems to make sense for commercial banks currently not to offer term deposits of over 24 months and to pay lower interest rates on term deposits of 24 months than on those of shorter maturities. On the other hand, this is not a welcome development in relation to the need to encourage the growth of deposits of long-term maturities on the basis of which banks can extend long-term credit, which is still scarce relative to the needs of borrowers, including SSEs.

Data from commercial bank branches which responded to the questionnaire showed no particular months of the calendar year when their respective total deposits were at the lowest or highest levels. Nonetheless, the average ratio of disparity between their respective highest and lowest month was 18%, with branches in urban areas averaging nearly 17% and those in rural areas about 24%. The higher ratio of disparity for rural branches appears to be due to their being subjected to a higher degree of seasonal swings, largely influenced by seasonal agricultural activity, than urban branches.

On the other hand, the data of all commercial bank branches as aggregated and published by the Reserve Bank of Malawi clearly show that their deposit liabilities reach the lowest level in the first quarter and peak in the third quarter of the calendar year. The peaking of deposits at commercial banks, which form the bulk of broad money supply, in the third quarter is reflected/influenced by the fact that net inflows of funds into Malawi, as summarised by net foreign assets of the banking system, are also at their highest in the third quarter. This is the quarter when the marketing activities of estate and smallholder crops are also at their highest. The bottoming out of deposits at commercial banks in the first quarter is also influenced/reflected by the bottoming out of net foreign assets of the banking system in the same quarter, when crop marketing activities are also at their lowest and the rains are at their peak.

*4.1.1 Deposit links between IFIs and commercial banks*

One of the major aims of the present study is to contribute towards the quest for integration between financial segments. Table 3 confirms what has been established in the section of the study dealing with the informal financial sector (Chipeta and Mkandawire, 1995) that there is some significant link by way of informal financial institution deposits at commercial banks.

**Table 3 IFI depositors and deposits at commercial banks**

| | *Number of Depositors* | | |
|---|---|---|---|
| | *Average per respondent branch* | *Total for the 14 respondent branches* | *Average % of total deposits per respondent branch held by IFIs at end '91* |
| Trader | 40 | 560 | 5.57 |
| Moneylenders | - | - | 0.14 |
| Savings & Credit Associations | 2 | 28 | 1.00 |
| Co-operative Savings Associations | 1 | 14 | 0.36 |
| Community Funds | 2 | 28 | 2.00 |
| Tobacco estate owners | 14 | 196 | 3.93 |
| Other | - | - | - |

*Source*: Calculated from survey data.

In interpreting the data in Table 3 it should be borne in mind that commercial banks, like other formal financial institutions, are unlikely to know much about which of their clients are involved in informal financial transactions. Such knowledge probably diminishes the higher the degree of secrecy with which the informal financial agent prefers to conduct his/her lending transactions. This may be why no respondent commercial bank branch reported any of the moneylenders as clients; these are known to be secretive in their transactions. The degree of secrecy appears to be less for other informal agents, including co-operative savings associations (CSAs) whose membership is limited to a few, and whose existence tends to be of short duration thereby further reducing the chances of being known by the banks where they deposit their funds. The lives of Savings and Credit Associations (SCAs) and Community Funds (CFs) are longer than those of CSAs. Perhaps because of this, the chances of being eventually known by their bankers are higher for SCAs and CFs than for CSAs, hence equally higher numbers of SCA and CF depositors were reported, as shown in Table 3.

The other reason, partly related to that of secrecy, why banks are unlikely to know most of their clients who are informal financial agents such as CSAs and CFs, is that their bank accounts, where applicable, are usually opened not in the names of the associations but of their individual office bearers such as treasurers. Also, moneylenders would not open their bank accounts serving their lending activity in the business name of 'moneylender' since that is not catered for in the existing legislation and registration of business. It was therefore not surprising that bank branches, on the other hand, had no problems in reporting the numbers of their depositors from the informal financial sector who were tobacco estate owners and traders, as these are legally registered and therefore open their bank accounts as such. This was also evident from the average proportions of total deposits per respondent bank branch held by tobacco estate owners and traders, which were about 4% and 6% respectively, much higher than the proportions of deposits held by the other informal financial agents reported as clients at bank branches.

It is clear from the above that information on which and how many informal financial agents deposit at banks (and how much) can be better collected from the agents themselves than from banks. The information discussed in the study on the informal sector is therefore likely to be more reliable than that presented in the present section, especially about CSAs, SCAs, CFs and moneylenders.

## 4.2 Deposit characteristics of SACCOs

Among semi-formal financial institutions, the number of respondents to the questionnaire was significant only in the case of SACCOs. This was largely due to the fact that, after discovering the difficulties SACCOS were encountering in completing the questionnaire, the research assistants resorted to completing it themselves while interviewing SACCO officials. However, unlike the case of banks and other formal financial intermediaries which accept deposits, little characterisation can be made of deposits put into SACCOs or of their lending, because the depositors/savers and borrowers are the members of the SACCOS and not outsiders and are individuals, some of whom are engaged in small-scale farming and other enterprises, as illustrated in Table 4. It is not surprising therfore that there was no large-scale enterprise saver/member for the three years 1990–92 as shown in Table 4.

Over the three-year period the average total membership, based on savers, per respondent SACCO rose by 84%, with small-scale entrepreneurs having risen by as much as 273%, small-scale farmers by 88% and 'other' by 77%. The substantial increase in SSE membership suggests that old and new members may be increasingly looking at SACCOs as a source of credit for their businesses, which is not surprising in view of inadequate extension of credit to SSEs by banks and

**Table 4 Savings and savers at SACCOs, by size of enterprise sector**

| *Enterprise sector* | *Year* | *Average No. of depositors per respondent branch* | *Average total in Kwacha per respondent branch* |
|---|---|---|---|
| SSEs | 1990 | 40 | 4,286 |
| | 1991 | 93 | 7,322 |
| | 1992 | 149 | 32,491 |
| LSEs | 1990 | - | - |
| | 1991 | - | - |
| | 1992 | - | - |
| SSAs | 1990 | 59 | 4,498 |
| | 1991 | 102 | 8,713 |
| | 1992 | 111 | 11,664 |
| Other | 1990 | 113 | 40,086 |
| | 1991 | 152 | 36,938 |
| | 1992 | 200 | 65,995 |
| Total | 1990 | 211 | 48,870 |
| | 1991 | 317 | 52,973 |
| | 1992 | 388 | 110,150 |

*Source:* Calculated from survey data.

other formal financial intermediaries, as well as by development finance institutions specifically established to assist SSEs. Over the same three years the average amount of total savings per respondent SACCO rose as sharply as 65.8% in the case of SSE members, 15.9% for SSA members and 65% for other members; these nominal rates of increase were also positive in real terms. Given that the SACCOs interviewed had existed for an average period of only five years, the substantial growth in the number of members and the amount of savings seems to indicate that their popularity is growing significantly. During the time of the survey in 1993 there was an average of only 2 SACCOs in a town or rural locality and only 5 in a district.

The disparity between peak month and low month for the volume of savings averaged 43%, with urban SACCOs averaging 34% and rural SACCOs higher at 48%, because of seasonality of incomes mainly of small-scale farmers.

### *4.2.1 Deposit links between the informal financial segment and SACCOS*

Table 5 shows that during the survey the only informal financial entities which were saving at SACCOs were SCAs and to a very small extent moneylenders. This is not particularly surprising, because the major objective of mutual aid informal financial entities is similar to that of SACCOs, namely to serve the financial needs of their members. Thus CSAs and CFs have not found it necessary to belong to SACCOs.

| Table 5 | IFI savers and savings at SACCOs | | |
|---|---|---|---|
| | *Average per respondent SACCO* | *Number of Savers Total for the 16 respondent SACCOs* | *Average % of total savings per respondent SACCO held by IFIs at end 1991* |
| Traders | - | - | - |
| Moneylenders | 0.25 | 4 | 1.44 |
| SCAs | 87.0 | 1,392 | 19.11 |
| CSAs | - | - | - |
| Community Funds | - | - | - |
| Tobacco estate owners | - | - | - |
| Other | - | - | - |

*Source*: Calculated from survey data.

On the basis of this argument, however, the CSA membership of SACCOs shown in Table 5 is to some extent surprising. Or it may be that, because of the varying degrees of secrecy with which some informal financial entities conduct their transactions, some of them could be members of SACCOs without SACCO officials knowing, which is more likely to be the case for some moneylenders and the short-lived small membership CSAs. Nevertheless, the message from Table 5 is that there are some deposit/savings links between some informal financial entities and SACCOs in the semi-formal financial segment, although the links appear to be few.

## 4.3 Comparative deposit characteristics

There were significant variations in the mean numbers of depositors. For almost each sector, there were more urban than rural depositors, reflecting geographical differences in the ability to save. In 1991, for example, the mean number of SSE depositors per urban commercial bank branch was 275 and per rural commercial bank branch only 4. The comparative mean numbers of SSE depositors at SACCOs were 130 and 77 respectively. Using the F-test, variation in the mean numbers of depositors is significant, and is due to both type of deposit institution and location. In the same year, the mean number of LSE depositors per urban commercial bank branch was 58 and per rural commercial bank branch 1. Variation in these means is significant and is entirely due to location. LSEs did not deposit money with SACCOs. SSAs deposited money at both commercial banks and SACCOs, with mean numbers in 1991 of 375 (per urban bank branch), 40 (per rural bank branch), 32 (per urban SACCO) and 134 (per rural SACCO). Variation in these mean numbers is not significant. The comparative mean numbers for other depositors were 2,800 (per urban bank branch), 3,722 (per rural bank branch), 421 (per urban

SACCO) and 30 (per rural SACCO). Variation in these mean numbers is significant and is due to type of lender.

When account holders are broken down by type of deposit, the geographical pattern of holders does not change much (see Table 6). For current and savings accounts at commercial banks, the mean numbers of holders at urban branches exceed those of account holders at rural branches for all sectors. For time deposits, the results are mixed. For deposits maintained at SACCOs, data are presented only for rural units. As such, no comparison between urban and rural SACCOs has been possible.

**Table 6 Mean number of account holders for each type of account, December 1991**

| Account | Deposit Institutions | Type of Account | Mean number of holders per *Urban Branch* | *Rural Branch* |
|---|---|---|---|---|
| SSEs | Commercial Banks | Current | 85.1 | 2.3 |
| | | Savings | 117.5 | - |
| | | Time | 0.2 | 1.3 |
| | SACCOs | Savings | - | 87.4 |
| | | Share | - | 24.1 |
| LSEs | Commercial Banks | Current | 34.9 | - |
| | | Savings | 21.9 | - |
| | | Time | 7.6 | 1.0 |
| SSAs | Commercial Banks | Current | 69.8 | 2.0 |
| | | Savings | 276.8 | 0.7 |
| | SACCOs | Savings | - | 70.3 |
| | | Share | - | 18.6 |
| Other | Commercial Banks | Current | 2,873.0 | 250.0 |
| | | Savings | 3,591.8 | 3,409.7 |
| | | Time | 106.1 | 39.0 |
| | SACCOs | Savings | 0.6 | 39.5 |
| | | Share | - | 9.2 |

*Source*: Calculated from survey data.

Statistically significant variations in the mean numbers of account holders, due to type of deposit institution, are those among 'other' time account holders and 'other' savings account holders. Those that are significant due to location are among SSE current account holders and SSA time account holders, while those that are due to both type of deposit institution and location are among SSE time account holders only.

With respect to informal financial institutions, significant variations among account holders were found among CSAs due to location, SCAs due to both location and type of deposit institution, and moneylenders due to the same factors.

The distribution of the mean amounts of deposits in 1991 is shown in Table 7. Reflecting the older age and higher deposit interest rates of commercial banks (Table 8), the mean sums mobilised by commercial banks were higher than those mobilised by SACCOs and the development finance institution (Malawi Mudzi Fund) in both urban and rural areas. But reflecting the greater ability of urban enterprises to save, for both commercial banks and SACCOs, the mean deposits mobilised in urban areas exceeded those in rural areas. Statistically significant variations in mean sums mobilised due to location are those deposited by SSE and LSEs. Those that are significant due to both type of deposit institution and location are the ones deposited by 'other' enterprises, while the ones that are just significant are those deposited by SSAs.

**Table 7 Mean amounts of deposits mobilised by branch by sector, 1991 (Kwacha)**

| | | *Mean Amount of Deposits* | |
|---|---|---|---|
| *Depositing Sectors* | *Depositing Institutions* | *Urban Branches* | *Rural Branches* |
| SSEs | Commercial Banks | 2,192,088.40 | 147,972.00 |
| | Development Finance Institution (MMF) | - | 21,960.00 |
| | SACCOs | 89,022.20 | 6,794.67 |
| LSEs | Commercial Banks | 11,096,663.00 | 103,150.67 |
| SSAs | Commercial Banks | 938,328.27 | 14,632.69 |
| | SACCOs | 5,133.20 | 75,722.33 |
| Other | Commercial Banks | 282,594.00 | 3,034,685.30 |
| | SACCOs | 199,410.80 | 5,351.44 |

Source: Calculated from survey data.

**Table 8 Some annual principal interest rates as at mid-June 1994**

| | Nominal % | Real %[a] |
|---|---|---|
| COMMERCIAL BANKS | | |
| Savings Deposits | 25 | -5.0 |
| Short Term Deposits | | |
| 7 days call | 14 | 16.0 |
| 30 days call | 18 | -12.0 |
| Fixed Deposits | 25.25 | -4.75 |
| 6 months | 25.50 | -4.50 |
| 12 months: | | |
| Up to K250,000 | 25.75 | -4.25 |
| Over K250,000 | 26 | -4.0 |
| 24 months: | | |
| Up to K500,000 | 23 | -7.0 |
| Minimum Lending Rate | 30 | 0.0 |
| BUILDING SOCIETY | | |
| Fixed Deposits (Deposits accepted between K10,000–K100,000) | | |
| 3 months | 25.25 | -4.75 |
| 6 months to 12 months | 25.50 | -4.50 |
| 13 months to 24 months | 23 | -7.00 |
| Savings Deposits | | |
| Up to K1,000 demand in any one day | 23 | -7.0 |
| Over K1,000 daily balance | | |
| Investment Deposits | | |
| Up to K1,000, 2 months notice | | |
| K1,001–K2,000, 4 months notice | 23.5 | -6.5 |
| Over K2,000, 6 months notice | | |
| Minimum Mortgage Rates | | |
| Owner-occupied over K20,000 | 23.5 | -6.5 |
| Flats and rented houses | 28.5 | -1.5 |
| Commercial properties | 32.0 | +2.0 |
| Post Office Savings Bank | 16.0 | -14.0 |
| MALAWI MUDZI FUND | | |
| Deposit interest rate | 16.0 | -14.0 |
| Lending rate | 18.5 | -11.5 |
| MALAWI UNION OF SAVINGS AND CREDIT CO-OPERATIVES | | |
| Savings deposits rate | 21.0 | -9.0 |
| Share dividend rate | 15.0 | -15.0 |
| Lending rate | 28.0 | -2.0 |
| SEDOM | | |
| Lending rate | 12 to 22 | -18 to -8 |

a) Assuming an inflation rate of 30%.
Source: Lending institutions enumerated above.

# 5. Characteristics of usual borrowers

## 5.1 Some characteristics of usual bank borrowing customers

As mentioned earlier in Chapter 4 on deposit characteristics, while data are available from branches classified by economic activity using ISIC codes, they are not further classified by size of enterprise. The classification into size of enterprise used here, namely SSE and LSE, is therefore regardless of their type of economic activity. Data on the small-scale agricultural sector (SSA), however, caused little problem. The class of 'other' essentially covers accounts held in the names of individuals and non-business organisations.

Table 9 gives some interesting data about loan/overdraft applicants and applications approved. However, the data have to be interpreted with caution, in view of the problems associated with the records of such information.

For rural branches of commercial banks, the average number of loan (here used to include overdraft) applicants per branch was higher than the number of successful applications in all three years 1990–92 for the SSE and other sectors. This is what would normally be expected; perhaps more so in rural areas because, on the usual basis of assessing creditworthiness, namely regular income to service borrowing and collateral security, proportionately fewer rural loan applicants are likely to be successful compared with urban applicants.

On the other hand, the average number of loan applicants per urban branch was, unexpectedly, consistently lower than that of loan approvals in all three years. This apparent anomaly may to some extent be explained, but not justified, as follows. Firstly, information on the number of approved/disbursed loans is readily available, while information on the number of applicants is not readily available as some loan officers may not keep records of all the applicants they handle. In this connection, it should be noted that, while a few applicants submit their applications in writing, many apply orally by visiting loan officers at the branches. What is agreed may sometimes not be recorded on the customer's information card, such as when the customer wants to overdraw his current account by a small amount and for only a few days or weeks. Some oral applications may be by telephone or by discussion with a senior loan officer/branch manager at a social occasion outside the bank. Some loan officers keep handwritten notes on their interviews with customers, but extraction of reliable information on loan applications and approvals from such records is better carried out by the writer himself than his successor. This was therefore a problem where such loan officers had been transferred during the period covered by the survey.

Secondly, a customer may borrow for a short period, say for three months, in the course of one calendar year. Whether or not some respondent branches in

**Table 9** **Commercial banks: numbers of loan overdraft applicants and applications approved/disbursed by size of enterprise sector**

Average number per respondent branch[a]

| | | *Applicants* | | | | | *Approval/disbursements* | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | *Male* | *Female* | *Total* | | | *Male* | *Female* | *Total* | | |
| *Enterprise Sector* | *Year* | | | | *(urban branch)* | *(rural branch)* | | | | *(urban branch)* | *(rural branch)* |
| SSE | 1990 | | | 6 | (7) | (1) | | | 8 | (10) | (1) |
| | 1991 | | | 7 | (9) | (1) | | | (74) | (93) | (1) |
| | 1992 | | | 20 | (25) | (1) | | | 86 | (108) | (1) |
| LSE | 1990 | | | 6 | (8) | (1) | | | 6 | (8) | (1) |
| | 1991 | | | 7 | (9) | (1) | | | 27 | (34) | (1) |
| | 1992 | | | 16 | (20) | (1) | | | 41 | (52) | (1) |
| SSA | 1990 | | | 15 | (12) | (25) | | | 30 | (33) | (20) |
| | 1991 | | | 19 | (12) | (42) | | | 55 | (60) | (36) |
| | 1992 | | | 33 | (26) | (59) | | | 51 | (51) | (52) |
| Other | 1990 | | | 61 | (21) | (208) | | | 74 | (43) | (187) |
| | 1991 | | | 77 | (24) | (272) | | | 267 | (269) | (260) |
| | 1992 | | | 117 | (62) | (321) | | | 298 | (301) | (287) |
| Total | 1990 | 68 | 91 | 91 | (52) | (235) | 83 | 16 | 119 | (94) | (209) |
| | 1991 | 85 | 12 | 115 | (60) | (316) | 321 | 78 | 423 | (457) | (297) |
| | 1992 | 109 | 19 | 190 | (138) | (382) | 329 | 84 | 476 | (513) | (341) |

a) The number of branches which gave answers making up the data in this Table varied up to 14.
*Source*: Calculated from survey data.

completing the questionnaire treated approvals of such loan applications separately, as made by one applicant, is not clear. Thirdly, lending on the current accounts of some customers is not pre-arranged on the basis of an application, but arises from the overdrawing of an account which is later reluctantly accepted by the branch management, given the standing of the customer. Or the account of customer A may be overdrawn because a cheque deposited in it is later dishonoured for lack of funds in the account of the drawer B at a different branch, while A has already drawn the equivalent amount from his account.

The above points suggest that we should not read too much into the actual figures presented in Table 9. Rather, we should try to make some broad sense from the trends and orders of magnitude depicted.

Table 9 shows that the average number of loan applicants grew for all sectors of enterprise, namely SSE, LSE, SSAs and 'other', during the years 1990–92; so too did the average number of loan approvals. The growth was proportionately highest for the SSE sector, which was an encouraging development; this was wholly accounted for by the urban branches of commercial banks. The growth of LSE loan applicants and approvals was also wholly attributable to urban branches, while LSE applicants at rural branches were negligible, as were SSE applicants. On the other hand, the numbers of SSA applicants in all three years were consistently higher at rural branches than at urban branches; so too was the case for the category of 'other' applicants.

On the basis of gender, it can be calculated from Table 9 that the overall average numbers of female loan applicants and successful ones were, respectively, as low as 15% and 24% of the males over the three-year period. Possible reasons for this are that there are fewer females in business than males. In the case of family businesses where the wife is also involved, the husband may tend to take the lead in contacting their bankers. Among salaried people, females may tend to be less self-indulgent and therefore have less urge to borrow than males.

As for the distance travelled to a bank branch by borrowers not resident within the vicinity of the branch, those in the small-scale agricultural sector covered the furthest distance, i.e. an average of 58 kilometres, followed by 'other' borrowers who covered an average of 17 kilometres, while SSEs and LSEs covered about the same distance, namely 4.3 and 4.6 kilometres respectively. It is therefore evident that transport cost is a much higher proportion of the transaction cost of the small-scale farmer than of an SSE or an LSE.

There was hardly any evidence of bank branches knowingly lending to informal financial entities. This is understandable; under the existing environment of no open recognition of informal lending activities, hardly anyone engaged in it would disclose to his formal bankers that he was borrowing for that purpose. Therefore, as stated when discussing deposit characteristics, the source of meaningful information on credit links between the formal and informal financial entities should be the latter themselves

## 5.2 Some characteristics of borrowers from SACCOs

Unlike the case of the urban branches of commercial banks, here the expected normal pattern was evident, namely, that the average number of approved loans per SACCO was lower than that of loan applications for both urban and rural SACCOs, as shown in Table 10. The overall rate of rejection of loan applicants was 3% over the three-year period 1990–92, with the sectoral rejection rates being 12% for SSE, 9% for SSAs, and the lowest rejection rate of 2% for 'other' borrowers. Interestingly, the SSA sector suffered no rejection of loan applications by urban SACCOs during the three years covered by the survey. As stated earlier, the savers in, and borrowers from, a SACCO are the members themselves.

The survey revealed that the average number of SSE borrowers per SACCO is considerably higher for urban than for rural SACCOs, and this was particularly so for the category of 'other' borrowers. On the other hand, small-scale farmers mainly borrow from rural SACCOs, as should be expected, The single largest category of borrowers is that of 'other', which essentially consists of individuals borrowing but not to finance an enterprise. As stated earlier, large-scale enterprises are not members of, and therefore do not save in or borrow from, a SACCO.

Female borrowers were only 13% of male borrowers during the three years to 1992.

when discussing deposit characteristics, the source of meaningful information on credit links between the formal and informal financial entities should be the latter themselves.

The distance travelled by borrowers to SACCO officials generally ranged from about 3 to 6 kilometres.

## 5.3 Comparative characteristics of usual borrowers

Mean numbers of loan applicants per branch by sector and by lending institution for the year 1992 are shown in Table 11. According to the data in that table, for SSEs and LSEs the mean number of loan applicants per urban branch is greater than those per rural branch. For SSAs, it is the mean numbers among rural branches that are the larger, while for 'other' borrowers, it is only at SACCOs that mean numbers of loan applicants at urban branches are greater. Variation in these mean numbers of loan applicants is significant and is due to both type of lending institution and location.

The distribution of mean numbers of loan approvals by sector and lending institution for the year 1992 is shown in Table 12. For SSEs, LSEs and SSAs, mean numbers of loan approvals at urban branches exceed those at rural branches. In contrast, for'other' borrowers, it is mean numbers of loan approvals at rural branches that are larger. Again, variation in these mean numbers of loan approvals is significant and is due to both type of lending institution and location.

**Table 10 SACCOs: numbers of loan applicants and applications approved/disbursed by size of enterprise sector**
**Average number per respondent SACCO[a]**

| *Enterprise Sector* | *Year* | *Applicants* *Male* | *Female* | *Total* | *of which: (urban branch)* | *(rural branch)* | *Approval/disbursements* *Male* | *Female* | *Total* | *of which: (urban branch)* | *(rural branch)* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| SSE | 1990 | | | 49 | (51) | (48) | | | 49 | (50) | (49) |
| | 1991 | | | 165 | (368) | (73) | | | 149 | (322) | (69) |
| | 1992 | | | 225 | (502) | (99) | | | 189 | (401) | (94) |
| LSE | 1990 | | | - | - | - | | | - | - | - |
| | 1991 | | | - | - | - | | | - | - | - |
| | 1992 | | | - | - | - | | | - | - | - |
| SSA | 1990 | | | 68 | (14) | (92) | | | 60 | (14) | (82) |
| | 1991 | | | 106 | (37) | (137) | | | 96 | (37) | (122) |
| | 1992 | | | 126 | (53) | (159) | | | 117 | (53) | (146) |
| Other | 1990 | | | 262 | (808) | (13) | | | 258 | (800) | (12) |
| | 1991 | | | 245 | (698) | (39) | | | 238 | (680) | (37) |
| | 1992 | | | 474 | (1,433) | (38) | | | 468 | (1,419) | (36) |
| Total | 1990 | 236 | 32 | 381 | (874) | (157) | 222 | 32 | 366 | (865) | (139) |
| | 1991 | 311 | 48 | 416 | 791 | 245 | 387 | 48 | 399 | (773) | (228) |
| | 1992 | 436 | 57 | 700 | (1,588) | (296) | 539 | 64 | 681 | (1,574) | (276) |

a) There were 16 respondent SACCOs, 11 rural and 5 urban.
*Source:* Calculated from survey data.

**Table 11** **Mean numbers of loan applicants by sector, 1992**

| *Borrowing Sectors* | *Loan granting Institutions* | *Mean Number of Loan Applicants* Per Urban Branch | Per Rural Branch |
|---|---|---|---|
| SSEs | Commercial Banks | 24.7 | 1.2 |
| | Development Finance Institutions | 12.0 | 11.0 (195.0)[a] |
| | SACCOs | 502.2 | 99.3 |
| LSEs | Commercial Banks | 20.4 | 0.7 |
| | Development Finance Institutions | 30.0 | - |
| SSAs | Commercial Banks Institutions | 20.4 | 0.7 |
| | Development Finance 30.0 | - | |
| Other | Commercial Banks | 61.8 | 321.0 |
| | SACCOs | 1,432.6 | 37.8 |

a) The figure in brackets refers to the Malawi Mudzi Fund.
*Source*: Calculated from survey data

**Table 12** **Mean numbers of loan approvals by sector, 1992**

| *Borrowing Sectors* | *Loan granting Institutions* | *Mean Numbers of Loan Approvals* Per Urban Branch | Per Rural Branch |
|---|---|---|---|
| SSEs | Commercial Banks | 108.7 | 1.3 |
| | Development Finance Institution[a] | - | 195.0 |
| | SACCOs | 400.6 | 94.0 |
| LSEs | Commercial Banks | 52.3 | 0.7 |
| | SACCOs | 2.0 | - |
| SSAs | Commercial Banks | 51.1 | 52.3 |
| | Development Finance Institution[a] | - | 28.0 |
| | SACCOs | 53.0 | 146.0 |
| Other | Commercial Banks | 300.0 | 287.0 |
| | SACCOs | 1,419.4 | 36.0 |

a) Malawi Mudzi Fund.
*Source:* calculated from survey data.

Variation in the mean numbers of male and female loan applicants and approvals is also significant and is due to type of lending institution and location. The relevant mean numbers are shown in Table 13.

**Table 13 Mean numbers of male and female loan applicants and approvals, 1992**

| *Laos Granting Institution* | *Mean Numbers of applicants* | | | | *Mean Numbers of Loan approvals* | | | |
|---|---|---|---|---|---|---|---|---|
| | *Male* | | *Female* | | *Male* | | *Female* | |
| | *Urban* | *Rural* | *Urban* | *Rural* | *Urban* | *Rural* | *Urban* | *Rural* |
| Commercial Banks | 46.1 | 338.0 | 161.9 | 26.7 | 334.9 | 306.0 | 100.6 | 23.3 |
| Development Finance Institution (Malawi Mudzi Fund) | - | 2.0 | - | 221.0 | - | 2.0 | - | 221.0 |
| Development Finance Institution (Sedom) | 40.0 | 15.0 | 5.0 | - | - | 10.0 | 2.0 | - |
| SACCOs | 808.4 | 267.4 | 115.8 | 30.1 | 1,180.6 | 246.6 | 140.0 | 29.4 |

*Source:* Calculated from survey data.

Variation in distances travelled by non-resident LSEs is not statistically significant, while for resident LSE borrowers it is (due to both type of lender and location). Variation in distances travelled by non-resident and resident SSEs is statistically significant and is also due to type of lender and location. For non-resident SSAs and resident and non-resident 'other' borrowers, the significance of variation in distances travelled is due to type of lender, while for resident SSAs, variation in distances travelled is significant and is due to both type of lender and location.

# 6. Loan processing and loan and overdraft characteristics

In commercial banks some loan processing and decision-making responsibilities are carried out by branches, while others are left to their head offices. The dividing line is the loan/overdraft limit up to which a branch is responsible and beyond which head office takes over in terms of decision-making or, for very high amounts, even loan processing.

For the respondent branches the average free limit was K113,857 at the time of the survey, with the average for urban branches being much higher at K143,000 than for rural branches at K7,000. Urban branches are generally bigger and cater for larger borrowers than rural branches. Typically a commercial bank branch has two free limits; a lower limit up to which the branch can lend without obtaining any collateral security from the customer; beyond this limit, unsecured lending is referred to head office for decision-making after the branch has processed the loan and made recommendations. Then there is the much higher limit up to which the branch can lend only if a customer provides collateral security; the only unsecured part of this lending may be an amount which is no more than the lower limit. Up to the higher limit all the loan processing and decision-making responsibilities are carried out by the branch. These loan limits apply to any enterprise regardless of its size measured by its number of employees, on the basis of which the questionnaire provided the four sectors, namely the SSE, LSE, SSA and 'other'. The two different free limits were not catered for in the questionnaire.

For a loan application above the higher free limit the branch processes the application, makes recommendations and refers the application to head office for decision. There is, however, a further category of loans of even much higher amounts on which not only are decisions made by head office but even the loan processing is carried out at head office by a corporate department dealing with lending to selected large corporate customers. These are yet again divided into two: those (lower amounts) approved by the General Manager and those approved by the Board of Directors.

The practice of a branch referring some processed loan applications and recommendations to head office for decision obviously reduces the speed of providing a loan to a customer; it also raises transaction costs in that head office carries out some reappraisal/re-evaluation of the detailed application prepared by the branch. However, these apparent disadvantages may be outweighed by an improvement in the quality of the relevant large loan through referring it to head office. If the decision-making responsibility on such a loan were left to the branch, it would be unrealistic to expect it to prepare an equally detailed appraisal of the application to convince itself of whether or not it should approve the loan. On the other hand, in preparing a detailed appraisal of the loan application in order to persuade head office to approve the loan, the approach to lending becomes more informed, reasoned and objective, which aspects are improved upon by the head office reappraisal. This would therefore tend to reduce the incidence of bad lending and so improve the quality of the lending portfolio. The benefits arising from this would tend to offset the additional transaction costs of referral to head office.

In the other financial institutions the review of feasibility studies, the analyses of credit for borrowers, the structuring of loans, the recommendations and decision-making are done in the following ways. At the New Building Society, headquarters staff are responsible for all these activities. At SEDOM branch and headquarters staff carry out the preparatory work and make recommendations for the appropriate decisions by the General Manager for loans below the free limit and by the Board of Directors for loans above the free limit. At the Malawi Mudzi Fund, the procedure is similar except that branch managers do all the preparatory work. And at SACCOs, local loan committees carry out all these activities.

Thus, from the point of view of the borrowing sectors (SSEs, LSEs, SSAs, and other), there is significant variation in loan processing and decision-making responsibilities due to both type of lender and location.

## 6.1 Loan and overdraft characteristics

### *6.1.1 Commercial banks*

This section looks at fluctuations in the number of loan applications and actual lending during a calendar year, average amounts lent to the enterprise sector by size, credit maturities and the setting of interest rates.

From the data gathered by the questionnaire from respondent branches it was not clear which was the typical month when the number of loan applications peaked and when it was lowest. Nonetheless, the average difference between the peak and the lowest month was 36%, with the average being 41% for urban branches and 17% for rural branches. From the comprehensive data published by the Reserve Bank of Malawi we get a good picture of fluctuations not in the number of loan applications but in the actual stock of loans and overdrafts. The stock of gross credit is lowest in the first quarter of the year, as is also the case with bank deposit liabilities, as noted earlier. The stock of credit peaks in the third quarter, again because of the same seasonality of economic activities noted when discussing deposit characteristics; in some years the peak is reached in the fourth quarter.

For the purpose of observing the growth of credit to the SSE, and other sectors, the distinction between loans and overdrafts appeared to be unimportant. After all, for several borrowers the question of whether the credit was extended through a loan or an overdraft was largely influenced by the convenience of administering the lending, including the facilitation of monitoring repayments. For example, many branches considered a loan administratively more convenient than an overdraft for salaried people because repayments could be arranged to take place on pay days by debiting their current accounts into which salaries are paid and crediting their loan accounts, or by arranging with their employers to deduct loan repayment instalments at source and remit the funds directly to the lending branch.

Because of the foregoing reasons, the yearly totals of the averages for loans and overdrafts per respondent branch in the right-hand column of Table 14 give more meaningful trends than either of the two separately. It can be worked out from this final column that during the three years to 1992 average lending per respondent branch to the SSE sector more than tripled. This growth may have been exaggerated through data inaccuracies. Nonetheless, a meaningful growth would not be wholly surprising since commercial banks have been heavily criticised for a long time for not doing much to assist SSEs and they may therefore be trying to correct the situation, as is partly evidenced by the increased interaction with SSE-development institutions such as SEDOM and DEMATT in recent years.

**Table 14 Commercial banks' lending by size of enterprise sector**

| *Enterprise Sector* | *As at end Year* | *Average amount in kwacha per respondent branch* Loans | *Overdraft* | *Total* |
|---|---|---|---|---|
| SSE | 1990 | 1,603,643 | 15,214 | 1,618,857 |
| | 1991 | 3,394,217 | 1,448,786 | 4,843,003 |
| | 1992 | 4,507,431 | 1,815,429 | 6,322,860 |
| LSE | 1990 | 5,192,857 | 6,869,836 | 12,062,693 |
| | 1991 | 10,790,349 | 12,019,450 | 22,809,799 |
| | 1992 | 12,694,140 | 14,523,929 | 26,693,343 |
| SSA | 1990 | - | 1,645,686 | - |
| | 1991 | 1,066,812 | 3,196,100 | 4,262,912 |
| | 1992 | 1,490,903 | 3,760,719 | 5,251,622 |
| Other | 1990 | 868,763 | 285,086 | 1,153,849 |
| | 1991 | 941,253 | 2,122,821 | 3,064,074 |
| | 1992 | 2,082,937 | 2,308,857 | 4,391,794 |

*Source*: Calculated from survey data.

Over the same period, average credit extended by a branch to the LSE sector more than doubled, and that extended to the category of 'other' borrowers more than trebled, while that to the SSA sector rose from 1991 to 1992 by only 23%. It is clear from Table 14 that the bulk of the credit was consistently extended to the LSE, with the proportions extended to the SSE, SSA and 'other' sectors not being very different.

As shown in Table 15, the average longest loan maturity in 1991 for the respondent branches was 24 months applied to the LSE sector, while the average shortest was 1.5 months and applied to the SSE sector. The average loan maturity for the SSE

**Table 15 Commercial banks: average loan maturities per respondent branch and by enterprise sector, in 1991**

| | *Number of Months* | | |
|---|---|---|---|
| | *Longest* | *Shortest* | *Average* |
| SSE | 5.57 | 1.50 | 3.50 |
| LSE | 24.0 | 5.79 | 6.0 |
| SSA | 15.50 | 6.29 | 8.93 |
| Other | 11.43 | 2.43 | 5.71 |

*Source*: Calculated from survey data.

sector, i.e. 3.5 months, was also the shortest compared with the averages for the other sectors. This may partly be explained by lack of data, especially cash-flow projections covering say, 6 to 12 months, on the basis of which lending of equivalent length can be based. The average loan maturity for the SSA sector, nearly 9 months, was the longest, essentially explained by the fact that seasonal credit for purchasing farm inputs is generally repaid after harvesting the crop and marketing it. It should be noted here, however, that for practical purposes the maturity distinction between medium/long-term bank credit and short-term lending is not really meaningful because an overdraft is renewed annually, as applies to most corporate customers.

Following the liberalisation of interest rates in May 1990, commercial bank head offices set minimum lending rates which are advised to their branches. Branches use their own discretion about how many percentage points to load on to the minimum lending rate. This, among other considerations, is largely influenced by the duration and the quality of relationship the customer has had with the bank/branch, the risk of a particular loan and the type of collateral security offered by the customer. As regards security, the more liquid and readily realisable the security is, for example fixed deposits held at the lending branch, the fewer the percentage points loaded on to the minimum interest rate for lending; the more difficult it is to sell and realise the security, for example, a commercial farm, the more the percentage points loaded.

### *6.1.2. Savings and Credit Co-operatives (SACCOs)*

Table 16 shows that average amounts lent per SACCO during the three years 1990–92 grew by nine times in the case of the SSE sector; this was faster than the seven-fold growth in the case of average credit to 'other' borrowers and the growth of only 15% from 1991 to 1992 in average credit to the SSA sector. The sharp growth in credit to the SSE sector indicates the increasing, though still small, role SACCOs are playing in assisting this sector whose demand for credit is far from being met; the growth in credit to the SSE sector was much faster in the case of urban than rural SACCOs.

**Table 16** **SACCO loans extended by size of enterprise sector**

| *Enterprise Sector* | *Year* | *Average amount in Kwacha per SACCO* *Total average* | *Urban average* | *Rural average* |
|---|---|---|---|---|
| SSE | 1990 | 6,128 | 5,011 | 6,6636 |
| | 1991 | 23,846 | 41,026 | 16,039 |
| | 1992 | 58,000 | 118,018 | 30,772 |
| LSE | 1990 | - | - | - |
| | 1991 | - | - | - |
| | 1992 | - | - | - |
| SSA | 1990 | - | - | - |
| | 1991 | 30,402 | 20,279 | 35,003 |
| | 1992 | 35,244 | 19,300 | 42,491 |
| Other | 1990 | 9,826 | 1,553 | 13,587 |
| | 1991 | 72,689 | 166,154 | 30,206 |
| | 1992 | 73,799 | 211,296 | 11,301 |

*Source*: Calculated from survey data.

# 7. The screening process, associated costs for screening, monitoring and contract enforcement, and repayment trends

Our survey results showed that in 1991 the average number of first-time SSE borrowers per respondent commercial bank branch was 7, compared with the average number of 74 for SSE loan/overdraft approvals shown in Table 9. Comparable numbers for the LSE sector were 8 first-time borrowers and 27 loan/overdraft approvals, and for the SSA sector 5 and 55, whereas those for 'other' borrowers were 16 and 267 respectively. Commercial bank branches normally lend to a customer who is not totally new to them. In the case of a current account holder, information about his ability to conduct such an account will usually have already been solicited by the branch from other branches of the same bank or other banks within the same area if he operated an account with any of them. And in deciding whether to lend to a customer or not, the good or bad conduct of his account, apart from other considerations, is an important factor whether or not he is a first-time borrower. That is why a customer who has just opened a deposit/current account will normally be observed for several months, on average ranging from 6 to 9 months, before his application for credit can be entertained. SACCOs also require their members to save on average from 3 to 5 months before borrowing.

It is clear from the bottom part of Table 17 that lending officers at commercial bank branches generally have other duties to perform. Thus less than half, i.e. 43.4%, of their total time was spent on loan/overdraft screening, monitoring and chasing overdue borrowing by all sectors. The largest single part of the 43.4% was spent on monitoring, i.e. nearly 23.6%, while screening took 17.6% and chasing 2.2%.

The highest proportion of the time of loan officers was devoted to borrowers in the LSE sector, followed by the category of 'other' borrowers, then borrowers in the SSA sector, and the smallest proportion was spent on borrowers in the SSE sector. Screening of a SSE loan application tends to take a shorter time than an application by an LSE. This is because the amount sought by an SSE will normally fall within the free lending limit of the branch, and there is therefore little need for rigorous appraisal by the branch to convince itself of whether or not to approve the application; also, even if a branch loan officer wishes to carry out some rigorous appraisal, he is constrained by the lack of available data on many SSEs, including cash-flow projections. On the other hand, screening a loan application of an LSE takes relatively longer, the more so when the large amounts sought are beyond the free lending limit of the branch, in which case rigorous appraisal of the application has to be prepared in order to convince head office, and this is facilitated by the usual availability of adequate data on large enterprises. Appraisal of such an application takes a few days. At the other extreme, the screening of some loan and overdraft applications takes less than an hour; this is usually the case with personal or some SSE customers who come to a branch to request the loan of a small amount

**Table 17 Commercial bank branches: average percentage of total time of loan officers spent on loan screening, monitoring and chasing overdue loans/overdrafts by enterprise sector**

| *Enterprise Sector* | | *All respondent branches* | *Urban branches* | *Rural branches* |
|---|---|---|---|---|
| SSE: | Screening | 2.06 | 2.26 | 1.33 |
| | Monitoring | 1.14 | 1.45 | - |
| | Chasing | 0.19 | 0.24 | - |
| | | 3.39 | | |
| LSE: | Screening | 3.88 | 7.03 | 1.67 |
| | Monitoring | 11.94 | 15.20 | - |
| | Chasing | 1.77 | 2.25 | - |
| | | 17.59 | | |
| SSA: | Screening | 5.61 | 5.77 | 5.00 |
| | Monitoring | 3.25 | 3.86 | 1.00 |
| | Chasing | - | 0.01 | |
| | | 8.86 | | |
| Other: | Screening | 6.01 | 3.52 | 15.13 |
| | Monitoring | 7.29 | 7.19 | 6.67 |
| | Chasing | 0.21 | 0.27 | |
| All Sectors: | | | | |
| | Screening | 17.56 | (40.5%) | |
| | Monitoring | 23.62 | (54.5%) | |
| | Chasing | 2.17 | (5.0%) | |
| Total | | 43.35 | (100.0%) | |

*Source:* Calculated from survey data.

and of short duration. The rest of the applications fall in between these two extremes of time spent on screening.

The business premises and farms of a number of borrowers are visited by loan officers in the process of screening, monitoring and even chasing overdue payments. Large farms (especially tobacco estates) of borrowing customers are regularly visited by agricultural officers of the banks who come from head offices, not the branches.

The direct costs of administering loans and overdrafts of bank branches do not seem to be large, namely, what is spent on loan officers in the form of salaries, the cost of their transport and related allowances when visiting borrowing customers, plus the cost of the stationery they use when screening and monitoring loans and overdrafts and when chasing payments which are overdue. The survey results indicated that the total administrative costs of lending to the SSE sector amounted to only 1.16% of total lending to this sector in 1991. The proportions, in ascending order, were 1.19% in the case of lending to the LSE sector, 2.04% for 'other' borrowers, and 3.74% for the SSA sector. The high proportion for the SSA is not surprising in view of the long distances that have to be travelled by loan officers, resulting in high transport costs. However, when account is taken of other costs related to lending in addition to the direct expenses on loan officers, total costs should obviously produce higher percentages of total sectoral lending than the above figures; these other costs include those incurred by a branch, both fixed and variable, such as expenditure on computers/calculators, furniture, messengers and drivers, as well as overheads and other costs incurred by the head office, especially on reappraisal of, and decision-making on, loans and overdrafts which are above the free limits of branches.

## 7.1 Loan repayment trends

The usual repayment schedule preferred by 75.8% of the financial institutions covered in this study is monthly payment of principal plus interest over the agreed period. Only 20.6% preferred bulk payment of principal plus interest. Another 2.9% used other, possibly more flexible, repayment schedules.

Delinquency in loan repayment was lowest among LSEs throughout the three-year period; the number reported was 1. It was highest among 'other' borrowers, but fairly high also among SSEs and SSAs. This trend seems to be related to ability to repay. The 'other' category consists of households and non-business organisations that are least able to repay loans. It is this same category that had the highest number of outstanding debts at the end of 1991. As of December 1991, the number of borrowers with debts outstanding from 1989 was lower than those for 1990 and 1991 debts, implying that most of the outstanding debts get paid eventually, usually after 12 months. Indeed, loans and interest still outstanding in 1991 were low in comparison with the total sums that had been lent.

Field data indicate that for commercial banks default in repayment is highest among 'other' borrowers, followed by SSEs. By December 1991, 19% of 'other' borrowers and 16% of SSEs had failed to repay their loans. Among the other categories of borrowers, default rates were much lower, 2% among LSEs and 5% among SSAs.

At other formal financial institutions delinquency and default are not serious problems. The New Building Society reported an overall default rate of only 2%. Indebank reported none, while LFC stated that it had some problems, but that they were not serious.

Semi-formal financial institutions are also divided among those that have no problems, such as INDEFUND and the MMF, and those that have high default rates like SEDOM and MUSCCO (22%).

In enforcing repayment, a variety of methods are available to lending institutions. Comparatively less use was made of law suits which are costly, foreclosure of collateral security, legal threats and input control. More use was made of management assistance to improve the performance of the borrowing enterprises and hence their ability to repay the loans.

With regard to the most frequent cause of delinquency in loan repayments, poor returns were cited by all the lending institutions, especially in relation to SSEs and SSAs. Many lenders also stated that borrowers were not committed to repaying their loans, while a few attributed delinquency to other more pressing needs of their borrowing customers. Poor returns were in turn attributed to an unstable economic environment and poor business management.

# 8. Links between the formal, informal and semi-formal financial sectors

Drawing on the information gathered through headquarters' interviews, this section reviews the direct deposit and credit links between the formal financial sector and both the informal and the semi-formal financial sectors.

As was concluded in the paper on the informal financial sector and as has been stated in earlier sections of this paper, direct deposit links between the formal and the informal financial sectors are significant, while direct credit links are not. Security is the most important motive among informal financial sector units for depositing funds with formal financial institutions, particularly commercial banks. Commercial bank managers do grant loans to informal lenders and other SSEs under their free limits. In general, however, they have only a limited involvement with informal lenders and other SSEs. The banks' standard conditions for granting credit are such as to put them beyond the effective reach of most informal lenders (the provision of collateral, demonstration of track record, preparation of business plans, understanding and acceptance of modern banking practices, etc). Furthermore, banks consider informal lenders to be entrepreneurs who are in general not trustworthy and whose businesses suffer from high failure rates. They also perceive that lending to informal lenders is not remunerative because of the relatively high transaction costs. This perception is wrong. This study has shown that lending by banks to informal lenders and other SSEs costs relatively less than lending by informal financial sector entities.

Nevertheless, banks prefer involvement in this sector to take the form of 'community affairs', whereby they will on-lend/grant funds accompanied by appropriate guarantees or will assist another organisation targeted at this sector - such as SEDOM. The latter activity may be through funding, provision of management support, secondment, etc.

Within the formal financial sector, it is normal banking practice for the balances of commercial banks to be held at other commercial banks. Other institutions in the formal sector, such as the Leasing and Finance Company or the New Building Society, maintain deposits at commercial banks in order to earn interest on their excess liquidity or because they may not have safe deposit facilities themselves. An interbank credit market among commercial banks has been established. This market is used when there is need for additional funds. The direct credit links of commercial banks with other formal sector financial institutions seem to be far less than direct deposit links. For the Post Office Savings Bank and the New Building Society borrowing from commercial banks would be unremunerative as they would lend the funds on at rates lower than those at which they borrowed. The Leasing and Finance Company, on the other hand, which lends at a higher interest rate, could borrow profitably from commercial banks.

Similarly, the deposit links of semi-formal financial institutions with the formal financial sector are more significant than their credit links. MUSSCO reported depositing funds with the LFC. The Malawi Mudzi Fund reported depositing money with the CBM, the NBM and the New Building Society. INDEFUND and SEDOM deposit with commercial banks. The MMF, SEDOM and INDEFUND do not have safe deposit facilities. MUSCCO has, but depositing money at the LFC enables it to earn a considerable income in interest on its idle balances.

As regards credit from formal financial institutions, SEDOM and the MMF are currently not mandated to borrow resources. Nor is MUSCCO. But, even if they had the mandate to borrow, they would not do so, as the rate at which they lend money is less than the cost of borrowing from the commercial banks and other formal financial institutions. Only INDEFUND has the mandate to borrow and it can lend at an interest rate that exceeds what it would pay on funds borrowed from the commercial banks.

As stated earlier, existing links are stronger by way of informal financial institutions depositing funds with formal financial institutions than by way of a credit flow from the formal to the informal. The deposits are made largely for safe keeping; otherwise, on the basis of the rate of return, there is no incentive for making the deposits in the case of those informal financial institutions, namely moneylenders and SCAs, which lend at much higher interest rates than the deposit rates at formal financial institutions. It seems, therefore, that there is not much that can be done to promote the deposit linkage between informal financial institutions such as moneylenders and SCAs, on the one hand, and formal financial institutions on the other.

The linkage that does have great potential is the currently negligible credit flow from the formal to the informal institutions, because the interest-rates charged are lower than those at which moneylenders and SCAs lend to their clientele. Apart from interest-rate differentials, there is a need for the informal sector to tap loanable funds from the formal sector when the latter has excess liquidity, as was the case during the greater part of the 1980s especially for the commercial banks. Given the negative perceptions formal financial institutions have about informal financial institutions, the flow of credit from the formal to the informal sector may continue to be negligible without government/central bank intervention. Official intervention could take the form of moral suasion, including emphasising the fact that it would not be as costly to lend to informal financial entities as appears to be generally perceived by formal financial entities. As has been shown elsewhere in this paper, the administrative cost of commercial bank lending to the SSE sector in 1991 was proportionately smaller than to the LSE sector, and the SSE sector is akin to the informal financial sector. The transaction costs of lending and the risk involved could be minimised by means of lending larger funds to a group of informal financial entities – agents who would jointly guarantee the credit.

The alternative of the central bank guaranteeing the formal financial institutions' credit to informal financial institutions could also be explored. In the case of the central bank not being convinced of the need to strengthen the link between the formal and informal financial sectors and the advisability of exercising its moral suasion on the formal financial sector to extend sizeable amounts of credit to the informal financial sector and, where need arises, even to guarantee such credit, the central bank itself would have to be subjected to moral suasion by the IMF and/or the World Bank.

The need to increase the volume of loanable funds in the informal financial sector could partly be met by some non-governmental organisation. These would be NGOs one of whose objectives is the promotion of income generating activities amongst their target groups by means of, *inter alia*, extending loans. NGOs could grant loans to SCAs and Community Funds, for example, for on-lending to their members, the advantage being that these informal financial institutions are likely to be better able to screen loan applicants amongst their members, monitor the loans and enforce loan repayments than the NGOs which are likely to have relatively less knowledge of such applicants.

At the moment our knowledge of NGOs' actual involvement in finance is scanty. They do keep deposits at banks and sometimes borrow from banks for short periods pending the receipt of funds from their sponsors, who are usually abroad.

A question can be raised as to whether the informal financial sector should be regulated in the same way as the semi-formal/formal financial sector and how. For example, in relation to SCAs and CSAs in the informal financial sector, it can be argued that, since their objective is the promotion of the economic/financial interests of their members, which is also the objective of co-operative societies, SCAs and CSAs should therefore also be subjected to the Co-operative Societies Act (Cap 47.02). However, the major argument against this is that turning SCAs and CSAs or other informal financial institutions into legal entities may reduce their efficiency in meeting their objectives. The speed and flexibility of their activities, facilitated by the very informal nature of their operations, may be reduced through the formal rules and regulations (on membership and other aspects) that they would have to follow, as well as the additional volume of internal documentation and correspondence with the relevant government department or agent. It would also be costly to operate because of the additional paper work and the payment of registration fees (Chipeta and Mkandawire, 1991).

It is not necessary to emphasise that the informal financial institutions derive their strength from the very unregulated informal nature of their operations; in fact, some of them were created because their founding members were unable to borrow from the officially regulated formal financial institutions. This is not to imply that informal financial entities do not have rules: they do have a simple code of rules for conducting their transactions, and some of them even have office bearers. But they do not suffer from delays in decision-making and other problems associated with bureaucracy. Subjecting them to regulation by government or its agent would bring in bureaucratic layers of reporting. Effective regulation would call for some form of periodic reporting on their activities, which is most likely to be unwelcome to the informal financial entitles, given the secrecy with which many of their operations, especially those of moneylenders, are conducted, and the additional costly paper work that would be involved.

When, for convincing reasons, formal financial sectors themselves are being liberalised in many countries, one wonders if there would be any real justification for trying to subject the informal financial sector to official regulation rather than letting it continue to operate under free market forces and meet its clientele's demand for financial services – a demand which the formal financial sector has been, and may continue to be, unable to meet in the required amounts for the required purposes and especially at the required (sometimes odd) times and places.

Maybe the most that the government could do is to ensure that the law clearly recognises the existence of informal financial institutions so as to create an enabling legal environment for them to operate freely without fear. But what should be avoided are official regulations, e.g. official registration and fees, periodic reports, etc. At present, the law seems neither to encourage nor to discourage the existence of informal financial institutions. Nonetheless, the existence of informal moneylending activities is acknowledged through the Loans Recovery Act (Cap. 6:04), whose aim is to limit the hardship inflicted on borrowers by high interest rates. Court action can be initiated by the lender or the borrower. The approach is, understandably, moral rather than economic. In the economic sense one would expect the borrower to have made a rational decision in borrowing from a given source, at least in terms of alternative sources of credit accessible to him and his capacity to repay the capital and to pay interest charges at the agreed rate, however high that might be. The Loan Recovery Act does not specify the types of moneylenders: they could be individual people, traders or SCAs.

# 9. Summary and conclusions

To conclude, the following points are worth noting. Firstly, the modern financial sector in Malawi is segmented into a formal sector that mainly serves large-scale business enterprises and a semi-formal sector whose target group is the small- and medium-scale business sector. The financial units within each sector are also segmented. Indebank Financial Services Ltd, a commercial bank, accepts deposits and grants credit only to the corporate sector. The NBM and the CBM have a more diversified deposit clientele, but, their lending is largely short-term to large-scale business enterprises. The Post Office Savings Bank mobilises deposits from small-scale savers, but, until recently, has lent money only to the central government. Then there are specialised formal financial institutions like the three leasing finance companies and the New Building Society. In the semi-formal financial sector, INDEFUND and SEDOM do not mobilise deposits; MUSCCO and the MMF do, but only from their members who are also the borrowers. The target borrowers for the MMF are the poor, for SEDOM they are small-scale enterprises and for INDEFUND medium-scale enterprises.

Secondly, the modern financial sector in Malawi is also fragmented. The formal financial sector acts as a depository of funds from the semi-formal financial sector, but not a source of credit to it. Within the formal financial sector, commercial banks act as a depository of funds for other formal financial institutions, but not a source of credit to them. And within the semi-formal financial sector, there are neither deposit nor credit links among the different institutions.

Between the formal financial sector and the semi-formal financial sector, what we have is, in fact, financial dualism, or extreme fragmentation into two sectors that have different relative prices and barriers to flows between them. Inadequate substitutability between these segments means that fragmented and dualistic financial markets are unlikely to function effectively in intermediating between savers and investors, in allocating financial resources, and in transforming and distributing risks and maturities.

Financial repression and structural and institutional factors explain the fragmentation and segmentation of the modern financial sector in Malawi. Prior to the 1990s, controls on financial transactions were in place. Until 1988, there were maximum ceilings on interest rates. Lending rates for credit to tobacco and maize estates were subsidised. Until 1990 all deposit and lending rates were controlled. And, until 1991, there were ceilings on the expansion of bank credit. The effect of direct credit allocation and interest-rate controls was to raise demand for funds and depress supply below equilibrium levels. Unsatisfied demand for funds forced financial intermediaries to ration credit by means other than interest rates. It also led to the establishment by government and the private sector of semi-formal financial institutions to cater for sectors that were unable to obtain credit from the commercial banks.

Financial liberalisation would be expected to lead to equalisation of interest rates and hence the merging of the formal and semi-formal financial markets. In practice, this has not happened, except with respect to INDEFUND, a privately-owned semi-formal financial institution. Interest rates at MMF, MUSCCO and SEDOM are still subject to control. Although they have been increased since liberalisation, they are still below the lending rates at the commercial banks. If these institutions were to borrow from the commercial banks, the funds would have to be lent out at a loss. Further interest-rate liberalisation, and not continued interest-rate subsidisation, is required here.

One desirable outcome of the financial liberalisation has been the equalisation of the Bank Rate and the savings deposit rate. This means that commercial banks are now encouraged to borrow from the central bank. Before, the liberalisation the Bank Rate was higher, so it encouraged commercial banks to mobilise their own funds rather than to borrow from the central bank.

Another desirable outcome has been the rapid growth in the number of depositors and in the size of deposits, as well as the rapid expansion in the number of loan applicants and approvals. Particularly interesting is the rapid growth in the number of SSE and SSA borrowers.

From the standpoint of promoting financial intermediation, one adverse consequence of interest-rate liberalisation has been the abolition by the commercial banks of certain medium-term time deposit instruments: time deposits with maturities of 13 to 23 months and time deposits of over 24 months (since 1987). A related development has been the lowering of interest rates on time deposits of 24 months. The reason for this is that, in a liberalised interest-rate environment where changes can be frequent, the commercial banks do not want to bind themselves contractually to a large amount of medium-term deposits at high rates of interest. Should interest-rates fall subsequently, average interest rate margins may decline. With this adverse possibility, one can understand why commercial banks have responded in this way. But in relation to the need to encourage the growth of medium-term deposits on the basis of which banks can extend medium-term credit, this development is not welcome, especially given that there is insufficient long-term liquidity in the financial market.

Since there are no ceilings on interest rates, the commercial banks can charge high rates of interest on longer-term credit to offset the higher rates of interest paid on medium-term time deposits. Worthwhile long-term projects are there for financing. The problem is that the commercial banks are more interested in financing short-term projects.

Abolishing certain medium-term deposits and lowering interest rates on others may also be considered to be a method of reducing the cost of funds. To the extent that a number of non-bank financial institutions are offering attractive medium-term deposit instruments, the action of the commercial banks may be putting them at a competitive disadvantage in resource mobilisation.

With respect to the structural origins of segmentation and fragmentation, it must be noted that different formal and semi-formal units have different transaction costs. The transaction costs of the commercial banks are lowest for SSE and LSE borrowers and highest for SSA and 'other' borrowers. For SEDOM which lends to SSEs, it cost K0.67 to lend every K1.00 in the mid-1980s. And for INDEFUND, which lends to medium-scale enterprise (MSEs), the comparable cost was K0.44.

Several institutional causes are also at work. Commercial banks in Malawi were established primarily to serve the working capital needs of import-export trade, and they are essentially oligopolistic. As the structure of the economy has changed over time, they have found it necessary to extend credit to agriculture and manufacturing. It must be noted, however, that the large amount of credit extended to indigenous tobacco estates was forced upon them by the authorities in the 1970s. Their interest in lending to other indigenous sectors, though growing, is limited.

Among other institutional factors accounting for the fragmentation are lack of suitable collateral among SSEs and SSAs and lack of adequate discretion among bank branch managers to lend money. In order to encourage banks to lend to SSEs and SSAs, changes in the legal system may be required to facilitate the development of legal collateral substitutes acceptable to banks and regulators. In addition, more decentralisation of decisions, monitoring and enforcement by banks may be required to make branches more active in lending to a wider range of clients.

For financial integration to increase in Malawi, more competition is also required in the banking system. In turn, this requires that more firms should be licensed to operate banking businesses. Increased competition should cause banks to compete for customers, resulting in financial widening. One commercial bank has agreed to on-lend to SMEs, including informal financial institutions, resources to be made available to it by the UNDP under a poverty reduction programme. Depending on the success of this experiment, the commercial bank concerned may in future lend its own resources to this target group.

In order to foster the integration of the financial sector in Malawi, two other constraints will need to be addressed. First, there is the question of whether the country should continue to establish formal and semi-formal financial institutions that serve particular niches of the market, specialising in a narrow range of financial products. Integration would certainly be better served if modern financial institutions were more diversified in terms of clientele and financial services. Secondly, there is the question of the underdeveloped financial market lacking specialised institutions like discount and acceptance houses and a stock exchange. The establishment of discount houses would provide a mechanism for increasing linkages in the formal financial sector and for increasing competition, while the establishment of a stock exchange and acceptance houses would improve the range of financial products available in the market.

In the semi-formal financial sector, the number of institutions is larger. But there is a need to consolidate some of their activities, to improve the operational efficiency of SEDOM, to liberalise interest rates fully, to encourage those that are not doing so to take deposits from any SME, to include informal financial institutions among their target borrowers, and to reduce the minimum sum that can be lent out.

At present several institutions in the semi-formal sector are controlled in relation to interest rates and credit allocation and only the Malawi Mudzi Fund and SACCOs mobilise deposits. Interest-rate liberalisation of this sector may thus enable it to meet excess demand for financial services. Apart from seeking short-term funds, semi-formal financial institutions may need to mobilise term funds and apply the low transaction cost methods of the informal sector to expand lending. The access of semi-formal sector institutions to formal credit is also limited. Improved access to formal credit may enable them to expand their lending operations.

The varying degrees of secrecy with which typical informal financial entities prefer to conduct their transactions is a major factor explaining the persistence of fragmentation not only within the informal sector itself but also between it and the formal and semi-formal financial sectors. Because of this, there may well be more of the informal financial entities who are bank customers than the small numbers known to the banks. Lack of official recognition of the informed financial entities also appears to contribute to the persistence of fragmentation in that these entities are hardly able to transact with banks openly in the name of informal lenders.

The fragmentation between the informal and formal sectors is more pronounced on the lending than on the deposit liabilities side of the banks. In other words, the indications are that the flow of resources from the informal financial sector to the banks is more than the reserve flow. Policy efforts aimed at promoting integration of the two sectors would therefore have to pay greater attention to promoting the expansion of bank credit to informal financial entities.

We have seen that the direct costs of administering bank branch lending to SSEs does not appear prohibitive; the cost per kwacha lent to an SSE is even lower than to an LSE. The relatively low levels of bank credit to SSEs may therefore be explained by other factors, including bank perceptions of lending to SSEs as being quite risky.

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