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FINANCIAL LINKAGE AND DEVELOPMENT IN SUB-SAHARAN AFRICA: THE INFORMAL FINANCIAL SECTOR IN NIGERIA

Adedoyin Soyibo

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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 *Nigerian* case study, reporting the results of the field work on the behavioural characteristics of *informal* financial organisations/agents and the operational constraints in urban and rural areas.

Machiko Nissanke
(Project Coordinator)

May 1995

Contents

Tables

Figures

1. Introduction

1.1 The problem in context

The importance of credit in the transformation of developing countries, as regards the rural areas, is beyond doubt. Accordingly, a number of policy interventions aimed at ensuring the easy access to credit of rural dwellers, farmers and small-scale industries have been attempted in developing countries. For example, in Nigeria a multiplicity of formal institutional arrangements have been put in place to ensure such access for farmers and agro-allied and small-scale industries. Among these are the operations of the Nigerian Agricultural and Co-operative Bank and the Agricultural Credit Guarantee Scheme operated by the Central Bank of Nigeria (CBN); setting up by the state governments of parastatals charged with providing subsidised credit to farmers; directions to banks to allocate a percentage of their loan portfolios to farmers at concessionary rates; the promotion of rural banking with the CBN directing commercial banks to open branches in rural areas and to lend a given proportion of the deposits mobilised within these areas; and recently, the operations of the Community Banks and the People's Bank whose lending activities are directed in the main to the lower-income groups. Yet the access to credit of rural dwellers, in particular small-scale farmers and agro-allied industries, has not improved.

Most of the credit agencies have had to face several operational problems, including gross inadequacies in staffing organisation and management and poor performance in loan recovery (Olomola, 1992). Yet, within the same environment rural credit obtained from informal sources has performed much better, in particular exhibiting a very low loan default rate. Hoff and Stiglitz (1990) ascribed the rather disappointing performance of formal interventions for providing cheap rural credit to an inadequate understanding of the workings of rural credit markets.

This study investigates the workings of the informal financial sector in Nigeria. It analyses the structural and institutional constraints militating against the integration of the various sub-units of the informal financial sector on the one hand, and with those of the formal sector on the other. New theories about rural credit markets indicate that all lenders are confronted with problems arising from information asymmetries, because they are unable to ascertain *a priori* who among the borrowers have a high probability of default. Moreover, as loan disbursement and repayment occur at different periods, the conditions assumed before repayment begins, may fail to obtain. This is the so-called imperfect information paradigm (Hoff and Stiglitz, 1990) which, as a result of differences in costs and transactions characteristics, often leads to specialisation within the market.

1.2 Immediate objective of the study

In general terms, this study aims to provide a better understanding of the workings of the informal financial market in Nigeria, i.e. its operational characteristics and how it differs from the formal financial sector. Specifically it seeks to provide information (via the rural–urban dichotomy) relating to:

(i) the types of institutions in the sector;
(ii) the extent of their savings mobilisation and financial intermediation activities;
(iii) the practices adopted in savings mobilisation and lending;
(iv) the costs characteristics of their savings and lending activities;
(v) how these costs are translated into prices;
(vi) the impact that practices and their associated costs have on product quantity and quality; and
(vii) the differences between the practices, costs and products of the sector and those of the formal financial sector.

1.3 Hypotheses

The study is designed to test a number of hypotheses focusing on:

(a) the origins of segmentation;
(b) why interest rates do not clear markets;
(c) the persistence of fragmentation between segments;
(d) the persistence of fragmentation among informal units; and
(e) how integration might be improved.

These hypotheses are classified, where appropriate, into their policy-based, structural and institutional aspects.

It can be postulated that the origins of segmentation in the financial markets are found in financially repressive policies which lead to informal/semi-formal financial institutions mobilising savings and providing credit for those who are denied access to the formal financial institutions. In terms of the policy-based aspects of this hypothesis, under a repressive financial regime interest rates will diverge from those of the formal system and will converge only when the regime is liberalised. In terms of the structural origins, we postulate that different approaches to, and practices in, screening loan applications, and in monitoring and enforcing of contracts should result in different transactions costs.

To explain why fragmentation persists, we argue that funds fail to flow from formal to informal segments because lack of information, high perception of risk and high transaction costs deter banks from expanding their lending activities to include small borrowers and informal units. It is important, therefore, to identify the type of information used by informal lenders to ascertain their perception of risk and to measure their transaction costs with a view to establishing how they compare with those of the formal sector.

It is also postulated that informal units remain fragmented because each of them is limited by the scope of its direct contacts, the short-term nature of its transactions, and the limited information it has about markets. Informal units cannot lend more than they can mobilise (if they do, for a short term only and as a surplus from another activity).

To improve financial integration, therefore, informal units need to have better access to formal credit in order to enable them to expand their transactions. Semi-formal units may apply low transactions-costs methods to term funds to expand their lending.

2. Methodology

2. 1 The data

The data for this study were generated using a comprehensive questionnaire comprising 13 sections. The information sought by the questionnaire includes the following:

- The deposit characteristics of the various informal financial institutions, or the capital base of the agents for the period 1990–92. The section examines the liabilities or the capital base of informal lenders/associations and how these are generated.

- The characteristics of lending operations in order to provide insight into the origins of the lending undertaken by the various informal financial institutions studied and how they developed.

- The characteristics of the usual borrowers in order to provide information on their background and gender and the numbers of loan applicants.

- The lending to small-scale and micro enterprises in order to generate information on how informal financial institutions relate to this important but often neglected sector of the economy.

- The characteristics of loans, their maturities, and other conditions from which can be generated a comprehensive data set on loan sizes, maturities, collateral, interest rates, and lending capacity.

In general, the data generated covered a three-year period with a view to providing some insight into possible changes in the process resulting from the effects of financial liberalisation. To establish the validity or otherwise of the hypothesis that a major constraint to the development of effective linkages among financial sectors is the widely varying information base and transaction costs, the questionnaire sought relevant information to measure the various costs and to assess the screening, monitoring and contract enforcement procedures. For each aspect of the loan transaction process, the study establishes the information used, assesses its adequacy and establishes how the information was obtained. It then proceeds to estimate the administrative cost component of the process using estimated personnel transport and stationery costs – and disaggregates them, by borrower categories, to discover the proportion of the unit loan amount expended as administrative overheads. Such proportions, compared over several informal financial institutions, can provide insight about their relative 'cost efficiency'.

2.2 The sampling approach

Because of inadequate knowledge about informal financial sector operators, it was difficult to obtain a *purely* scientific sampling frame for the study. In order to obtain a representative sample, it is necessary to reflect the population's diverse ethno–cultural, religious and demographic characteristics in the sample to be studied. The study therefore adopted a multi-stage sampling procedure. The first stage was to select three pre-determined zones of the country – Southwest, Middle Belt and *Core* or *Far North*. This was a deliberate sampling process, intended to reflect the diverse ethno–cultural and regional backgrounds of the respondents.

The Southwest Zone, consisting of Lagos, Oyo, Ogun, Ondo, Osun, Edo and Delta States, is the most cosmopolitan of all the Nigerian zones. Native to this zone are Yorubas, Edos, Urhobos, Itsekiris, Delta-Igbos and other small ethnic groups. In addition, the fact that Nigeria's melting pot, Lagos, is in the zone ensured that other ethnic groups could be adequately represented in the sample. The Southwest also ensures religious balance because there is a sizeable representation of different religious groups in this zone. The cultural traits of smaller ethnic groups in the south were expected to be captured by the inclusion of Edo and Delta States in the zone.

The Middle Belt consists of states like Kwara, Kogi, Benue, Plateau States of Nigeria. Indigenous to these states are minority ethnic groups like Ebiras, Tivs, Igalas and Idomas, among others. Farming is the main occupation. The choice of the zone was expected to bring to the fore the ethno–cultural traits of Northern minorities in the operation of informal finance, if there were any.

The *Core* or *Far North* consists of such states as Kano, Katsina, Sokoto, Jigawa, Yobe, etc. This zone was chosen to reflect the cultural traits of the Hausa/Fulani and the religious impact of Islam on the operation of informal finance.

From these three zones, nine States were selected – Lagos, Oyo, Ogun, Edo, Kwara, Kogi, Kano, Ondo, Kaduna. These coincided with the states of origin or residence of the interviewers employed. It was hoped that their knowledge of the areas and their familiarity with the mores of the different peoples would facilitate identification of informal financial operators and improve access to credible data.

The second stage of the sampling process involved the selection of towns/villages, ensuring an approximate balance between urban and rural areas, apart from the case of Lagos State. The third stage involved the selection of financial operators from the selected town/village. To identify known operators, interviewers visited notable individuals in the communities studied who helped in arranging a link. A total of 81 questionnaires were sent out, 64 of which were found usable, giving a response rate of 79%.

The questionnaires found usable were distributed as follows:

Moneylenders	20
Savings and Loans Companies	3
Savings and Credit Associations	12
Savings and Credit Cooperatives	10
Credit Unions	4
Esusu Collectors	15
Urban-based respondents	45
Rural-based respondents	19

2.3 Method of analysis

The data analysis is basically descriptive, using frequency distributions, proportions and means to make judgements about the characteristics of the different operators in the informal financial sector. The relationships between the types of unit in the informal financial sector, the location of the units and other relevant variables were also established using cross-tabulations.

3. Review of the relevant literature

3.1 Informal finance in Nigeria

The literature on informal finance has grown over the years. In early days it was dominated by the contributions of historians and anthropologists. Later agricultural economists featured prominently, particularly in relation to assessing its impact on the financing of agricultural activities. However, little appears to have been done in relation to analysing the economic performance of the sub-sector and the extent to which it complements or competes with the formal sector. Moreover, there has been hardly any systematic study of the impact of the informal sub-sector on the income-earning and investment-inducing capacities of individuals, households and businesses.

Perhaps the first notable book to discuss informal finance in Nigeria was that by Johnson (1921), who highlighted the character and *modus operandi* of *esusu* (see below) among the Yorubas of southwestern Nigeria. Among other earlier writers who focused mainly on *esusu* and to some extent other forms of informal finance in Nigeria are Ajisafe (1924), Nadel (1942), Bascom (1952), Amago (1957), Ogunyemi (1967) and Adegboye (1969).

The growing literature on informal finance in Nigeria was enriched in the 1970s by the contributions of Odubanjo (1970), Onyemelukwe (1970), Ugoh (1973) and Okorie and Miller (1976), among others. More recent contributions include those of Abasiekong (1981), Adekunle (1985), Ajayi (1986), Akinwumi (1988), Ajayi (1988), Akinwumi (1990), Nwoko and Ajayi (1990), Akinoye (1990), Udry (1990) and Olomola (1992). The latter two contributions, Udry (1990) and Olomola (1992), apply the concepts of the imperfect information paradigm, (i.e. the issues of moral hazard and adverse selection in rural credit) to the study of informal finance in Nigeria, and attempt to bring to the notice of policy-makers and scholars alike those characteristics of informal finance that can be exploited by formal financial institutions in order to improve their performance, particularly in relation to minimising the risk of default.

Informal finance in Nigeria, particularly in the rural areas, is of two main types: *cash* and *kind*. The literature appears to have focused more on the *in-cash* variety. A common characteristic of the two types of informal finance is that they attempt to make pooled resources available for individual use. The *in-kind* type of informal finance which often involves pooling of labour, is used in agricultural projects such as land clearing, planting, harvesting and so on, or for building a new village meeting place, for example. Among the Yorubas, there are two types of this labour-pooling approach. The *aaro* pools the labour of two or more people, usually friends or members of the same age-group to work, often on a farm, for a given period. This has to be 'repaid' to other members of the pool on a rotating basis, for the same length of time. The member on whose farm the pool works *may* provide food and other refreshment on the days when the group works on his farm. Whatever is provided is expected to be 'repaid' as other members benefit from the work of the pool.

The other type of *in-kind* informal finance among Yorubas involving pooling of labour is called the *owe* and involves more people than the *aaro*. It can be employed in agricultural projects like land clearing, planting and harvesting. Whoever wants to use this type of labour-pooling technique will set aside a day or two for the purpose and invite as many people as possible in the village or other adjoining settlements to take part. On the appointed day, the invitees would meet on the farm to do the required work for as long as it takes to finish. The host usually provides them with food and drink. Cash compensation is not used at all. Of course, courtesy demands that if the host is invited to any other *owe*, having benefited previously, he is obliged to attend.

In the savannah belt of Nigeria, in particular among the Hausa/Fulani, the use of animal-power credit is another type of *in-kind* informal finance. The adoption of animal traction in farming, though known for a long time in the Northern parts of Nigeria, has remained low partly because of many farmers' lack of finance to acquire the draught animals and associated tools or to hire them for use on their farms (Olomola, 1992). Because of lack of cash, farmers in need of the services of draught animals often approach their owners and negotiate the release of these animals for use on their farms on a credit basis. When the charge for the particular operation (ridging or weeding) is agreed, the days on which the operation is to be carried out are also fixed. The farmer then makes a pledge as to the time and form of payment for such services. Loan repayment is usually also in kind. It is done either by deploying family labour to work on the lender's farm or by selling farm products to the lender equivalent the loan amount as agreed by both parties. This type of in-kind informal finance is an example of credit-product market interlinkage, which Olomola (1992) has cited as one way of minimising the problem of information asymmetry between lender and borrower.

The most common type of informal finance in Nigeria involving the transfer of cash is the *esusu*. Among the Yorubas, it is also known as *ajo*, and by various other names among other Nigerian ethnic groups; among the Igbos, *isusu* or *otutu*, and the Edos as *osusu*, among the Hausas as *Adashi*, among the Nupes, as *dashi*, among the Ibibios as *efe* and among the Kalabari Ijaws as *oku* (Okorie and Miller, 1976). The operation of the *esusu* in Nigeria will be discussed in detail later in this section.

Moneylenders are another important group of informal finance operators that have existed in Nigeria for a long time. The belief that moneylenders extract economic surplus provided by peasant labour, capital and possibly land (Von Pischke, 1991) holds also in Nigeria. It is not uncommon for farmers to pledge their economic trees such as cocoa, kolanut, rubber, and oil palm, and even their entire farms as collateral for money borrowed from moneylenders (Adegboye, 1969, 1983; Abasiekong, 1981). In days gone by, children were also pledged as collateral and would live and work with the moneylender until such time as the loan had been repaid in full. These are examples of usufruct loans in which a lender occupies and uses a borrower's economic resources such as land until the principal has been paid (Hoff and Stiglitz, 1990).

The belief that moneylenders are highly exploitative and the fact that *esusu* collectors are also limited, unorganised and unco-ordinated in their operations, provided the rationale for the development of semi-formal organisations like savings and loans companies, savings and credit associations, savings and credit co-operatives and credit unions. Many of these organisations are registered under one type of legislation or another. However, financial intermediation is not their only, or their major, function. Other functions may include retail trading, farming, and subsidising members use of organisational resources. Mobilisation of deposits and lending are carried out to varying degrees by these organisations, depending on who their promoters and what their business objectives are.

The organisation and operation of *esusu* or *ajo* can be classified according to the individuals around whom they are organised, in other words the types of the main operating agents of which there are two: individuals and groups. Individual *esusu* collectors can also be classified by their mode of deposit mobilisation: daily or periodic. Periodic mobilisation of deposits is more common in rural areas, where individual clients take their deposits to the houses of *esusu* collectors weekly, fortnightly or monthly. However, daily collection of deposits is more common in urban centres among traders, and artisans like mechanics, plumbers and other tradesmen. The collector moves from one client to another, by bicycle or motorcycle; some more established collectors sometimes use cars. Clients of individual collectors tend to be more common in marketplaces and shopping centres. The usual period of deposit before withdrawal is allowed is a month in the case of daily collectors, while for periodic collectors it can be up to a year or more. Rather than pay depositors interest on their deposits, individual *esusu* collectors collect the last period's (or day's) deposit as commission. Thus, for 26 daily deposits in a month, the depositor will be entitled to withdraw at the end of the month the value of 25 daily deposits. The amount deposited by each client with the individual collector varies, depending on the financial capacity of the depositor.

In terms of rules and regulations and operational practice, *esusu* clubs can be classified into two: those with written rules and regulations as well as bye-laws, which can be termed organised esusu associations, and those that have no written rules and regulations, but operate solely on the basis of trust, which can be termed *esusu* associations. The general practice is that members of *esusu* clubs contribute a fixed amount periodically and all or part of the accumulated funds are allocated to one or several members in rotation, until all members have been covered. *Esusu* clubs are also known in the literature as Rotating Savings and Credit Associations (ROSCAs). Of course, all *esusu* clubs collect their deposits at fixed centres. Figure 1 depicts schematically the organisation and operation of *esusu* or *ajo* in Nigeria.

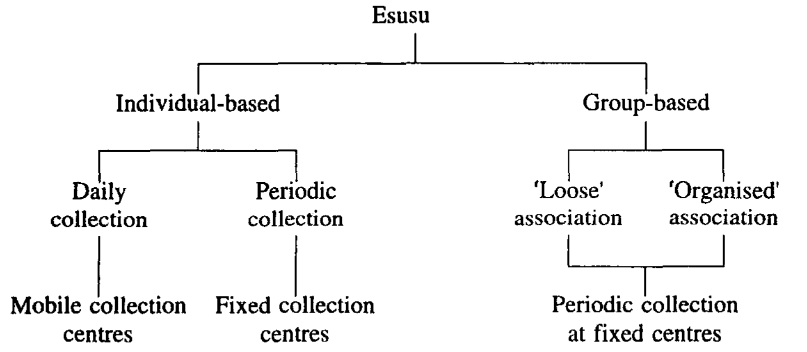
Savings and Credit Associations and Credit Unions operate in a more formalised way than *esusu* clubs. They are much closer to variants of the formal financial system. Savings and Credit Associations may or may not be registered under legislation; savings and credit co-operatives are always registered under the Co-operative Association Act. In fact, credit societies often come together to form larger units called unions, and modify their operations to include subscriptions of share capital, deposit-taking and lending operations. Credit unions are well known as precursors of People's Banks. For example, the Banques Populaires or Caisses Populaires in some francophone African countries had their origin in credit unions. Credit unions have also helped to link small savers with co-operative and commercial banks in order to earn interest on unions' deposits. They also use unions savings as collateral to obtain loans for on-lending to members (Akinwumi, 1990).

3.2 Some empirical studies

Deposits mobilised by *esusu* groups in Nigeria have been studied extensively by anthropologists and agricultural economists. For example, Okorie and Miller (1976) studied 25 of these clubs in Ohaozara sub-division of the then East-Central State of Nigeria, while Nwoko and Ajayi (1990) studied the savings potential of *esusu* clubs in the Old Oyo State. The latter study estimated the number of *esusu* societies in the state to be 19,890 in 1979 with an average of 865 societies per local government area; the corresponding figures for 1989 were 19,979 and 868 societies. It also estimated the membership strengths of these societies as 895,050 in 1979 and 1.069 million in 1989, representing 34.41% and 32.19% of the rural population of the state respectively. Savings generated by *esusu* societies can be substantial. Thus in 1985, total savings generated stood at ₦8.17 million per month, an average of ₦3,697 per community per month. The estimated savings mobilised in 1989 in the state amounted to ₦69 million per month. With this large volume of savings, the establishment of a rural banking extension programme by the commercial bank was recommended as a means of linking rural savings generated by the informal sector with the formal sector.

Udry (1990) and Olomola (1992) applied recent developments in the theoretical literature on rural credit markets in order to analyse informal finance in the rural areas of Nigeria. Using the theory of economic behaviour under conditions of incomplete markets and imperfect information, this literature emphasises that,

Figure 1 Organisation and operation of *Esusu* or *Ajo* in Nigeria.



because moral hazard and adverse selection are prevalent in credit transactions, credit markets are likely to incorporate organisational features that serve to mitigate or accommodate the problems caused by these information asymmetries. Udry (1990) reported the findings of a detailed survey of 198 households conducted between 1988 and 1989 in four randomly selected villages near Zaria, Kaduna State in north-central Nigeria. The study established that nearly all loans are transacted within the village or kinship group. The transactions appear to be extremely informal; they generally occur in private with no witnesses or written record. Although the borrower and lender negotiate the size of loan, most transactions are carried out without setting an explicit (nominal) interest rate or repayment date. The simplest and most direct penalty for a default is the exclusion of the defaulter from future opportunities to borrow from the lender. Alternative mechanisms for enforcing credit obligations are available by means of appeal to the community authorities. There is direct evidence that information flows freely between lenders and borrowers, as 92% of all loan transactions are contracted within the same village. Moreover, there is no indirect evidence of information asymmetries. The use of collateral is relatively unimportant; only 3% of loans reported using collateral, usually land. The study also showed no evidence of interlinkage of the credit market with land, labour or product markets. Credit contracts were also shown to play a vital role in risk pooling in the area surveyed; the repayment owed by the borrower being dependent on the absorption of production and consumption shocks by both borrower and lender.

Olomola (1992) dealt with the nature, role and effectiveness of interlinked credit transactions in the Nigerian rural informal sector. The study used primary data obtained from a sample of 159 small-scale farmer borrowers randomly selected from five villages in Kebbi State, in north-western Nigeria. Interviews were also held with different types of lenders in the area in order to obtain an informed view of the mechanisms involved in credit interlinkages.

The study identified three types of credit interlinkages in the study area: labour-credit, marketing-credit and draught-animal-power-credit interlinkages. Factors causing borrowers to become involved in interlinked credit transactions include inadequate working capital, inadequate income to meet consumption expenses and previous debt obligations. Thus, 73% of the average loan obtained was used for the acquisition of farm inputs, 16% for household consumption and 11% for the settlement of old debts.

In labour-credit interlinked transactions, the borrower who obtains the credit makes repayment in kind using family labour. This contract is generally only between borrowers and moneylenders. The borrower benefits by obtaining the credit required, while the lender usually charges about 25% less than the average wage rate in pricing the labour supplied by the borrower.

Marketing-credit interlinkage involves borrowers who are securing working capital to improve on their turnover and income, the products are then sold to the lender. Animal-power-credit interlinkage, on the other hand, involves the provision of the services of draught animals as credit in kind to the farmers. The repayment, also in kind, can be in one of two forms: family labour or sale of products to the lender.

4. The structure of informal financial institutions

4.1 Personal characteristics of informal lenders

Our analysis of the data indicates that *only* four of the identified informal financial units are present in the rural areas: these are moneylenders, Savings and Credit Associations, Savings and Credit Co-operatives and *Esusu* Collectors. The other two, Savings and Loans Companies and Credit Unions, are located only in urban areas. This is not surprising, since they are semi-formal institutions which operate under some legislation and require more management expertise than is usually present in rural areas. Only one type of semi-formal financial institution, the Savings and Credit Co-operatives, thus has a significant showing in rural Nigeria.

According to our sample, informal finance operators are generally above 40 years of age. The rural *esusu* collector is on average the youngest in the group of informal finance operators with an average age of 40. In contrast, the urban moneylender is on average 43 years of age. However, while other rural informal lenders are generally in their middle forties, their urban counterparts tend to be older, their ages varying between 47 for Savings and Loan Company (SLC) managers/owners and 54 for Credit Union (CU) leaders, on average.

While the business of informal finance in Nigeria may not attract highly trained personnel, some fairly literate people do take it up. Thus moneylenders, savings and loans company (SLC) owners/managers, savings and credit cooperatives (SCC) as well as Savings and Credit Associations (SCA) attract fairly educated men and women. Indeed, on average about 60% of operators in these groups have above secondary education. In general, urban informal financial operators tend to be more educated than rural informal lenders. On average, the time rural informal lenders spent in school varies between 6 years for *esusu* collectors, 9 years for SCA leaders, 9.5 years for SCC leaders and 9.8 years for moneylenders. Urban *esusu* collectors spent on average about 7.2 years in school, while urban moneylenders spent an average of 10.5 years. However, the urban SLC owner/manager spent on average about the same time in school as the *esusu* collector, while urban SCA and SCC leaders spent on average 16.8 and 14 years respectively. The longer exposure of SCA and SCC leaders to education and the shorter exposure of *esusu* collectors should not be surprising given their respective clienteles and complexity of their modes of operations. SCA and SCC leaders tend to have a more educated clientele, and they are required to keep more detailed accounting information than *esusu* collectors. Moreover, some of the SCA and SCC leaders have served, or are still serving in the public service.

Informal financial business is generally carried out on a part-time basis in Nigeria. In urban areas, *esusu* collectors devote 60% of their time to informal finance, more than any other group. Next is the moneylender who devotes as much as 40% of his time to it. It is not surprising that moneylenders have other interests, because of the high risk involved in the business. Urban CU leaders devote only 5% of their time to the business of informal finance. It is interesting that rural informal finance operators devote less of their time to the business as compared with those in urban centres, particularly because of the importance of informal finance in supplying rural credit. The rural SCC leaders in our sample spent 40% of their time in the business. On the other hand, rural moneylenders devote 34% of their time to the business, while SCA leaders devote only 27% to informal finance activities. Rural informal finance operators can only do business part-time given that they are also often involved in other rural activities as farmers, artisans, traders and the like.

4.2 Deposit characteristics

Moneylenders do not in general mobilise deposits, but other informal finance operators do. On average, *esusu* collectors cover more small depositors than any other informal sector operator in urban centres; in contrast, the savings and credit co-operatives lead in the coverage of small depositors in rural areas. Between 1990 and 1992 the average number of deposits mobilised by *esusu* collectors in urban centres varied between 293 and 455. Correspondingly in rural areas, the average number of deposits mobilised by the savings and credit co-operatives was 306 in 1990, but this was overtaken in 1992 by *esusu* collectors who mobilised, on average 367 deposits (Table 1). The fact that a semi-formal financial institution, the Savings and Credit Co-operatives, has a significant showing in the coverage of small depositors in the rural areas, suggests that the formal financial institutions can improve on their performance by incorporating some of the practices of informal financial institutions into their operational guidelines.

In this regard, the observed dismal failures of formal interventions in rural credit (Udry, 1990; Hoff and Stiglitz, 1990; Olomola, 1992) can be counteracted from two perspectives. First, there can be improved mobilisation of deposits from these areas. Second, as will be seen later, the experiences of the informal sector in mitigating the problems of moral hazard and adverse selection can help reduce the problem of default which is rampant in formal interventions in the rural credit market.

The jump in the average amount of deposits mobilised by *esusu* collectors in 1992 to more than four times its value in 1991 suggests that this unit of the informal sector is still growing fast in the rural areas, as seen in Table 2. This indicates that in spite of the liberalisation of the formal financial sector, the informal sector still thrives.

Table 1 **Average number of deposits mobilised**

Institutions	*1990*			*1991*			*1992*		
	Sample	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*
Savings & Loans Companies	15	15	n/a	19	19	n/a	23	23	n/a
Savings & Credit Associations	52	56	48	66	74	59	86	101	72
Savings & Credit Cooperatives	180	85	306	160	89	268	176	102	288
Credit Unions	38	38	n/a	28	28	n/a	32	32	n/a
Esusu collectors	250	293	30	374	423	83	438	455	367

The average deposit amount mobilised by some informal financial institutions can be relatively substantial. The Savings and Loans Companies, in spite of the small number of deposits, sometimes mobilise higher amounts compared with other informal units, although, with liberalisation, the average deposit mobilised by the SLCs was reduced by nearly three-fold in 1990–91. The reduction in deposit amount mobilised per capita is even greater. This tends to support the hypothesis that liberalisation can encourage the movement of depositors from semi-formal institutions. For other informal financial institutions, the impact of liberalisation in reducing the deposit amount mobilised is not so pronounced, particularly in the rural areas. In the case of credit unions, the deposit amount mobilised remains more or less constant. This is because contributions to these organisations are fixed.

In the urban centres, there is no evidence of seasonal variation in the flow of deposits for most operators. However, the months of June/July/August are adjudged the peak periods of deposit mobilisation in rural areas. These months coincide with the harvest of farm products. For *esusu* collectors, December/January is usually the period of least deposits, both in rural and urban areas, as depositors often withdraw what they have accumulated for spending on the festive season of Christmas. This is equally true of withdrawals for Islamic festivals.

Thus it can be inferred that the deposit mobilisation of the informal sector, particularly in the rural areas, is highly volatile. Natural seasonal changes also show that in periods of poor harvest very low deposits will be mobilised and hence there will be little to be lent by the operators to promote financial intermediation.

Table 2 **Average deposit amount mobilised (Naira)**

Institutions	*1990*			*1991*			*1992*		
	Sample	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*
Savings & Loans Companies	1,269,000	1,269,000	N/A	321,500	321,500	N/A	475,500	475,500	N/A
Savings & Credit Associations	111,680	105,030	117,000	136,657	105,720	162,437	287,871	351,339	224,403
Savings & Credit Cooperatives	138,113	176,447	87,000	199,746	278,941	120,550	272,331	373,568	41,100
Credit Unions	28,000	28,000	N/A	27,500	27,500	N/A	25,000	25,000	N/A
Esusu Collectors	148,700	199,615	51,200	144,212	162,959	41,100	224,662	167,922	333,200

4.3 Structure of lending operations

There were some variations in the sources from which lending capital was raised by the different groups of informal financial practitioners studied. Moneylenders raise lending capital mainly from personal savings (45%) and income from other activities (40%). Savings and Loans Companies raise their loan capital mainly from personal savings and inheritance. However, some informal groups depend on the deposits of clients as a major source of lending capital. Among these are savings associations (58.3%), savings co-operatives (40%), credit unions (100%) and *esusu* collectors (37.5%). In addition, 50% of *esusu* collectors indicated that they derive lending capital from personal savings.

Most institutions reported that their capital base had grown over time. This was in an attempt to meet the increasing demand for informal financial services. On average, the capital base of the moneylenders had grown by about 264% between 1990 and 1992, that of the savings and loans companies by 148%, and that of the *esusu* collector by 111%. Across urban and rural areas, average growth in capital base does not seem to show any significant difference. While it is 167.9% for the urban informal lender, it is 165.4% for the rural informal lender. This suggests that, in both rural and urban areas, demand for the services of the informal sector is growing at about the same rate and that the implementation of financial liberalisation *alone* cannot stultify the growth of the informal sector.

Most informal financial groups have improved on their initial capital base. For example, more groups indicated that they were currently deriving their lending capital from mobilised deposits, namely credit unions (100%), savings associations (76.9%), savings co-operative (55.6%), *esusu* collectors (56.3%) and savings and loan companies (50%). Moreover, some informal financial groups currently plough back profits from their operations into lending capital, namely moneylenders (55%), savings and loans companies (50%) and *esusu* collectors (31.3%). This suggests that over time informal institutions in Nigeria are improving their financial intermediation activities of channelling funds from surplus to deficit unit of the economy, in spite of the implementation of the policy of financial liberalisation of the formal financial sector.

However, there is no evidence that these institutions receive loans from each other or from the banks to improve their capital base. This tends to support the hypothesis of fragmentation within informal units and between them and formal units.

Requests for loans from users of informal finance fluctuate extensively during the year. In the urban areas loan applications are greatest in November and January when these are likely to be required for Christmas purchases and the replenishment of pre-Christmas levels of consumption, respectively. In the rural areas, loan applications are highest in January for the same reason as in the urban centres, as well as in February, March and June during the land clearing and planting seasons. The increase in loan applications in March and October in the urban areas may be due to requests from traders who want to stock up in preparation for Easter and Christmas purchases, respectively.

4.4 Characteristics of usual borrowers

Traders constitute the largest group of clients of informal finance both in the rural areas and the urban centres. Lending to small business is next in order of importance in urban centres, while lending to farmers comes second in the rural areas. Among moneylenders, public servants are the third most important clients (13.3%) while farmers are the third most important clients of *esusu* collectors (7.7%) in the urban centres. The pre-eminence of traders not surprising since they are the most important depositors with these institutions. In fact, about 85% of urban and 80% of rural *esusu* collectors have traders as their main clients. Small businesses are the clients of 20% of the moneylenders in urban areas, but no informal unit in the rural areas reported giving loans to small businesses. This shows the limited extent to which the informal sector can help in promoting development, particularly in the rural areas, and its possible limited impact in promoting financial integration.

Borrowers tend to live in the same locality as lenders in the informal sector. Thus, for some informal lenders, such as the urban savings and loans associations and credit unions, *all* their borrowers live in the same locality as the lender, while urban *esusu* collectors indicated that 84.6% of their usual clients live in the same locality. The picture painted by rural informal lenders is no different from that of their urban counterparts. This result agrees with those of Udry (1990) and Olomola (1992), where it was found that borrowers tended to live in the same locality as lenders, thus reducing the problem of adverse selection and moral hazard often associated with granting credit.

The informal financial sector witnessed steady growth in the number of loan applications and loans granted between 1990 and 1992 in both rural and urban areas and among all units of the sector (Tables 3 and 4). The steady growth in business was also witnessed along the gender dichotomy: increase in growth was observed in the numbers of both male and female applicants/loanees. However, in general in both urban and rural areas, there are usually more male applicants/loanees. For example, for the urban *esusu* collectors, while the average number of male loan applicants varied between 37 and 76 during the period 1991–92, the corresponding number of female applicants varied between 34 and 59.

Among esusu collectors in the rural areas, all those who applied for loans during the period under study obtained them. However, among urban *esusu* collectors, a higher proportion of men than women applying for loans obtained them. All those

Table 3 **Average number of loan applicants**

Institutions	*1990*			*1991*			*1992*		
	Sample	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*
Moneylenders	51	59	10	62	67	48	70	76	56
Savings & Loans Companies	36	36	N/A	56	56	N/A	69	69	N/A
Savings & Credit Associations	30	60	10	49	72	26	63	93	34
Savings & Credit Cooperatives	56	50	65	75	80	68	79	72	89
Credit Unions	21	21	N/A	21	21	N/A	22	22	N/A
Esusu collectors	41	50	12	42	48	19	130	123	157

Table 4 **Average number of loans granted**

Institutions	*1990*			*1991*			*1992*		
	Sample	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*
Moneylenders	27	31	8	43	42	46	62	67	50
Savings & Loans Companies	19	19	N/A	23	23	N/A	35	35	N/A
Savings & Credit Associations	18	29	9	35	49	20	48	73	24
Savings & Credit Cooperatives	49	47	53	67	77	53	66	60	76
Credit Unions	21	21	N/A	21	21	N/A	21	21	N/A
Esusu collectors	33	40	12	99	41	28	83	74	116

in our sample who applied for loans in Savings and Credit Associations, Savings and Credit Co-operatives, and Credit Unions in urban centres and rural areas were invariably successful. This is not surprising, given that members in these semi-formal institutions know each other and there are stiff sanctions against default. This contrasts with the case of credit from moneylenders where the approval rate is lower, perhaps because of the high-risk nature of the business and the fact that the loan approval rate by rural moneylenders tended to be higher than that of their urban counterparts, particularly in 1991 and 1992. This can be explained by the stronger kinship ties and the greater social sanctions exercised in the rural areas, which moneylenders employ to their advantage in case of default. These analyses show that the informal sector is still a force to be reckoned with in the provision of rural credit, in spite of the implementation of financial liberalisation policy.

4.5 Lending to small and micro-enterprises

Our sample shows that lending to small and micro enterprises is generally not particularly important, as most units in the sector indicated that they lend for non-working-capital purposes: in urban centres, apart from moneylenders, over 66.7% of all other informal sector units, and in the rural areas an even higher proportion of informal sector units, varying from 66.7% for *esusu* collectors, 75% for savings and credit cooperatives, 80% for moneylenders to 83.3% for savings and credit associations. The lukewarm attitude of informal lenders to small and micro enterprises is often attributed to the perceived non-profitable nature of these businesses; it is often felt that they are bedevilled with cash-flow problems and the risk of poor returns. However, in spite of the fact that most informal units do not lend to small and micro enterprises, they would be willing to do so. In general, over 60% of all units in the sector in both rural and urban centres indicated their willingness to do so.

5. Characteristics of informal sector credit

The characteristics of informal sector credit that will be considered in this study are loan sizes, maturity rates, interest rates and the capacity of lenders to lend.

5.1 Loan sizes and maturities

The average loan size varies by type of informal finance provider, location and the sources of lending capital. Accordingly, the discussion in this subsection will be related to the type of informal finance provider.

(i) *Moneylenders.* The average loan provided by moneylenders is the highest among all informal sector providers. In the urban areas the average loan amount varied between ₦223,820 in 1990 and ₦358,880 in 1992 (Table 5). The highest amount granted by urban moneylenders in our sample in 1992 was about ₦50,000, while the lowest amount was about ₦10,000. However, the average maturity period in the same year was 5 months.

In contrast, the average amount granted by the rural moneylender was about 12.5% of that granted by his urban counterpart. Thus the average amount varied between ₦29,000 in 1990 and ₦44,400 in 1992. The highest amount granted in 1992 by rural moneylenders in our sample was about ₦13,000, while the lowest amount was a little over ₦1,500. The average maturity in the rural areas was 3 months, 2 months less than the average maturity in urban centres.

(ii) *Savings and Loans Companies.* This unit of the informal financial sector usually operates only in urban centres and it is semi-formal in nature. The SLCs were very active in the early days of financial liberalisation but many of them collapsed after a time. This is epitomised in the uneven nature of their performance, with an average loan size of ₦187,000 in 1990, jumping by nearly 120% to ₦409,500 in 1991 and declining sharply to ₦61,500 in 1992. The average maturity in 1992 was 3 months, while the longest maturities were 6 months and 1 month respectively.

(iii) *Savings and Credit Associations.* The average loan size granted by this unit of the informal sector increased significantly in the urban centres during the period under study. Thus the average loan grew from ₦47,675 in 1990 to ₦137,417 (an increase of over 188%) in 1991 and ₦333,805 in 1992. In contrast, in the rural areas, the average loan grew from ₦26,980 in 1990 to ₦30,950 (an increase of 14.7%) in 1991 and ₦38,930 in 1992. This increase in loan amount sourced from SCAs between 1990 and 1992 is not surprising, given the fact that during this period the formal sector was experiencing high costs of funds as a result of the

Table 5 **Average amount lent (Naira)**

Institutions	*1990*			*1991*			*1992*		
	Sample	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*
Moneylenders	193,848	223,820	29,000	190,926	262,793	32,820	271,524	358,880	44,400
Savings & Loans Companies	187,000	187,000	N/A	409,500	409,500	N/A	61,500	61,500	N/A
Savings & Credit Associations	36,178	47,675	26,980	137,416	243,882	30,950	186,368	333,805	38,930
Savings & Credit Cooperatives	37,800	43,667	31,933	248,825	408,750	88,900	399,061	688,775	109,348
Credit Unions	19,000	19,000	N/A	22,500	22,500	N/A	30,000	30,000	N/A
Esusu collectors	29,970	33,587	15,500	29,841	32,861	16,250	48,382	54,911	19,000

impact of reforms in the financial system which caused that customers to have to look for other sources of credit (Soyibo, 1994). The average maturity period was 5 months in the urban centres. The longest maturity was 9 months and the shortest 2 months. Rural area maturities were almost the same, except that the longest maturity was 7 months.

(iv) *Savings and Credit Cooperatives.* Like the SCAs, the average loan sizes of the SCCs increased significantly during the period 1990–92 in both the rural areas and the urban centres. Thus, the average urban loan grew from ₦43,667 in 1990 by over nine-fold to ₦408,750 in 1991 and by over 16 times to ₦668,775 in 1992. The increase in the average loan procured by rural dwellers was no less spectacular. The improvement may be connected with the unintended effects of liberalisation, which resulted in the high costs of funds alluded to above. The average 1992 loan maturity in urban centres was 6 months, while in the rural areas it was 5 months. The shortest maturity in the urban centres was 1 month and the longest 8 months, while the corresponding rural area maturities were 3 and 13 months respectively.

(v) *Credit Unions are usually located in urban centres.* They are umbrella associations for co-operative organisations. Their management and organisation require greater skill and expertise than most other informal financial units, as evidenced by the higher level of education of their leaders. Accordingly, they are more structured and hence much closer to the formal financial institutions. This perhaps explains why the average amount of their loans was the smallest among the entire informal financial sector studied. They appear to be more conservative in assessing loan applications than other informal financial institutions. Thus the average loan granted by CUs is significantly smaller than that of other groups, even though there is a steady increase over the period – rising from ₦19,000 in 1990 to ₦22,500 in 1991 and ₦30,000 in 1992. However, the CU group has the longest average maturity in the subsector at 8 months. The shortest maturity was 4 months, while the longest was 8 months. This is not surprising because credit unions have strict operational rules to which members are required to adhere.

(vi) *Esusu Collectors.* The *esusu* collectors in this study comprise itinerant collectors who go from one market place to another or from home to home to mobilise daily deposits as well as those who are approached by depositors periodically in their homes. Among them are the groups often referred to in the literature as ROSCAs, consisting of *esusu* clubs and others referred to earlier.

In general, the average loan paid out by *esusu* collectors is a fraction of the deposit mobilised in both urban and rural areas. This is not surprising, given their *modus operandi,* and the fact that depositors usually ask for their deposit within a short time. The average amount of the loan provided in urban centres during the period 1990–92 was usually about twice or more the amount paid out in the rural areas. Again, there is a steady increase in the amount during this period. Thus the average urban loan increased from ₦33,587 in 1990 to ₦54,911 in 1992. In general, loans procured from the *esusu* collector have the shortest maturity of all the informal finance units. The average maturity is 3 months in both urban and rural areas, while the longest and shortest maturities are 6 months and 1 month respectively in urban centres, with 5 and 2 months as the corresponding figures for rural areas.

The foregoing analysis shows that credit provided by informal financial units is usually limited in size and of very short maturity. Thus, it can seldom be used to finance capital formation and other longer-term investments. However, when used for working capital and 'rolled over' on a continuous basis, such credit can have some impact on economic development.

5.2 Interest rates

Interest rates are usually calculated on a monthly basis by the informal sector. It is not unusual for moneylenders to charge as much as 20% per month, that is 60% for a loan maturity of 3 months. There is a wide disparity in interest rates charged, depending on the informal financial institution and its location. Interest rates are generally lower in the Credit Unions and Savings and Credit Co-operatives than in other institutions. Location has an effect on the interest charged by moneylenders and Savings and Credit Associations; rural interest rates were higher for SCAs, particularly in 1990 and 1992 (Table 6).

During the period under study, lending rates in the formal sector were very high with a minimum value of 35% per annum, and interbank rates were getting as high as above 100% per annum in 1992. Yet, on average, it can be seen that informal sector rates are much higher. Moreover, we can observe a great disparity among the segments of the sector. However, our data show that their business increased during the period under study, suggesting that the high cost of funds in the informal sector did not appear to depress demand.

This agrees with the finding of the World Bank (1995) that despite the higher borrowing rates in the informal sector, rural borrowers still depended largely on IFIs, mainly because of difficulties in accessing credit in the formal financial sector. Hoff and Stiglitz (1990) argue that interest rates serve dual functions in the granting of credit: a price function as well as an indirect screening and/or incentive function. The use of high interest rates may therefore reflect the high costs of a lender *directly* expending resources on screening applicants and enforcing loan conditions. The intervention of institutional credit may thus barely diminish the influence of the informal sector, unless the new institutions find substitutes for the direct mechanisms used by the informal sector to overcome the problem of screening, incentives and enforcement (ibid.). The present study found that some informal lenders charged differential interest rates between old and new customers; in the rural areas this averaged 2% and in the urban areas 12.5%. These reflect the greater influence of relative closeness and kinship in rural rather than urban areas

Table 6 Interest rates in informal financial sector

Institutions	*1990*			*1992*		
	Sample	*Urban*	*Rural*	*Sample*	*Urban*	*Rural*
Moneylenders	19.0	22.7	6.0	19.3	20.2	15.0
Savings & Loans Companies	8.0	8.0	N/A	10.0	10.0	N/A
Savings & Credit Associations	15.3	12.3	19.8	24.1	13.3	40.3
Savings & Credit Cooperatives	6.4	1.7	13.5	8.3	2.5	20.0
Credit Unions	2.0	2.0	N/A	2.0	2.0	N/A
Esusu collectors	12.4	12.6	12.0	15.8	16.4	13.0

in granting informal credit, a finding which is in agreement with those of Udry (1990) and Olomola (1992) in Northern Nigeria.

5.3 Collateral and the capacity to lend

The use of securities/guarantees, though widespread, varies among informal finance providers. In particular, the request for asset collaterals is more common among semi-formal operators, although credit unions seldom ask for it. Thus *all* the savings and loans companies in our sample always ask for (asset) collateral, while only 76.9% of savings and credit associations do so. The non-use of (asset) collateral by credit unions is probably taken care of by the structure of their organisation and the fact that members own shares in the organisations which can easily serve as implicit collateral in case of default. Among moneylenders over 60% always ask for collateral, while only 37.5% of *esusu* collectors always do.

The most common type of security requested is a personal guarantee, although among moneylenders and loans companies buildings may be asked for in urban centres. In rural areas, apart from a personal guarantee, guarantors are also used as security. This finding shows that personal trust is the hallmark of informal credit in Nigeria.

In general, informal financial operators do not perceive themselves as having sufficient capacity to meet the credit requirements of their clients. Thus only 27.8% of moneylenders in our sample indicated that they had the capacity to satisfy the perceived requirements of their clients. All the savings and loans companies in the sample believed that their capacities were inadequate. Thus informal financial providers are constrained by limited lending capital to reject applications that are perceived as good. This conclusion is independent of one type of institution and location. This finding agrees with our hypothesis that the informal financial sector is limited in the scope of its operations.

This suggests that there is an opportunity for financial integration by means of greater access of the informal sector in Nigeria to formal credit.

6. Risks assessment, repayment and links with formal institutions

The first 3 sections of the chapter analyse the information used by informal financial providers in screening loan applications, the importance attached to such information and the method of information-gathering as well as their associated costs. In this connection, and contrary to the popular view, it is interesting to learn that most informal lenders keep some type of record of their transactions. In rural areas *all* our respondents kept records of their loan transactions while 93.3 per cent of urban respondent informal finance providers keep loan transaction records. At least 90% of *all* individual types of informal finance lenders surveyed indicated that they kept records of their loan transactions.

There is a wide variation in the quality and reliability of records kept across types of informal lenders. The general ledger is more common with credit unions (100%), savings associations (58.3%), *esusu* collectors (53.3%), savings and loans companies (50%) and savings and credit cooperatives (44.4%). Among moneylenders, the types of records often kept are lists of debtors (44.4%), general ledgers (27.8%) and individual ledgers (22.2%). Keeping lists of debtors is also practised by SCAs (33.3%), SCCs (33.3%) and *esusu* collectors (26.7%), while individual ledgers are also kept by some SCAs (22.2%) and *esusu* collectors (13.3%). In order of popularity, the types of loan transaction records kept by informal financial operators are: general ledger, list of debtors and individual ledger. This order of popularity is maintained even when the data are disaggregated along the urban/rural dichotomy.

6.1 Screening practices and information used

Applications for loans from informal financial institutions are often made verbally, except in the case of moneylenders and (surprisingly) *esusu* collectors, where our sample indicated that for 60% of each group written requests were the norm. When viewed across rural and urban areas, the result is split almost 50/50. Thus, it can be said that both verbal and written loan requests are used in the Nigerian informal financial sector.

Personal knowledge of loan applicants constitutes a major method of screening them. Most informal finance groups have some knowledge of the applicants. Only in about 20% of our sample cases were clients unknown to lenders. This is in agreement with the findings of Udry (1990) and Olomola (1992). In the case of Credit Unions, *all* borrowers are known to the lender. However, only in very few cases do informal lenders have any business relationships with borrowers. For example, 25% of moneylenders and one-third of SCAs in our sample had business relationships with their borrowers. *Esusu* collectors and savings and credit co-operatives indicated that they never had any business relationships with their clients.

In screening applicants, over 70% of both rural and urban informal lenders obtain information about their clients from third parties who usually live or work in the same area as the applicant. Except for credit unions, which never seek third-party information, this generalisation is true for all types of informal financial operators. In the information sought from third parties, emphasis is placed more on personal character, attitude and income than on business information such as size and reputation, among others. Thus, individual character is ranked as the most important information sought by informal lenders from third parties. Other important 'personal' information sought concerns individual wealth, family wealth and attitude to debt. This result agrees with our earlier finding which indicated a personal guarantee as being the preferred type of collateral. A guarantor is expected to be sure of the character of the applicant and other personal attributes like his attitude to debt. In general, most informal lenders obtain the type of information they want before granting loans.

The major criterion seems to be that, as long as satisfactory information is obtained, then loans should be granted. 'Repeat' applicants can sometimes be successful in securing loans. However, they have varying degrees of success, and are in general, less successful than 'first time' applicants who averaged 85% success compared with 36% for 'repeat' applicants.

It is interesting to note that, in spite of the fact that informal financial providers do rather limited 'investment' lending, most of them rank direct returns on investment as the most important project evaluation criterion, except for savings and credit associations which rank family integrity highest and savings and credit co-operatives which rank personal wealth highest. Credit unions, which do not get involved in 'investment' lending, do not seem concerned with project evaluation criteria.

6.2 Screening Costs

To estimate screening, monitoring and contract enforcement costs, we focused on the average variable cost and the marginal cost of each additional unit of a loan. These consists of variable personnel costs, measured according to the time spent on screening loan applications, travelling to project sites, and the salaries and wages paid, as well as expenses on transport and stationery. The opportunity cost of the time of personnel engaged in screening was used as an input to the salaries and wages paid for screening.

Where problems of missing data occurred, we did not estimate the cost of screening as a percentage of total loans granted. In general, except for savings and loans companies, which are closest to the formal institutions, the estimated costs of screening as a percentage of total loans were generally below 4%. This agrees with the views of the World Bank (1995) that the transaction costs of informal financial institutions are generally low by virtue of the high degree of competition among the sector's agents, the perfect knowledge (on the part of its closely knit participants) within fragmented markets, and hence the *minimum search costs* associated with processing loan applications. For the rural moneylender transaction costs were 2.7% and 3.8% for the rural savings and credit associations in 1992; for credit unions and the urban *esusu* collector, they were less than 1%. The high cost of screening for the savings and loans companies should not surprise any observer, since the institution operates almost like a formal financial institution, using indirect screening methods which can be very costly. It is little wonder that there was a drastic reduction in the average loan amount granted by this class of informal lenders in 1992 (Table 7).

6.3 Loan monitoring process and associated costs

After granting loans, few informal lenders monitor how the loan is used. This is not surprising, given the rather short maturity of their loans. Moreover, lending is usually done within the locality, and the strong kinship relationship that helps ensure repayment may make monitoring unnecessary. In addition, very little if any, lending is done for productive purposes. Only 22.2% of savings and credit associations in our sample *always* monitored the way loans are utilised, while 11.1% sometimes did. Among savings and credit cooperatives 11.1% *always* monitored while 33.3% sometimes did. Credit unions *do not* monitor the use of loans at all.

Moneylenders virtually never monitor loan usage (over 93%), leaving about 7% who *sometimes* monitor. Only 33.3% of *esusu* collectors sometimes monitor use of loans, while the balance of 66.7% never do. It is interesting that only in the rural areas is loan monitoring actually carried out by 18.8% of informal lenders, usually on farmers by savings and credit associations and savings and credit co-operatives. Among SCAs, loan monitoring costs about 0.2% of the loan amount, while it is about 0.1% for SCCs. Transport costs constitute the greater share of the monitoring costs of SCAs and personnel time the major share of monitoring costs of SCCs.

6.4 Loan repayment trends and contract enforcement costs

The most common loan repayment schedule used by informal financial operators in Nigeria is monthly payment of principal plus interest over an agreed period. In fact, it was the only method adopted by the savings and loans companies in our

Table 7 **Estimated screening costs, 1992**

Institutions	*Sample*			*Urban*			*Rural*		
	Average Screening Cost (₦)	*Average Loan Amount (₦)*	*Cost as % of Loan Amount (₦)*	*Average Screening Cost (₦)*	*Average Loan Amount (₦)*	*Cost as % of Loan Amount (₦)*	*Average Screening Cost (₦)*	*Average Loan Amount (₦)*	*Cost as % of Loan Amount*
Moneylenders	1,192	271,524	*	358,880	-	-	1,192	44,400	2.7
Savings & Loans Companies	16,000	61,500	26.0	16,000	61,500	26.0	N/A	N/A	N/A
Savings & Credit Associations	5,486	186,368	3.0	9,475	333,805	2.9	1,496	38,930	3.8
Savings & Credit Cooperatives	2,685	399,061	*	688,775	. -	-	2,685	109,348	-
Credit Unions	150	30,000	0.5	30,000	150	0.5	N/A	N/A	N/A
Esusu collectors	317	48,382	*	317	54,911	0.6	-	19,000	-

* Not meaningful because of problems of missing data.

sample. Moneylenders, savings and credit co-operatives, credit unions and *esusu* collectors also adopt the schedule of bulk payment of principal plus interest at the end of the period, although this practice is more pronounced with moneylenders (33.3%) and credit unions (50%). Other schedules adopted are monthly payment of interest up to the end of the maturity when the principal is paid in a lump sum or daily repayments. While the former is more common with savings and credit associations as well as co-operatives, the latter is more common with *esusu* collectors.

Loan repayment default varies from one operator to another. Among moneylenders it comprised 14% of borrowers and concerned 7.5% of the principal in 1991. The corresponding ratios for other groups of informal lenders are 17.1% of borrowers and 2.2% of principal for savings and credit associations and 20.5% of borrowers and 2.7% of principal among *esusu* collectors. In urban centres, the default rate in 1991 is estimated as 20% of borrowers and 5% of principal, while in rural areas it is 13.2% of borrowers and 11.3% of principal. While the difference in default rate on principal between urban centres and rural areas appears significant, the average payment lag between rural and urban areas is the same (3.3 months). In general, the average lag in repayment for delinquent loans is about 3 months, except in the case of credit unions where the lag is 4 months.

Lenders are divided as to the factors that are responsible for delinquency in loan repayments by borrowers. While some attribute it to poor returns on the loan, others attribute it to other 'more pressing' demands, while a few attributed it to a general lack of interest in repaying on the part of the borrower.

The most common method adopted by informal financial operators to forestall default is making personal threats, although co-operative unions often use control of output. This suggests that interlinked credit transactions are practised in the informal financial sector in Nigeria. This result agrees with the finding of Olomola (1992) but contrasts with that of Udry (1990). Confiscation of collateral is the next most common method adopted by moneylenders and savings and loans companies, while threats of legal action are often made, if personal threats fail, by savings and credit associations and *esusu* collectors. In urban centres, when personal threats fail, lenders then apply collateral confiscation, while rural lenders fall back on threats of ejection. Informal financial operators tend to use 'personal' but unorthodox methods to forestall repayment default. Such more formal and 'impersonal' approaches as legal suits, police action, etc. are seldom employed. This is not surprising given the deep sense of communality that pervades informal financial business. The slowness and the corruption and graft of legal proceedings may make their choice unpopular. Moreover, there are the misgivings and prejudices of people about seeking legal action, particularly in rural areas. The general belief is that 'no two parties would be friends in the aftermath of a court action'.

Loan enforcement costs are almost non-existent among informal lenders, particularly because of the relatively low default rate. However, amongst moneylenders, our estimate was 2.9% of the loan amount in 1992.

6.5. Institutional linkages with banks and other formal financial institutions

The most prominent relationship between the informal and the formal financial sectors is the fact that most of the informal operators have bank accounts; only 17.9% do not. The most important reason for having a bank account is to ensure the security of their deposits. This is particularly true of *esusu* collectors, although the credit unions studied regarded earning interest as the most important reason for opening bank accounts. Of those with bank accounts, savings deposits was the commonest type of account opened (51.1% of our sample), while 28.9% opened demand deposit accounts. A combination of demand and savings deposit was opened by 13.3%.

On average, informal financial operators make deposits in banks between 5 and 12 times a month and withdraw funds between 5 and 1 times a month. *Esusu* collectors make 11 deposits (or about three times a week) and 2 withdrawals, on average, per month. Informal financial operators in urban centres interact more with banks than those in rural areas. Only 15.6% of our entire sample – mainly moneylenders, savings and loan companies and savings and credit co-operatives – dealt with borrowers through banks. Only 35.9% of the sample were known to their banks as informal lenders.

About 20% of the entire sample had applied – on average 2 to 5 times – for bank loans, with success rates varying between 100% for *esusu* collectors and 40% for savings and credit co-operatives. However, it is not known whether what they called 'loans' included overdraft facilities.

Bank loans are used for boosting lending only by moneylenders and *esusu* collectors. Other groups (including some moneylenders and *esusu* collectors, as well) use such loans for other economic activities. Thus, it can be said that some informal lenders are doing on-lending business with bank funds. While about 56.6% of informal lenders are aware of going bank lending rates, only 20% of them allow this to influence their lending rates. It is interesting that more rural lenders (42.9%) indicated that they allowed knowledge of bank rates to influence their lending than urban lenders (12.2%). Only 46.4% of – particularly among savings and credit associations (66.7%), *esusu* collectors (53.8%) and savings and loans companies (50%) – lenders said that they would be interested in lending bank credit to their clients. In fact, the desire for on-lending of bank credit is stronger in rural areas (60%) than urban centres (41.5%).

The analysis suggests a rather weak linkage between the informal financial sector and banks because of the small proportion of informal sector activities going *directly* going through banks. Moreover, the volume of business involved is also low. Thus, the linkage between the informal and formal financial sectors of Nigeria tends to be narrow and shallow.

Concluding remarks

This paper has shown that, in spite of financial liberalisation, the volume of business in the informal financial sector has been on the increase in Nigeria. Contrary to the hypothesis of interest-rate convergence between the formal and informal sectors as a result of liberalisation there is evidence that some informal operators even use formal sector interest rates as a reference point for charging higher rates. It would appear that the existence of the informal financial market depends on other factors besides policies of financial repression in the formal sector. Theoretical advances on the workings of informal credit over the past decade have anchored the continued existence of the informal sector on the problems of imperfect information and costly enforcement of contracts. This paradigm distinguished two types of mechanism, direct and indirect, for combating the problems. Indirect mechanisms rely on the design of contracts by lenders such that, when borrowers respond to these contracts in their own best interest, the lender obtains information about their riskiness and borrowers are induced to take action to reduce the likelihood of a default and to repay the loan whenever they have resources to do so. Direct mechanisms rely on lenders expending resources to screen applicants and enforce contracts (Hoff and Stiglitz, 1990).

Informal lenders have a complex web of networks of direct mechanisms of screening loan applicants and enforcing loan contracts, through their deep personal knowledge of clients and their kinship relationships with them. This study has shown that this is true of Nigerian informal financial operators who rely mainly on personal guarantees as security and obtain information about borrowers, usually from third parties living in the locality.

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